

# Securities Finance: Fixed Income & Repo Market Update

## Key Highlights from a Panel Discussion

Fixed income and repo market participants are adapting to new regulations and fiscal realities such as Quantitative Easing (QE) and strong demand for high-quality liquid assets. Panelists in a recent BNY Mellon roundtable took a close look at key market data and trends, and discussed the impact on lenders of high-grade sovereign bonds and collateral in the repo markets.

### KEY HIGHLIGHTS

#### Monetary policy divergence

Recent volatility, particularly in relation to interest rates, not only in the U.S. but globally, might represent a shifting opinion on how monetary policy divergence is evolving.

- Based on Bloomberg data, since the financial crisis, the G4 central banks' balance sheets have grown to over \$10 trillion, with the growth rate varying between 1.5 times to 4 or 5 times. However, the balance sheets for the Federal Reserve and European Central Bank (ECB) are diverging, with the Fed having ended its QE program, while the ECB has recently begun its largest multi-year bond buying program.
- Central bank liquidity has been a primary determinant of asset values over the past several years. The current impact of the ECB's QE program on risk assets is still unclear, and that is driving very high valuations for certain securities, as well as a level of volatility that has not been seen in years.
- Monetary policy divergence is predicated on stronger economic growth from the U.S., contrasting with weaker growth in the Eurozone (EZ) and many other parts of the world. This assumption has been put to the test with the U.S. posting one of the weakest first quarters versus developed market peers. The expectation in our view is for a rebound in economic activity in the aftermath of the harsh winter, uncertainty has fueled volatility especially amidst the debate over the path and timing of interest rate increases. In contrast, EZ data has generally exceeded expectations, creating the impression of a reversal of fortune between the U.S. and EZ, as depicted in Chart 1.

Chart 1: Reversal of Fortunes: Economic Outlook Improves in EZ – Weakens in US

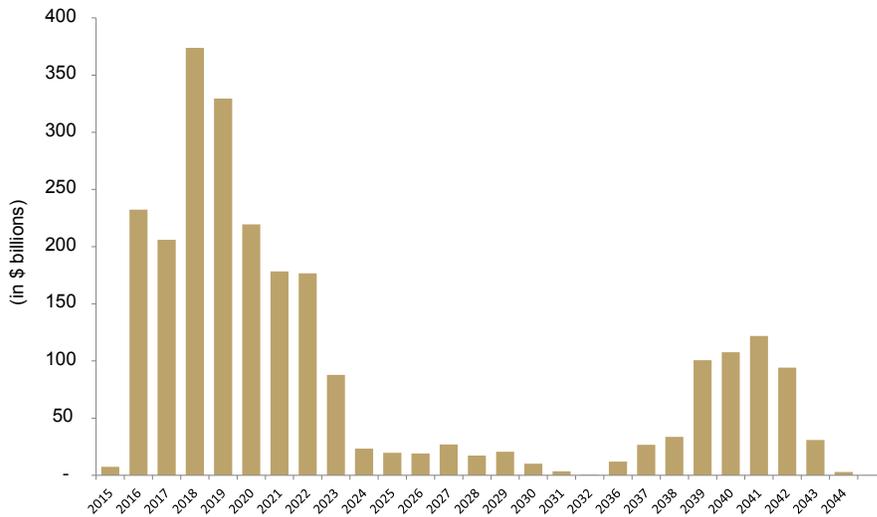


Data Sources: Bloomberg, Citigroup Economic Surprise Index



- After three QE programs and Operation Twist, the Federal Reserve's balance sheet has grown to levels never seen before. How it manages its securities holdings can have significant implications for investors. One of the largest concerns is how the central bank will handle the upcoming maturities of treasury securities it currently holds.
- There is almost no maturing debt in the Federal Reserve's portfolio this year, but the portfolio will start to amortize in 2016, as depicted in Chart 2 below. At that point the Federal Reserve will roll over all of the maturing debt as it comes due - at least until rates begin to rise. The scenario will change in the next couple of years, however. In 2014 there was \$770 billion of net issuance of the new debt. About \$220 billion comes due in 2016, and that increases to more than \$300 billion in both 2018 and 2019 out of a \$4 trillion portfolio.

