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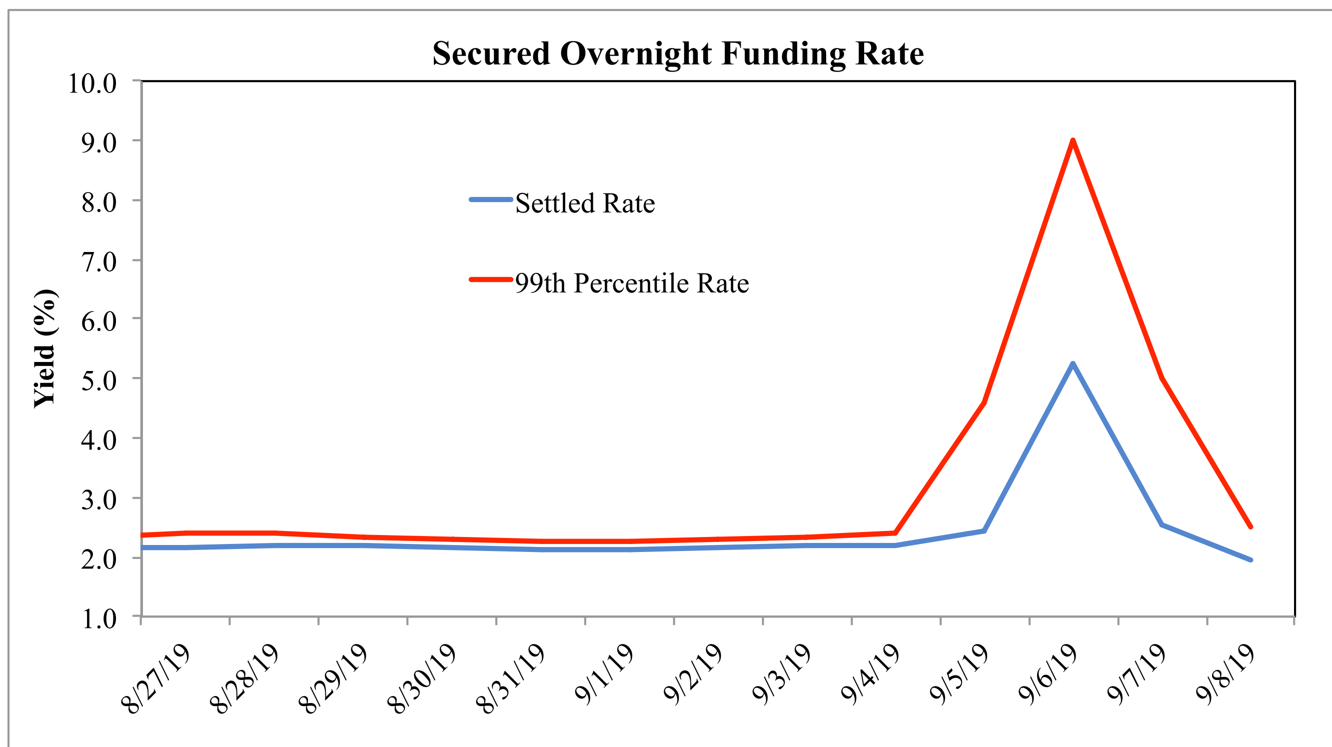
State Of the Markets: Macro Commentary

Is The Current Stress In Repo Reflecting Another LTCM Type Event?

