STATE STREET

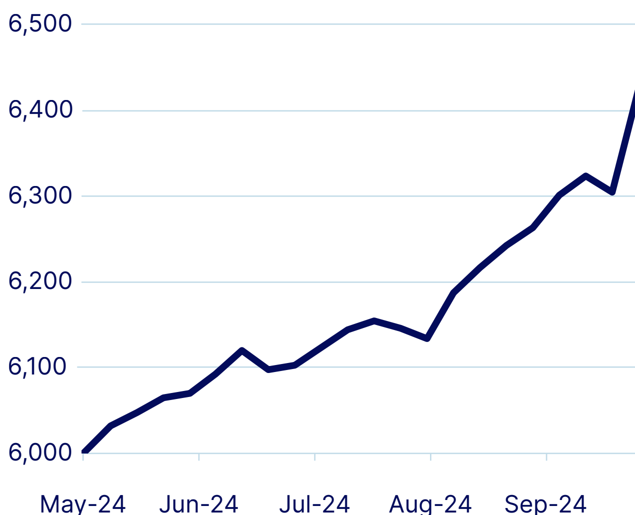
Centrally cleared repo market brief

Inflows continued to money market funds (MMFs) this quarter and the short-end remained in focus even as Fed rate cuts kicked off.

The Treasury yield curve was inverted throughout the quarter, ushering inflows to the front-end. Overall MMF volumes rose >$320B **(Figure 1)**, far more than the $60-70B upticks seen in Q1 and Q2. MMFs slightly transferred balances from repo to outright Treasury purchases (2% shift) but overall allocation to repo remains relatively high at $2.5T (just under 40% of overall holdings).

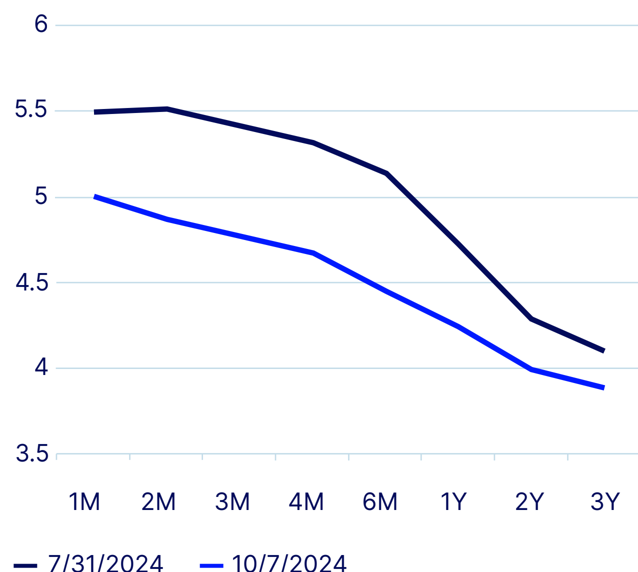
Since the Fed's strong 50 bps cut on 9/18, the yield curve remains inverted but has begun to flatten slightly via rising rates on the medium-to-long end **(Figure 2)**. The 1M minus 3Y spread has dropped from 139 bps on 7/31 to 111 bps as of 10/7. Even as flattening begins, the ultra short-end has remained largely unaffected and has actually experienced incremental flows: overall MMF volumes have increased $150B since 9/18.

Figure 1: MMF balances ($B)



Source: Bloomberg

Figure 2: Treasury yield curve (%)



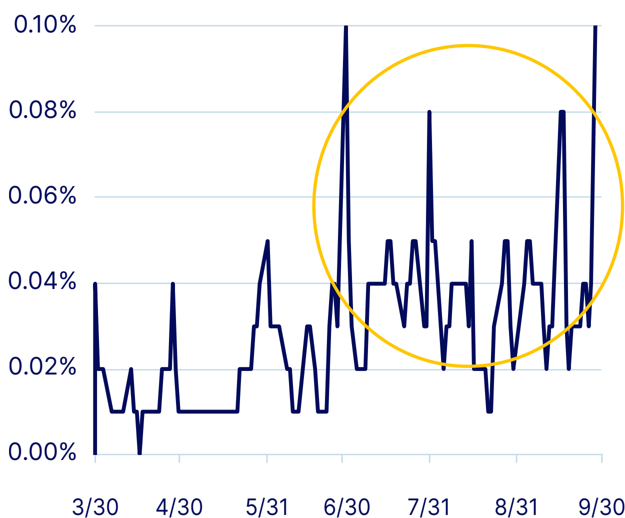
Source: US Treasury

Heavy repo cash was met with strong collateral supply, which elevated repo rates and kept FICC Sponsored Repo attractive relative to the Fed RRP. Hedge funds, in particular, boosted FICC participation significantly.

