STRATEGY WEEKLY

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Fed addresses tensions in repo markets

Key Points

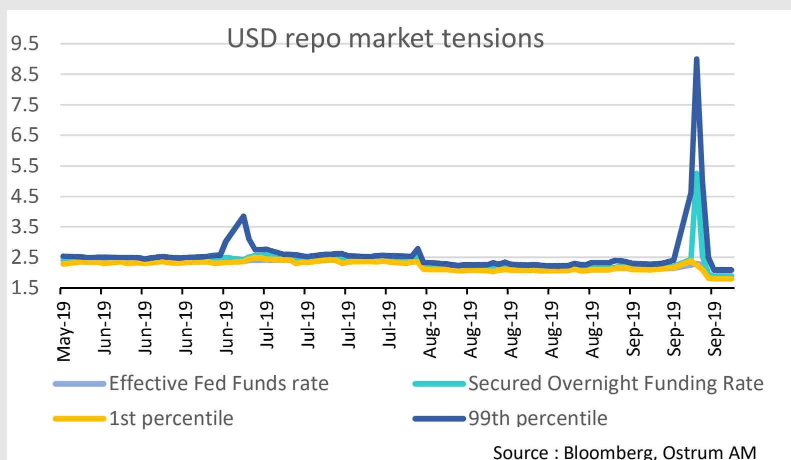
- **Fed: 25bp rate cut, IoER decreases by 30bp**
- **Tensions in repo markets: Fed intervenes**
- **Bond yields fall: Bunds trade near -0.60%**
- **Inflows slow in euro IG credit, profit taking on risky assets**

The FOMC meeting was overshadowed by unexpected tensions in repo markets. The Fed intervened in markets by injecting overnight liquidity. Equities pared back advances late last week. The S&P500 index dropped back under the 3000 threshold. Conflicting signals regarding the situation with China and US sanctions on Iran have sparked some buybacks. European markets in turn were broadly stable. Banks, automobile and resources underperformed erasing post-ECB gains whilst health care and utilities fared better than the overall market.

T-note yields declined to less than 1.7% and the yield curve flattened out. The rapid decline in oil prices weighed on inflation breakevens. Ten-year Bunds decreased to just over -0.6% after the release of PMI surveys pointing to a sharp contraction in manufacturing in Germany. Meanwhile, Italian spreads widened by about 10bp.

Credit markets traded more heavily due to the recent pickup in primary market activity. Weakness in TLTRO demand may signal increased bank bond supply ahead.

Chart of the week



Repo rates (SOFR: secured overnight funding rate) have spiked unexpectedly early on last week.

Excess demand for overnight funding has caused unusual volatility in repo market rates on September 17th. At the intraday high, repo rate reached 9% (99th percentile) versus a session low about 2.25%. The Fed stepped in offering $75b worth of overnight funding.

Repo tensions have impacted unsecured Fed Funds transactions as the effective rate traded through the upper limit of the Fed's target range.

Tensions in USD repo markets

The 25bp Fed Funds rate cut was fully priced by markets even if easing was not consensus within the FOMC. Committee economic forecasts signal no notable change in growth, inflation or unemployment over the years to come. 'Market guidance' was clearly a factor in the Fed's decision to lower rates. In turn IoER declined by 30bp to 1.80%.

Repo markets seized up last week on the eve of the FOMC's decision. Overnight funding rates peaked at 10% on an intraday basis in this crucial market providing liquidity to the economy. The rate spike is a symptom of the changes in the functioning of money market since the crisis. Central Banks play a central role and are no longer just lenders of last resort. Furthermore, unsecured money markets have shrunk in the past few years because of QE and tighter bank regulation. Interbank unsecured lending cannot be a substitute for repo lending any more.

Liquidity demand rose sharply early on last week. Corporate tax disbursements due mid-September induced money market fund outflows, so that funds did not roll repo holdings. Coupons paid out by the Treasury were significant around September 15th inducing liquidity needs for the US Treasury. Moreover, the bond correction after the ECB likely reflected sales from real money investors. Market-makers hence bought bonds to be financed in repo markets. All of the above contributed to increased funding demand and higher overnight repo rates. The Fed intervened to lend as much as $75b. The transaction has been rolled every day since last Wednesday.

Fed: no more QE but a new repo facility

The Fed will likely expand its toolkit by introducing a standing overnight repo facility, indeed a symmetrical scheme of the current reverse-repo facility which is used by the Fed to keep rates from falling below the lower end of the Fed Funds target rate. Outstanding reverse-repo transactions currently hover about $300b. The size of the operations is limited only by Fed holdings of securities. This is standard monetary policy even though the sizes of liquidity-providing and liquidity-withdrawing operations occurring on the same day are extremely large. Before the financial crisis, the Fed would intervene at the margin when interbank lending activity did not allocate bank reserves efficiently. Hence the Fed will likely intervene both ways on a daily basis in considerable sizes. Furthermore, the Fed may decide to cut interest on excess reserves well below the lower end of the Fed Funds and enlarge the target band to encourage interbank lending whilst committing to intervene at the target range boundaries. A new operational framework will likely be debated at the October meeting.