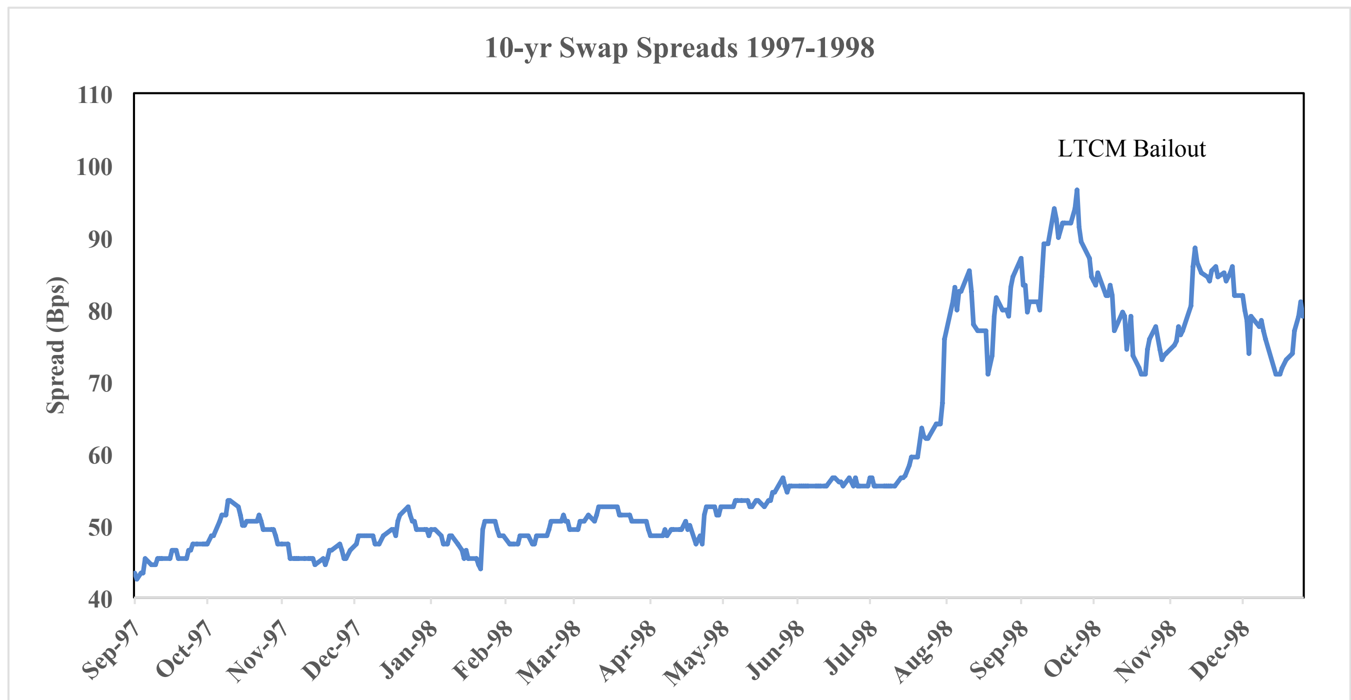
I don't know about you but the stress in the repo market last week certainly caught my attention. Something about this turmoil seemed odd to me--its not every day that the Fed loses control of the overnight market for a whole week and is forced to bring the surge in repo rates, Figure 1 below, under control by dumping between $50-70 billion of reserves into the system on a daily basis. Rather than rubber necking and continue to cruise on by the wreck of the repo market and pick up my update on my usual topics, I paused and tried to figure out what was going on; thinking that this pop in overnight rates is the "canary in a coal mine". After doing the initial due diligence, I am still concerned. I've rounded up the usual suspects and I am left with more questions than answers of what was driving the repo stress. That in of itself is a problem. First, I don't buy the current set of explanations, at least the ones I have read about or heard. Yep, the Treasury auction settlement is large, and corporate tax payments are going out. However, I find it difficult to believe that repo desks—at least the ones I have interacted with (BTW, check your wallet when leave after talking to them) —did not anticipate these flows. So, my next thought was LTCM.

