Rocketing Repos – Why Your LGIP And Money Market Rates Soared

Many of you have probably noticed a dramatic increase in the daily yields on your money market funds (MMF) and local government investment pools (LGIP). These increases are expected to be temporary and are the result of an unusual confluence of events. We generally try to avoid getting overly technical in our commentaries, so we’ll try to keep this simple.

Money market funds and local government investment pools invest a large portion of their assets in repurchase agreements, affectionately known as “repos” in market parlance. The MMFs and LGIPs buy securities from banks and broker/dealers who agree to repurchase those same securities a day, or a few days, later. Repos are an important short term investment and liquidity management tool for those with cash, and an important tool used by banks to manage their reserve requirements and by broker-dealers to finance their inventory of securities. Think of repos as the grease in the gears of the fixed income market.

Starting on Monday, repo rates rocketed higher due to a number of factors. Corporate tax payments were due, causing corporations to reduce cash balances held in banks and money markets. Settlement of a significant amount of new issuance from corporations and the Treasury drained cash from investors and left broker-dealers with a large inventory of securities to finance. In short, a supply/demand imbalance forced those needing cash to pay substantially higher rates to borrow it. Repo rates reportedly climbed as high as 10% yesterday. MMFs and LGIPs with cash to invest are the beneficiaries of this demand for funds, and thus the dramatic increase in their daily rates.

The spike in repo rates in turn sent the effective fed funds rates above the 2.25% upper band of what had been the Fed’s target range before this afternoon’s rate cut. When this degree of imbalance occurs, the Fed comes to the rescue by injecting cash into the system through open market operations. The Fed enters into repos with broker-dealers, in effect lending the broker-dealers the cash they need to finance their inventories. The Fed performed these operations yesterday and again this morning, and they have announced they’ll do it again tomorrow. Today’s cut in the fed funds target rate is a separate matter, but the Fed also lowered the interest on excess reserves rate paid to banks by 30 basis points from 2.10% to 1.80%, now just 5 basis points above the bottom of the new fed funds target range. That should encourage banks to place less cash with the Fed and put more into repo. These actions should begin to correct the imbalance and bring the fed funds and repo rates back into the target range, which is now 1.75-2.00%.

Please see disclosure on page 2.
The Fed will need to consider whether the recent trouble was just an anomaly or an indication of a larger problem. Pressure on repo rates around month- and quarter-ends has become common, but spikes this large in the middle of the month are unusual. It could indicate the level of reserves in the system has gotten too small and the Fed could respond in a number of ways. A reduction in the rate paid to banks on excess reserves (which they just announced), expanding the balance sheet in a program that will look a lot like quantitative easing, and a standing repo facility for broker-dealers are all options.

The Fed’s actions the last two days shows they are paying attention and reacting quickly. This spike in repo rates and the associated jump in MMF and LGIP rates should be short lived.