Yields decline, profit-taking in equity markets

In financial markets, the Fed's intervention sparked flows into bonds especially as tensions with Iran emerged. The attach on Saudi Aramco production facilities will nevertheless not lead to a prolonged loss of output so that oil prices finally came down again. T-note yields sled below 1.7% fully erasing the steepening move in the wake of the ECB's decision.

In the euro area, the drop in Bund yields (-0,58%) was reinforced by disappointing PMI in Germany in September (41.4 in manufacturing). Budget surplus will be put to work to support activity in Germany. Angela Markel indeed announced green public investments worth €54b over the next four years (0.4pp of GDP). Similarly, The Netherlands laid out a plan to spend 0.7pp of GDP next year. Core yields did not react to the news possibly because bond valuations were 'attractive' relative to swap rates at the time. The ECB, which has long called for fiscal expansion, is nevertheless unlikely to change current plans for monetary easing.

In sovereign market space, Italy spreads increased by about 10bp last week. Long positioning in BTP markets likely hit its limit. Political risk has receded, and we expect spread narrowing to resume with some help from the ECB. Bonos were well bid after S&P's rating upgrade to A. The 10-year spread stands at 73bp against German Bunds. In addition, low demand at the first TLTRO-III operation (€3b) came as a surprise to most market participants. Banks seem to prefer issuing senior bonds, which enjoy preferential regulatory treatment, do not require collateral and are longer maturities.

Hence, credit markets have traded heavy of late. Spreads widened to the tune of 3bp last week to 111bp against Bunds. Increasing spreads reflect significant slowing in investment grade credit fund inflows in the past few weeks. As concerns high yield markets, spreads rose 8bp to 348bp, which likely correlates with profit-taking in other risky asset markets.

Equity market have retreated early on this week. Large volumes on Friday in a down trading session may hint at further weakness ahead. Utilities outperformed in US equity markets whilst banks and automobiles fell back in European markets. Current index price dynamics reflect swift rotations of sectoral allocations and a lack of underlying support from corporate earnings growth.

Main Market Indicators

G4 Government Bonds	23-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.74 %	-2	+15	-13
EUR Bunds 10y	-0.58%	-10	+9	-82
EUR Bunds 2s10s	16 bp	-9	-6	-69
USD Treasuries 2y	1.65 %	-11	+12	-84
USD Treasuries 10y	1.68 %	-16	+15	-100
USD Treasuries 2s10s	4 bp	-5	+3	-16
GBP Gilt 10y	0.55 %	-14	+7	-73
JPY JGB 10y	-0.21 %	-5	+2	-21
€ Sovereign Spreads (10y)	**23-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	29 bp	+1	-1	-17
Italy	141 bp	+9	-58	-109
Spain	73 bp	-1	-8	-44
Inflation Break-evens (10y)	**23-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	74 bp	-6	-2	-
USD TIPS	160 bp	-8	+6	-11
GBP Gilt Index-Linked	340 bp	-1	+4	+23
EUR Credit Indices	**23-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	111 bp	+3	+2	-41
EUR Agencies OAS	47 bp	-1	-3	-13
EUR Securitized - Covered OAS	42 bp	-1	-3	-21
EUR Pan-European High Yield OAS	348 bp	+8	-57	-165
EUR/USD CDS Indices 5y	**23-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	55 bp	+9	+3	-33
iTraxx Crossover	222 bp	-22	-50	-132
CDX IG	59 bp	+8	+2	-28
CDX High Yield	324 bp	+8	-33	-126
Emerging Markets	**23-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	333 bp	+7	-37	-82
Currencies	**23-Sep-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.099	-0.15	-1.41	-4.06
GBP/USD	$1.243	-0.01	+1.3	-2.52
USD/JPY	¥107.51	+0.43	-1.97	+2
Commodity Futures	**23-Sep-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$64.2	-$4.8	$5.4	$9.2
Gold	$1 521.7	$18.5	-$5.2	$240.1
Equity Market Indices	**23-Sep-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 994	-0.14	5.15	19.42
EuroStoxx 50	3 537	0.53	6.08	17.84
CAC 40	5 631	0.51	5.70	19.03
Nikkei 225	22 079	1.47	6.61	10.31
Shanghai Composite	2 977	-1.77	2.75	19.37
VIX - Implied Volatility Index	15.11	3.00	-23.96	-40.56

Source: Bloomberg, Ostrum Asset Management

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