Figure 1. Overnight Secured Repo (Fed Funds) Widened Substantially Last Week



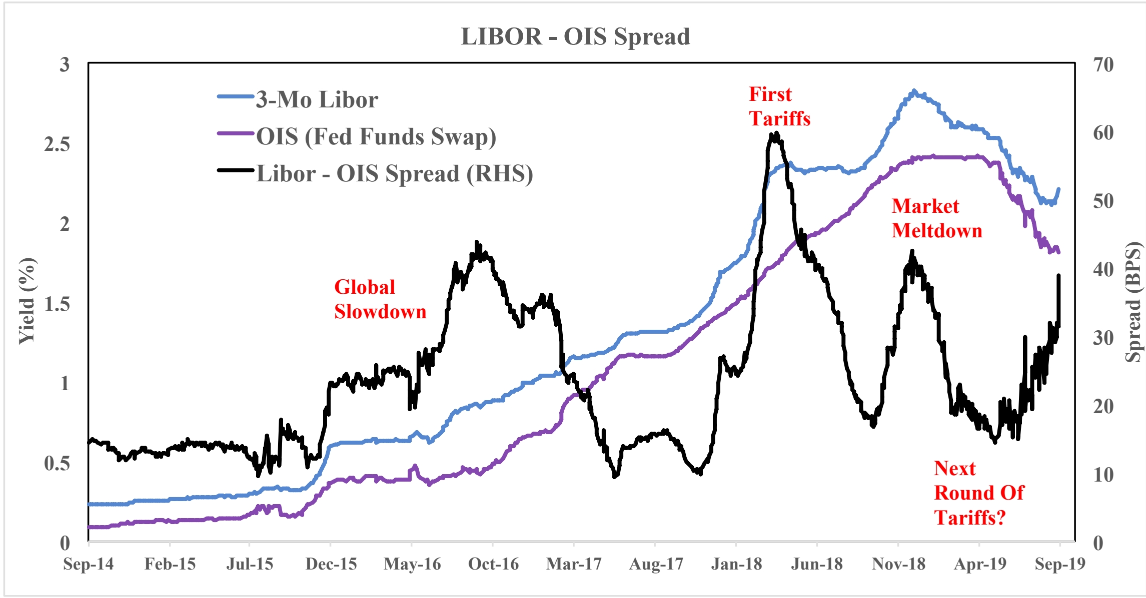
The seemingly out of place stress in the repo markets today reminded me of the events that preceded the blow up of Long-term Capital Management (LTCM) in 1998. And that event led to the Fed to intervening much as they did in the events after Lehman in 2008. The initial tremors of LTCM problems started in the summer of 1998. I remember being on the trading desk at Goldman and talking about the strange widening of swap spreads. We blamed it on the thinly staffed swap trading desks at the end of August. However, that widening really reflected the start of the meltdown of the leveraged positions held by LTCM, and also held by the multitude of arb desks and other hedge funds across that had followed LTCM lead in positionings. The core of LTCM strategy was leveraging low risk basis trades such as buying off-the run Treasuries and selling on-the run. This exposed them to sudden risk-off events, which happened a few times in 1998. For example, the basis widened across asset classes after the surprise of Russia defaulting on their local currency debt rather than it USD debt. The resulting capital call from the mark-to-markets started a cascading set of unwinds that drove the basis even wider and created a tsunami of a risk-off event, Figure 2 below. Ultimately, the Fed cut rates over 100 bps to ease the impact of the unwind.

Figure 2. The LTCM Event Drove Swap Spreads Wider



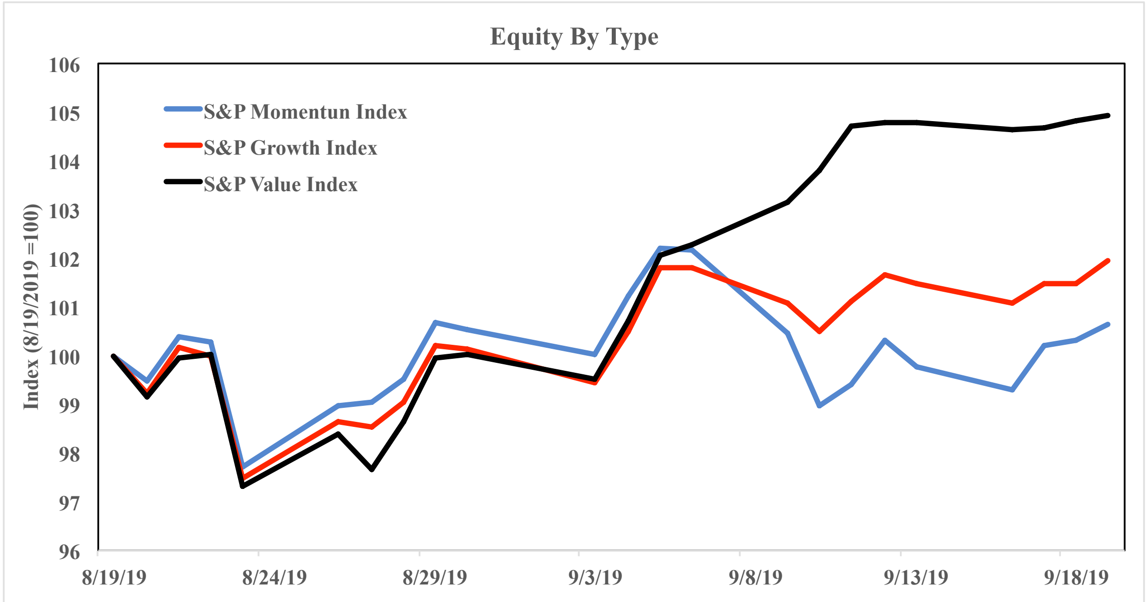
So, maybe there is something going on, particularly since the stress in the funding market has been going on since May. As shown in Figure 3 below with the LIBOR-OIS spread. This spread is an indicator of stresses in counterparty credit and it has been widening since May. This would would suggest that the repo stress is a reflection of a bigger problem, but what?