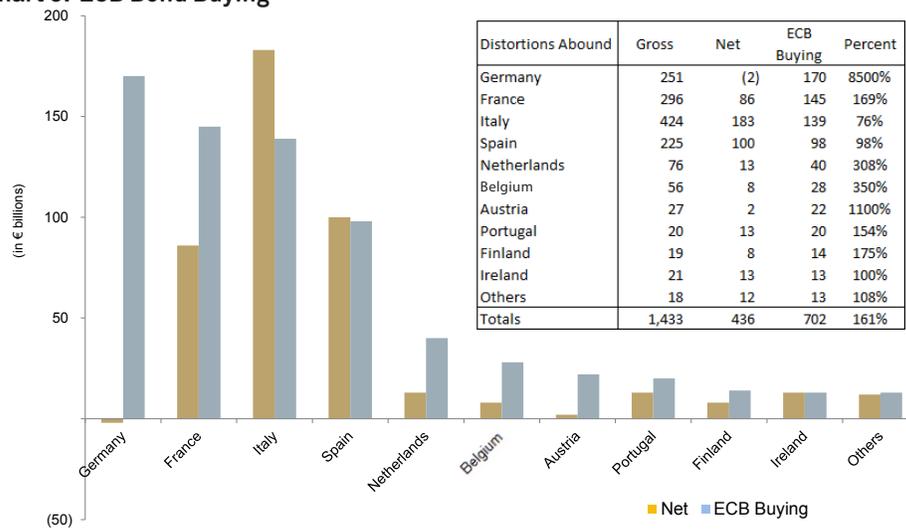
**Chart 2: Fed Portfolio Begins to Amortize Aggressively Next Year**



Data Source: Federal Reserve

- **In the Eurozone**, the ECB plans to purchase about €700 billion worth of bonds, representing 170% of the €400 billion in net issuance as depicted in Chart 3 below. It will buy more than 100% of most of the core countries' planned net issuance with the exception of Italy and Spain. Germany's planned net issuance will likely be negative considering the ECB will likely buy about €170 billion worth of German bonds.

**Chart 3: ECB Bond Buying**

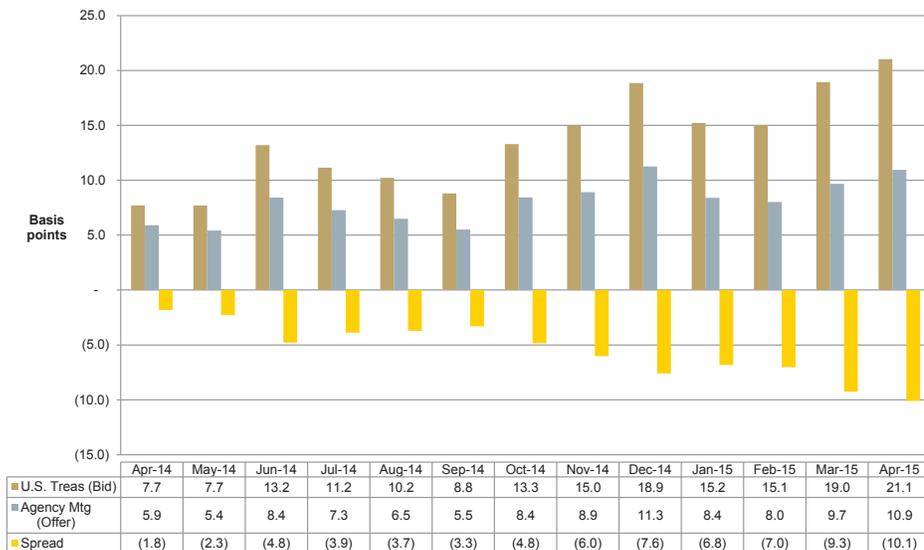


Data Sources: Bloomberg, ECB, Individual Central Banks

## CURRENT OBSERVATIONS AND POTENTIAL IMPACTS TO MARKETS:

- **Money market fund reform** will have an impact on the short end of the market. It is likely that several hundred billion dollars will shift into government funds. A couple of large money fund complexes have announced plans to convert some of their prime funds to government funds. This will enable them to continue to operate with stable Net Asset Values (NAVs) and avoid gates and fees that are problematic for most investors.
- **The short end of the yield curve remains relatively flat**, without much of a pickup expected for six months or more. One-month to three-month investments are yielding from the low teens to the mid-20s. Fed funds have traded in a tight range – 12 to 13 basis points for the past six months. Treasury repos have been trading in the 7 to 9 basis points range, and agency mortgage repos are about 2 basis points higher.
- **The Federal Reserve's \$300 billion reverse repo facility is supplying much needed treasury collateral** to the market. The facility is open to about 160 participants; each has the ability to request up to \$30 billion in collateral at the current rate of five basis points. Usage is low, running between \$90 billion and \$100 billion daily. Usage tends to spike at quarter ends, so the Federal Reserve added several hundred billion in additional collateral in December 2014 and March 2015.
- **The cost of raising cash in the repo markets has become expensive recently.** This is further exacerbated at month end, days when Government Sponsored Enterprises' cash is withdrawn from the market for P&I payments and when there is heavy coupon settlement.

