US Rates Strategy

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Ending QT: Repo pressure

We are a bit surprised with the recent pick-up in SRF usage and the level of tri-party repo rates given the level of reserves and market liquidity. That said, we think the conditions for an efficiently sized Federal Reserve balance sheet have been met and the FOMC can end QT at its December meeting.

- Bill and coupon settlements together with tax payment dates are now regularly pushing repo rates above IORB and triggering usage of the Fed's standing repo facility (SRF).

- SRF use has not been large – only a few billion dollars per day. But its regularity and the narrow spread between market rates and the program's minimum bid rate indicate borrowers are **more willing to borrow overnight liquidity from the Fed**.

- Dallas Fed President Logan has observed that an efficiently sized Fed balance sheet in one in which overnight rates are within a couple of basis points of IORB.[1] **The recent tightening in repo and fed funds rates suggests this size balance sheet has been achieved and that it may be time to end QT**. We think the Fed may end QT at its December meeting.

- That said, *none* of the Fed's standard measures of liquidity adequacy have tripped into danger-territory. **Banks reserves are just under $3trn and remain above 12.5% of bank assets**. The Fed's median RDE (reserve demand elasticity measure) is still close to zero (Figure 1). This suggests that a further reduction in reserve balances would barely move the fed funds-IORB spread. **Separately, there is nothing to suggest banks are facing liquidity strains because of private credit issues**. Discount window borrowing is very light and as far as we can tell there have not been deposit outflows.

- As a result, our sense is that regular SRF use and the tightening in repo rates may have more to do with the **sources of cash in the repo market than the level of bank reserves**.

- **Indeed, because the tightening has been more abrupt in tri-party repo rates than fed funds our sense is the pressure is coming from a change in money fund behavior**. Money fund balances have been relatively steady since October 1. We think retail balances could fall if the government shut-down and the absence of paychecks causes households to tap into their savings.

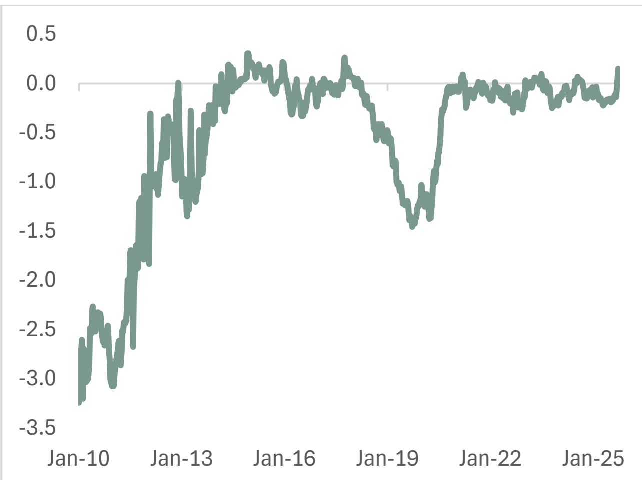
- But the continued heavy bill issuance this month may have now become harder for money markets

[1] See, "Effective and Efficient Central Bank Balance Sheets", L. Logan, Federal Reserve Bank of Dallas, February 25, 2025.

to absorb at tight spreads to OIS.[2] As bill-OIS spreads widen, money funds may be shifting their allocations from tri-party repo to bills (Figure 2). That said, the effect on their portfolio WAMs is yet too small to see in the daily data.

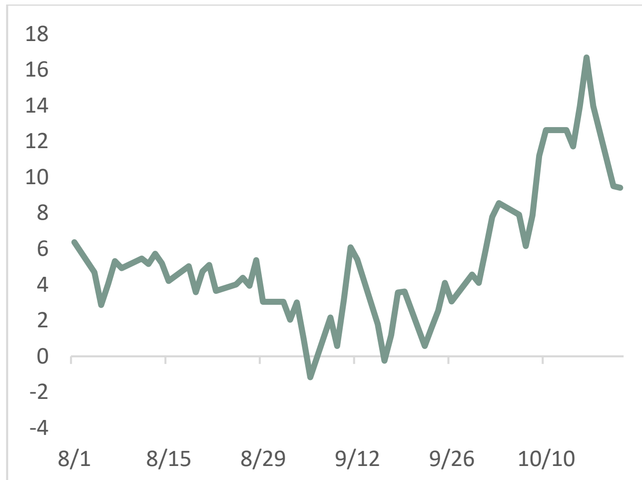
- **This shift in allocations may have increased money funds' relative bargaining power in the tri-party market. However, at the same time, the willingness of banks and dealers to use the SRF – even in small amounts and, particularly at narrow spreads to the program's minimum bid rate - suggest there is a limit to their relative negotiating power**. We think repo rates may stay elevated as borrowers and cash providers work out a new equilibrium.

Figure 1: Median RDE (bp)



Note: Measures the basis point spread change in FF-IORB for each 1% change in the ratio of bank reserves to assets. Source: Federal Reserve, SMBC Nikko

Figure 2: 3m bills less OIS (bp)



Source: Bloomberg, SMBC Nikko

- Data on the demand for funding is a bit ambiguous. There has not been a notable increase in sponsored repo activity which might occur if the demand for financing was rising faster than the capacity of dealers' balance sheets to expand.

- In theory, lowering the IORB rate could pull down repo rates if the reduction is large enough to encourage banks to lend in tri-party market rather than leaving their cash at IORB. **While it is possible the Fed might consider cutting IORB next week, we are somewhat skeptical**. First, while repo rates are heavy, they are not trading significantly above IORB. More importantly the increased willingness of dealers to use the SRF suggests the program is working as intended. There is no strong case for the Fed to interfere with the establishment of a new equilibrium in the bargaining power between cash lenders and borrowers. **If the SRF was not working, we think the Fed might be more willing to nudge IORB lower**.

- **While the reserve data suggest that balances remain ample, we think the recent pressure**

[2] We recently observed that money funds were eager to absorb nearly all the Treasury's summer issuance with little back-up in yields. Funds may have reached a saturation point sooner than anticipated.

in tri-party repo rates and memories of September 2019 may encourage the FOMC to end QT in December.

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