Figure 3. Counterparty Stress Has Been Growing Since May



My first suspect was to look for a repricing event that could in turn drive a deleveraging cycle, aka LTCM. That suspect was the equity market. Preceding the repo stress was the reversal of equity market performance from momentum stocks to value stocks, which is shown in Figure 4 below. Momentum stocks had outperformed value stocks by 40 percent since 2017, while growth had outperformed value by 30%. That trend reversed course with value overperforming momentum and growth. While there is substantial leverage in that trade, it does not seem to be of a magnitude to generate such a repo move. Particularly given that even after the recent underperformance, the momentum and growth trade is still up a lot.

Figure 4. Reversal of Momentum/Growth Vs Value Has Been Substantial



My next suspect was foreign banks domiciled in the US pulling cash out of the USD repo market, as they typically do during quarter ends. In that case, the USD basis should be widening as it typically does during a quarter end.. However, just the opposite has happened. In the analysis at Jackson hole, Du shows that the deviations of currency basis Currency Interest Rate Parity (CIP) widens during quarter ends, as shown in Figure 5 below. He also shows that this corresponds with non-US banks deleveraging their balance sheet and pulling out of the repo market during these periods, Figure 6. However, as shown in Figure 7, currency bases actually narrowed since the start of the repo stress. This, in my view, points the source of the stress at US repo participants. Again, the question is what's going on.

Figure 5. Deviations From CIP Widens Over Quarter Ends

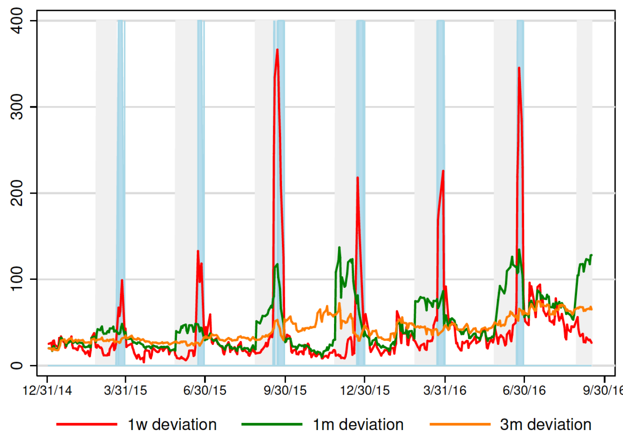


Figure 5. Illustration of Quarter-End Dynamics of CIP Deviations
The blue shaded area denotes the dates for which the settlement and maturity of a one-week contract spans two quarters. The grey shaded area denotes the dates for which the settlement and maturity dates of a one-month contract spans two quarters, and excludes the dates in the blue shaded area. The figure plots the one-week, one-month and three-month Libor CIP deviations for the yen (in absolute values) in red, green and orange, respectively.

