Macro Strategy

DBS Focus

USD rates: Implications of QE-lite

Strategy/US/Rates

Group Research

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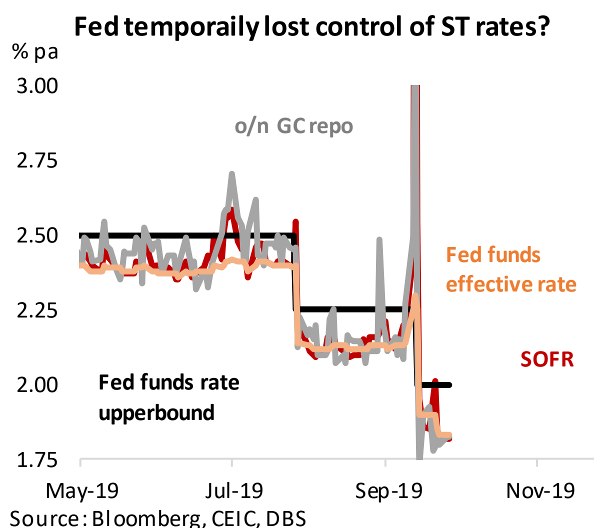
- *The Fed will likely embark on permanent open market operations (POMO) and a standing repo facility to address liquidity issues*
- *POMO should not be misconstrued as quantitative easing. While some of the outcomes are similar, the aim of POMO is to cap short-term USD rates*
- ***Implications for investment**: Term repo rates would ease and UST-swap spreads would narrow*

USD Rates: Implications of QE-lite

Following disruptions in the repo market over the past month, the Fed will probably embark on permanent open market operations (POMO, which may end up being called QE-lite) and have a standing repo facility in place to cap unwanted spikes in short-term USD rates.

To recap, the Fed temporarily lost control of overnight rates in September as the effective Fed funds rate popped to 2.30% (above the upper bound of the corridor of 2.25%). Concomitantly, the overnight GC repo rate and SOFR also spiked to 3.50% and 5.25% respectively. Subsequently, the Fed injected liquidity via overnight and term repo facilities (temporary measures) and successfully brought down overnight USD rates in the process. Once the Fed gets a handle of how much liquidity is needed, more permanent measures could be introduced at the October FOMC meeting.

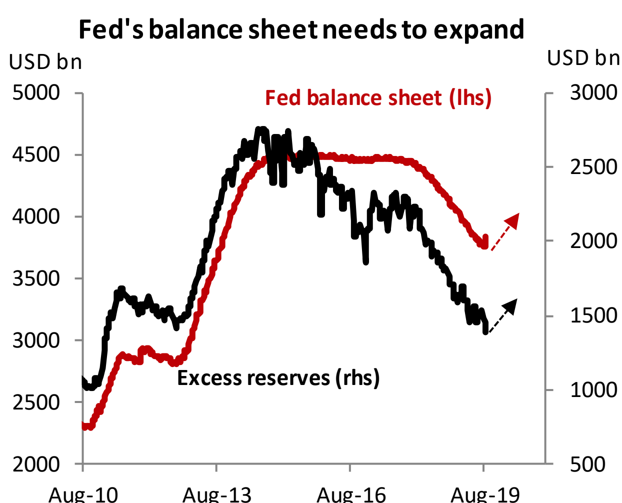
Fed temporaily lost control of ST rates?



Source: Bloomberg, CEIC, DBS

Dealing with a liquidity deficit

Several factors - bloated dealer balance sheets, issuances, tax repayments - contributed to tight funding but we think that the shortage in reserves is the elephant in the room. By traditional measures, spikes in the repo rates should not have happened. Excess reserves, as traditionally calculated, still amount to USD1.3tn. To be sure, this figure has shrunk from a peak of 2.7tn in 2014 as lending activity and quantitative taper took place. However, the amount of excess reserves is sizable and far more than what the Fed was operating on (close to zero excess reserves) prior the Global Financial Crisis (GFC).



Source: Bloomberg, DBS

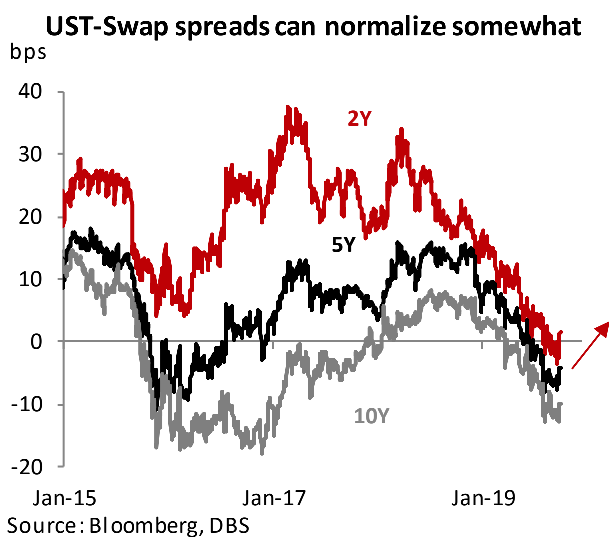
Excess reserves, as traditionally measured, is a misnomer. New regulatory requirements have tied up a large chunk of these excess reserves and the system is likely in shortage. The point that excess reserves are concentrated in several large banks should not detract from the fact that they would probably lend if they have the excess liquidity. We can estimate how much asset purchases the Fed has to embark on by looking at the balance sheet size of the Fed in recent days. Compared to the low in end-August, the Fed's balance sheet has expanded by about USD 100bn as repo activities began. Providing another 50-100bn in excess liquidity is probably a logical choice and this would require the Fed to expand its balance sheet by about USD 200bn (a figure that market participants are gravitating towards) on a more permanent basis. Subsequently, organic growth of the balance sheet (roughly tracking nominal GDP growth) could be needed as excess reserves get drawn down. On top of this, a standing facility needs to be in place to deal with seasonal changes (quarter-end, tax repayment) in liquidity.