**Chart 4: U.S. Treasury GC (Bid) and Agency Mortgage Repo (Offer)**



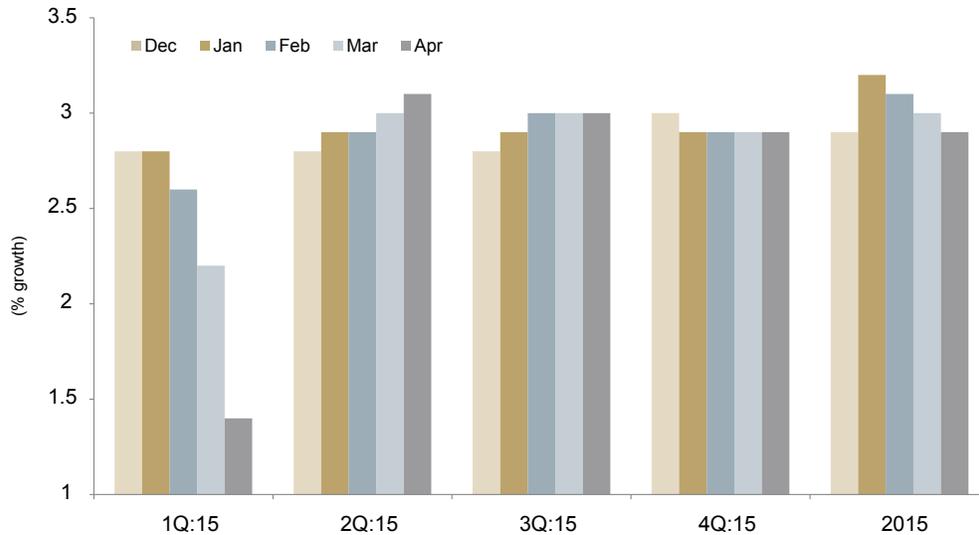
Data Source: Market levels determined by BNY Mellon internal trading applications

- **Banks may have largely completed their high-quality liquid assets purchasing**, and BNY Mellon's broker-dealer counterparts expect to be fully compliant with the Liquidity Coverage Ratio before the January 1, 2017 deadline. Some broker-dealers are already fully compliant.
- **There is a significant need for non-cash, balance sheet neutral trades.** The non-cash balances in the U.S. government book (and overall) has grown more than 13% over the last 12 months due to "non-cash upgrade trades". We anticipate that the non-cash component of BNY Mellon's book will continue to grow.
- **In EMEA, the non-cash element of our trading book has increased to** represent about 70% of current activity.
- **The ECB QE program started** on March 9, 2015, and the ECB expected to purchase \$60 billion worth of bonds per month. It actually purchased about \$52.5 billion, and \$11 billion of that was German government bonds.
- **Considering the reduction in supply, there should be a reverse repo facility in place to put those bonds back out into the market**, otherwise the reduction in supply could cause volatility in repo pricing. There are some "lender of last resort" facilities in place; many are regional programs, but there are many challenges associated with them.

### WHAT TO EXPECT IN THE 2ND HALF OF 2015

- The Federal Reserve took \$1 trillion of QE out of the system when it ended its tapering, and that has been replaced with close to a trillion dollars in yen and euro based QE. But it remains to be seen whether the money flows and risk assets will continue to benefit the way they did under the Fed's QE program.
- Ultimately, investors and market practitioners will need to deal with the volatility caused by monetary policy divergence.
- In our opinion, the U.S. economic data will be strong enough to support a U.S. interest rate increase in September or December of this year. Rate increases cannot be viewed in a traditional way, given where we are in the economic cycle. It is unlikely rates will rise in response to rampant inflation, growth or asset bubbles akin to the housing crisis. The Federal Reserve may raise rates because they want the normalization process to begin, but it is questionable whether the market and economy can support it. We believe the market can support the slow increase that the Federal Reserve is putting on the table.

**Chart 5: Still Expecting a Rebound 1Q:15 GDP Expectations Fall – FY:15 Little Changed**



Data Source: Bloomberg

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