Figure 6. Quarter End Dynamic In Deviations In CIP Driven By Non-US Banks

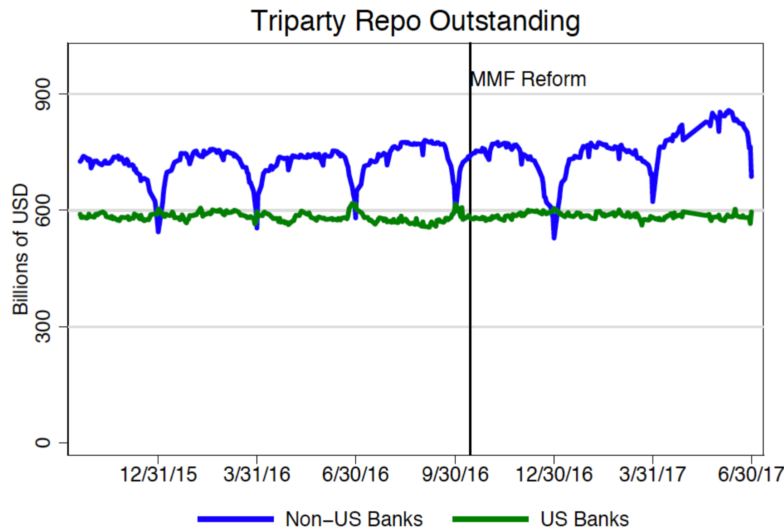


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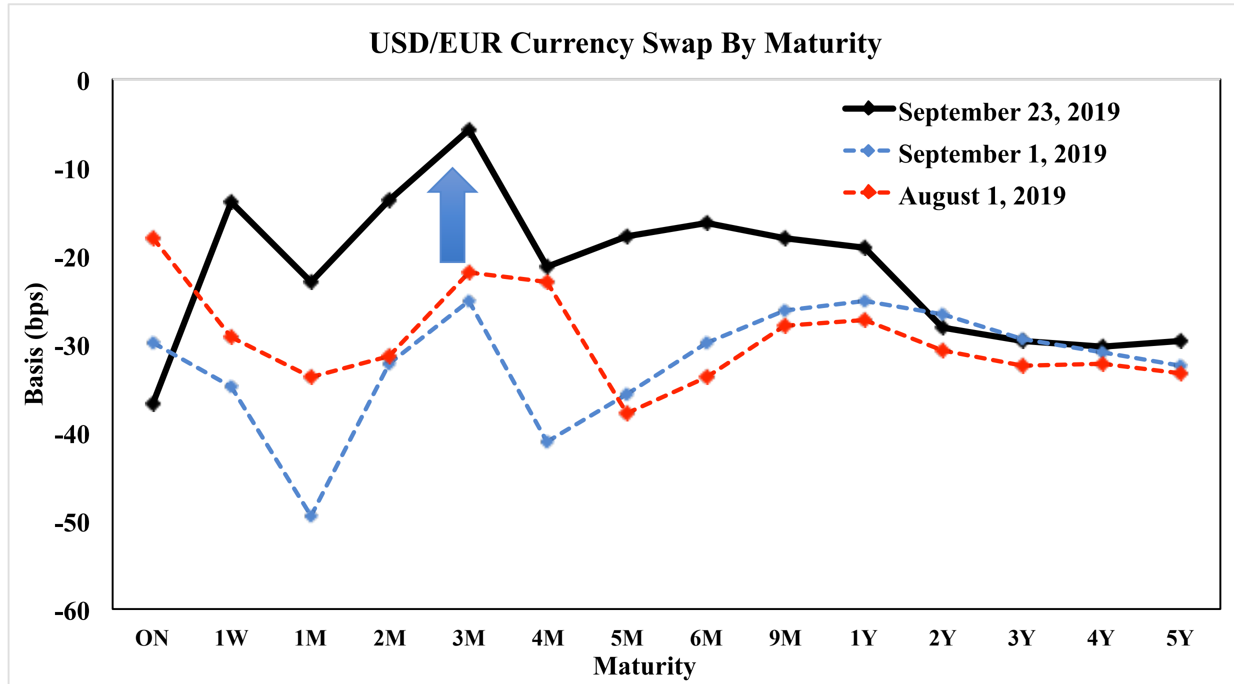
Figure 7. Deviations From CIP Have Actually Narrowed Not Tightened



Now, I am back to my original question: What is driving the repo stress. To this I am adding: What is driving the fall in the demand for USD assets, and maybe these two events are linked. And that would point towards US banks. But it is not clear. Yes, maybe there is a LTCM problem lurking beneath the surface but maybe all of this is explained by the growing data that supports slowdown not just in the US but around the world. Even if the US/China trade issues get solved in October, the impact on growth is "baked in the cake" With that in mind, I am moving back to my original view of global slowdown, and what it means for asset pricing. Think December 2018….

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