POMO (QE-lite) is not QE

The upcoming round of asset purchases should be viewed as permanent open market operations (POMO) and not another round of quantitative easing. The objective of POMO is to inject enough liquidity into the financial system to ensure smooth day to day running. Once sufficient reserves (around USD 200bn) have been added to the system, the pace of balance sheet expansion should slow to that of nominal GDP growth. There is no intention to reduce term premium to provide support to the real economy or the financial market.

	POMO	QE
Aim	inject liquidity into the system to allow funding markets to function. Cap short-term rates	stimulate the economy by lowering long-term rates
Size	small, about USD 200bn	large, can top USD 1tn
Bank Reserves	goes up	goes up
Instrument	likely govvies	a mix of assets are possible
USTs	yields modestly lower	yields lower

By contrast, QE is aimed at supporting the economy. Through the GFC and the Eurozone crisis, short-term rates dropped to zero as policy makers scrambled to cushion the slump. In order to render monetary policy even more stimulate, QE was introduced and became a key policy tool as short-term rates hugged close to the zero-bound. By buying assets, central banks can reduce term premium and risk premium (across both the mortgage and credit space), stimulating lending in the process. QE sizes also tend to be much larger (Fed's QE 1: USD 1.8tn, QE 2: USD 0.6tn, QE 3: USD 1.7tn).

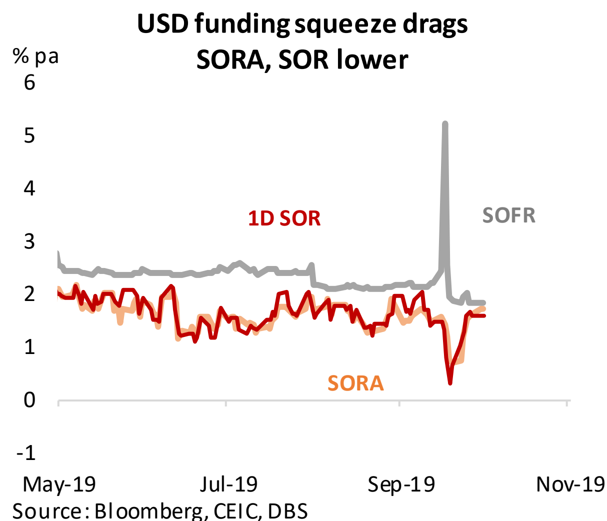


Source: Bloomberg, DBS

Implications of POMO

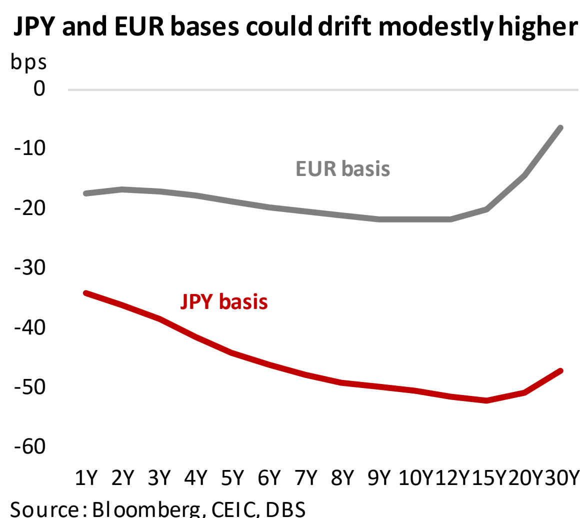
First, POMO would increase banks' excess reserves above what is needed for regulatory purposes. Paired with a standing repo facility, the spikes in overnight USD rates (repo, SOFR, Fed funds effective rate) seen last month should take place with less frequency. The more sizable and more immediate the balance sheet expansion, the quicker term repo rates should fall as market participants become more confident about funding.

Second, UST-swap spreads should narrow as Treasuries outperform swaps. In times of tight liquidity, government bond yields tend to be elevated relative to similar maturity swaps. The current situation is also exacerbated by lack of paying interests as USD interest rates drifted lower over the past year. We think that USD rates may have stabilized and see liquidity conditions improving once the Fed embarks on POMO. UST-swap spreads could generally widen out across all tenors.



Source: Bloomberg, CEIC, DBS

Third, implied overnight USD funding rates (from the different currencies) should see greater stability. The USD funding squeeze generally did not impact term rates or cross currency basis swaps (3M tenors and above). However, implied overnight rates and 1M rates did get squeezed. In Singapore, the 1D SOR (an FX-implied rate which tends to be dragged down when there is demand for USD) fell briefly



Source: Bloomberg, CEIC, DBS

below 0.5% (form a trading range of between 1.5-2.0%) as USD tightness bites.

Fourth, EUR and JPY bases versus the USD could narrow modestly (turn less negative). More aggressive asset purchases by the European Central Bank (ECB) and the Bank of Japan (BOJ) increases the supply of their domestic currencies relative to the USD, thereby putting downward pressure on the bases. From a demand perspective, low domestic yields (in Europe and Japan) tend to push investors to seek foreign investments (fx-hedged), driving the EUR and JPY bases lower. If the Fed does POMO, there would be slightly more supply of USD relative to other currencies.

What to look out for in POMO?

The Fed is set to run repo operations through October 10 and in theory, that could be extended indefinitely. However, a permanent increase in the Fed's balance is needed to sooth USD funding pressures and **we think that the Fed will deliver POMO and provide a standing repo facility. The timing, size, pace and scope (what tenors to buy) of POMO (if announced) will be critical to watch out for.**

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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