Treasury net new issuances were particularly strong this quarter (>$650B, the highest level seen yet this year). New collateral supply hitting the market bid up repo rates (SOFR) and a general lack of specials kept overall average rates elevated. The average SOFR-RRP spread was ~4 bps – significantly higher than 1.8 bps in Q2 – and jumped to 8-10 bps around month-ends when dealer balance sheets are particularly strained **(Figure 3)**. Higher SOFR rates pulled volumes into FICC Sponsored repo (average volumes up 31%) and out of the Fed RRP **(Figure 4)**.

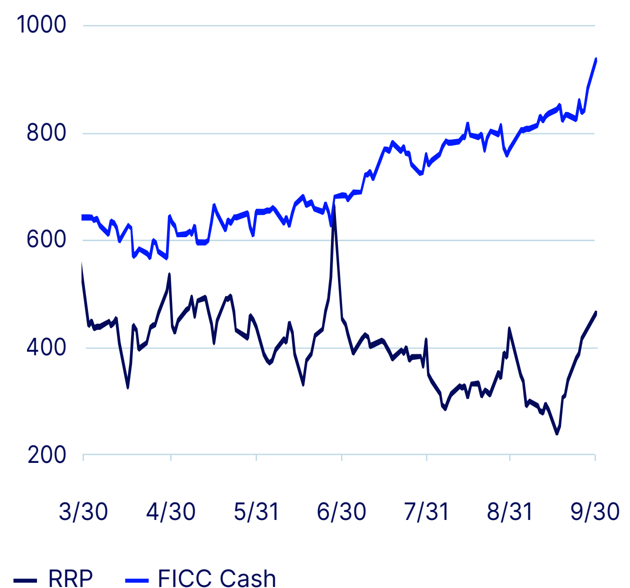
Gross FICC volumes hit an all-time high of $1.78T at September month-end. Heightened demand for repo is putting progressively more pressure on dealer repo sheets, particularly for smaller or uncleared providers. This growing strain has further pushed repo toward cleared, established providers. Hedge funds, in particular, have drummed up repo balances on market volatility and yield curve repricing – these volumes have increasingly found a home in the cleared space. FICC Sponsored cash borrower (primarily hedge fund) volumes were up 42% on average and peaked to $846B at September month-end. In the first week of October, gross FICC balances have remained strong in the $1.6T range even after the advent of the Fed's cutting cycle. Fed RRP balances now sit around $300B following gradual declines over the last two quarters (20% average drops in Q2 and Q3).

Figure 3: SOFR – RRP spread (%)



Source: Bloomberg

Figure 4: Fed RRP vs FICC ($B)



Source: DTCC, Federal Reserve

While FICC Sponsored repo is expected to remain favorable to the RRP from a rate standpoint, some funds value the RRP as a secure diversification outlet from a counterparty risk exposure perspective. This dynamic is expected to keep overall facility balances somewhat stable or gradually declining in the near term.

