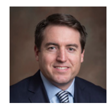
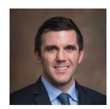
Is Repo Volatility Contributing to a Flight to Quality?

Unusual changes in overnight rates could have broader effects.

October 2019



Christopher Brown, CFA
Lead Portfolio Manager for Total Return Bond Strategy



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KEY INSIGHTS

- Technical factors are creating volatility in money markets, which we believe could be a contributor to the recent flight to quality in both bonds and stocks.
- We think that the Fed could eliminate much of the volatility by establishing a permanent repo facility to add reserves via the central bank's balance sheet.
- The Federal Reserve's action—or lack thereof—to permanently address this issue will inform our risk asset positioning in the Total Return Bond Strategy.

The well-publicized mid-September spikes in overnight lending rates illustrate how technical factors are creating volatility in some money market instruments, which we believe could be a key contributor to the recent flight to quality in both fixed income and equity markets. The Federal Reserve has not yet committed to taking measures to permanently address the unusual volatility in short-term lending markets. The central bank's action—or lack thereof—on this issue will inform our risk asset positioning in the Total Return Bond Strategy going into the end of the year.

Bonds, Stocks Seem to Send Conflicting Signals

In late August, portfolio managers from T. Rowe Price's Fixed Income, Equity, and Multi-Asset Divisions met to discuss the seemingly conflicting signals sent by stocks and bonds. In a sign of a positive economic outlook, equities had broadly climbed for the year to date. However, Treasury yields were simultaneously plummeting and sections of the yield curve were inverting, signs that bond investors feared a near-term recession.

Looking a little closer, however, we noticed a flight to quality in both markets. This year's stock market rally has featured low-beta,[1] defensive stocks easily outperforming cyclicals. In the fixed income markets, Treasuries and investment-grade corporates have outpaced high yield bonds. More recently, within the investment-grade corporate sector, the spread between credit quality yields has widened as AA rated debt has outperformed BBBs. In high yield, BB rated securities have outperformed CCCs by a wide margin.

[1] Beta measures the volatility, or risk, of a stock relative to the risk of the broad market.

USD 1 Trillion

2019 budget deficit through August.

Attractive Overnight Lending Rates May Drive Flight to Quality

There have also been unusual developments in the typically quiet money markets. A confluence of technical factors had been driving volatility in low-risk overnight lending rates meaningfully higher even before the spikes in September. We believe the unsettling nature of this volatility to market participants, as well as the relative attractiveness of these safe short-term investments, was likely drawing demand away from the riskier segments of global financial markets, contributing to the flight to quality that we have been observing.

Banks and some other financial institutions fund their longer-term investments in the overnight lending market, which is essentially the "plumbing" of the financial system. Much of this lending is through repurchase agreements (repos), which are short-term loans collateralized by U.S. government securities. Institutions needing cash can sell these high-quality assets to banks that have reserves to lend, agreeing to repurchase them the next day at a slightly higher price that provides a small return to the lender. When demand for funding exceeds reserves available for lending in the repo market, the rate can spike—which has the same effect on liquidity as a clogged pipe in a house.

Various Factors Clogging the Banking System's "Plumbing"

Several factors have coincided to drain reserves from the banking system. As the central bank shrinks its balance sheet, the Fed has stopped buying Treasuries to inject reserves. Also, as a result of regulatory capital requirements implemented after the global financial crisis, primary dealers[2] are now less willing or able to use their balance sheets to supply liquidity.

The expanding budget deficit, which fiscal stimulus has driven to over USD 1 trillion for 2019 through August, is another factor. The Treasury has had to increase its debt issuance to fund the deficit. Primary dealers have to buy any new Treasury supply not absorbed by bidders at auction, which removes more reserves from the banking system and increases demand for financing.

Repo Rates Spike in September

In mid-September, quarterly corporate tax payments were due to the Treasury, which temporarily removed even more liquidity from the system. This caused repo rates to spike as high as 10% and the federal funds rate to briefly exceed the top of the central bank's target range, prompting the Fed to temporarily add reserves by conducting repo operations. The elevated overnight rates may have exceeded the returns that institutions anticipated earning on their longer-term investments, dampening demand for riskier assets.

While overnight lending rates rose steeply in the midst of the global financial crisis, it is important to note that we do not view the recent repo spikes as an indicator of systemic problems. Unlike 2008 and 2009, the recent repo volatility is technically driven and not related to concerns about the solvency of the banking system.

Potential for More Market Volatility in Fourth Quarter

For regulatory reasons, banks typically become less active in using their balance sheets for repo as year-end approaches, setting up for even more volatility in the overnight lending market in the fourth quarter that could affect other markets. However, we think that the Fed could eliminate much of the repo volatility by establishing a permanent repo facility to add reserves via the central bank's balance sheet when needed to cap rates. In a step in that direction, Fed Chairman Jerome Powell referred to the volatility in overnight lending markets in his press conference following the September

[2] Banks that can buy and sell securities directly with the Federal Reserve.

> If the central bank continues along the path toward a permanent repo program, all else equal, we would be more inclined to add risk.

policy meeting, reassuring markets that the central bank is aware of the issue.

The Fed could also bring overnight rates down by aggressively cutting the fed funds rate, steepening the yield curve, although that method would not be as direct as implementing a permanent repo program. Also, to be successful, the central bank would need to commit to significantly more rate cuts than policymakers have signaled in recent communications. Considering the Fed's current assessment of the economy, we view this as unlikely.

If the Fed does not firmly commit to a more permanent solution to the recent repo volatility, we would position the Total Return Bond Strategy for more volatility in the fourth quarter. We would limit the portfolio's risk exposure as we would expect demand for riskier fixed income segments to be negatively impacted by ongoing "plumbing" issues.

However, after the repo rate volatility in mid-September, the Fed committed to conducting temporary overnight and term operations through mid-October. If the central bank continues along the path toward a permanent repo program, all else equal, we would be more inclined to add risk. Currently, we see value in bank loans and securitized credit and would likely favor these areas. Additionally, a calming of the recent "plumbing" issues, along with continued solid economic data, would be supportive of a steeper yield curve.

WHAT WE'RE WATCHING NEXT

Because bond markets can provide important signals and information about equities, and vice versa, we will continue to collaborate with T. Rowe Price's portfolio managers and investment analysts across the full range of asset classes. For example, we consulted with the firm's commodities and currencies analysts when evaluating the impact of the September 14 attacks on Saudi Arabia's oil production facilities and the ensuing volatility in oil prices.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material: Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default which may affect the value of an investment.

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