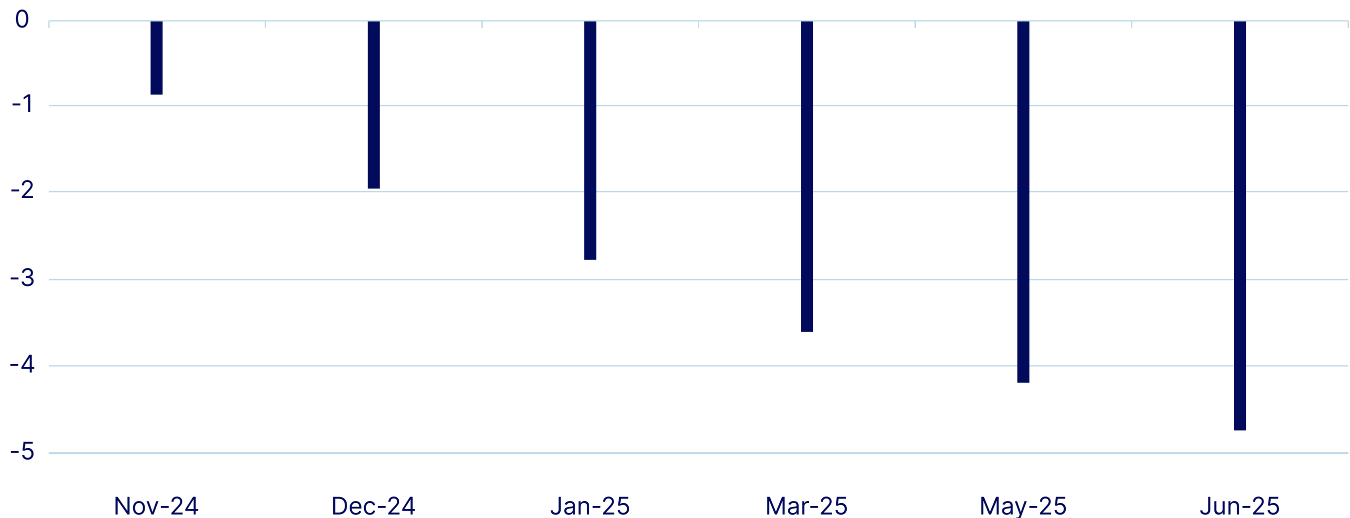
The Fed's easing cycle kicked off with an aggressive cut as inflation has begun to show signs of ebbing, but still has not reached target range.

Inflation cooled to start the quarter when June CPI (released in mid-July) came in just below expectations. While the Fed held rates steady at the July FOMC meeting, Powell opened the door for a September rate cut – subject to continued progress toward the 2% inflation target.

Subsequent economic data was dovish, culminating in an August CPI report showing a 2.5% annual increase – the lowest level since February of 2021. In response, the Fed enacted an aggressive 50 bps cut on 9/18 and officially ushered in an easing cycle. Since then, a strong jobs report has dampened near-term easing expectations, but the market still expects ~2 cuts by year-end and an additional 4-5 by the end of 2025 **(Figure 5)**.

As the market continues to assess the pace of future cuts, all eyes will rest on the September CPI print – scheduled for October 10 (not yet release at the time of this writing).

Figure 5: Number of cuts priced in market – 10/8/24



Source: Bloomberg

Looking ahead, the run-up to year-end is expected to bring heightened volatility to repo markets as dealers step away to shore-up balance sheet capacity. Given that cleared repo volumes are already at record-high levels, this typical seasonal strain is expected to be particularly strong this year. Repo market pressure should keep rates elevated – especially as collateral issuances and Fed QT continue while MMF balances either hold firm or begin to ebb with dropping rates. However, the pace of Fed balance sheet tightening will be a key factor in determining the extent of this pressure. Net new issuances in Q3 were decidedly strong and Fed QT continues to plug along – albeit at a dwindling pace ($25B/month). The Fed may alter the pace of tightening – especially if the tap of residual liquidity still sitting in the Fed RRP drains more quickly than expected.

Furthermore, subsequent rate cuts should begin to gradually take focus off the front-end – although yield curve flattening following the aggressive September cut has been fairly modest thus far. Amidst this backdrop, market participants are continuing to assess and prepare for the SEC's Treasury clearing mandate (fully effective for repo in June 2026). FICC Sponsored repo is expected to see significant inflows as a result of the mandate, far beyond the current record-highs (up to $4T according to recent projections). New access models will also change the ways in which participants access and incur value from repo. Both buy and sell-side firms alike will need to fully assess new optionality in order to best solution for a significant influx in activity.

FICC Sponsored repo is expected to see significant inflows as a result of the mandate, far beyond the current record-highs (up to $4T according to recent projections).

[1] https://www.dtcc.com/news/2024/june/04/ficc-treasury-clearing-activity-expected-to-increase-by-over-us$4-trillion-daily

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