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ANOTHER INTEREST RATE CUT AND HEIGHTENED ATTENTION TO THE REPO MARKET

FOMC UPDATE

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CB: *Good afternoon, everybody. It's Christian Brobst here again with Chuck Carmody to discuss this afternoon's Fed statement and the following press conference.*

Chuck, I'll start by asking you to just give a quick recap of the contents of the statement and the changes in policy.

CC: Today's meeting was largely in line with expectations. The Fed cut rates by 25 basis points. One interesting note is they cut the interest rate on excess reserves by 30 basis points, which we'll discuss a bit later in the podcast.

The vote today was seven to three. It's interesting to note that you had three dissenters: [Esther] George and [Eric] Rosengren dissented in favor of no change to rates, and you had [James] Bullard dissenting in favor of a 50-bp cut.

As far as the dot plot goes, the median is now unchanged for the balance of 2019, and through 2020, at 1.875%.

The economic projections that were included with today's statement were largely unchanged. The only notable change was that the GDP projections were slightly higher; otherwise, things were similar to what we saw back in June.

CB: *One thing I would point out that also occurred today is that they cut the target repo rate for overnight repo activity at the Fed by 30 basis points as well, which is in line with the change to the interest on excess reserves. So, the money markets obviously have been getting a lot of attention over the last couple of days, and even in this—the prepared comments at the press conference and some questions afterwards.*

Do you want to give the audience a quick recap on what repo markets actually do and why it's important?

CC: I think the repo situation is definitely worth spending some time on today. It's obviously gotten a lot of attention in the press and at today's press conference.

First off, as far as repo and what its purpose is, this is the main funding vehicle for Wall Street banks as far as their Treasury and other government bond positions. I liken it to your plumbing in your house: you don't really notice it until there's a problem.

There are really two parts to the repo market. There's the amount of cash available to be lent, and there's the amount of collateral in the system that needs to be financed.

CB: *Given that context [and] the disconnect that occurred over the last couple of trading days and the reopening of an overnight repo facility by the Fed, what caused the disconnect to happen?*

CC: Well, there were a couple of things, and Powell actually referenced these in his press conference. The first thing was a large corporate tax payment due on the 15th that caused a withdrawal of cash from the system.

You also had a significant—it was about $54 billion in net proceeds—Treasury settlement that occurred at the same time. So, the result was a large withdrawal of cash from the system.

CB: *And in a system where excess reserves at systemic banks are now measured at $1.4 trillion by the Fed, a shock of $100 billion in total—or maybe slightly more—is obviously measurable. Powell seemed to indicate that he's not concerned about the disconnect, and also referenced the fact that it has no implication on the economic outlook, but he also mentioned some potential remedies to prevent the problem from happening again. Do you want to cover those?*

CC: The first thing is what we've actually seen in the last two days: the Fed initiated overnight repo facilities that started yesterday, and then they had another one today, to basically replace liquidity in the system. So, the Fed can obviously continue to come with these overnight repo facilities on a daily basis, as needed, as far as street liquidity goes.

There are a couple other things, and these are probably longer-term solutions that the Fed needs to look into. The first—and this has been discussed at length in recent meetings—is the instituting of a standing repo facility. I was a little bit surprised, frankly, that this didn't get more attention today and that it wasn't discussed more, both in [Powell's] initial statement and then in the press conference. But that's certainly one thing that would help remedy the situation.

Another factor is the ability to drain collateral from the system. This involves a discussion around growing the Fed's balance sheet, which obviously is a much larger discussion.

And finally, the other thing—and this did come up at the press conference—would be regulatory changes that free up capital on bank balance sheets.

CB: *It was most interesting to me that they decided to actually set a target overnight repo rate on a go-forward basis, but not introduce a standing repo facility, while at the same time saying that they'd be available to conduct operations at any time they were necessary to keep the funding markets open. It just seemed like a bit of a contradiction to me.*

CC: I agree. It's definitely surprising to me that they didn't talk more about a standing repo facility. It certainly would help address the problems we've seen this week.

And it's not like they're not aware of the situation. It's been discussed. He actually referenced the fact that the Fed was aware this was a potential problem during the press conference. So, it's a little bit of a surprise that they didn't spend more time on that, but we'll see.

Obviously, this is something that is not going to go away. It will come up again—most likely at month-end and quarter-end periods. But the Fed needs to address this, and I expect to see more on this in the future.

CB: *So, the other side of the equation, which you briefly mentioned, is the opportunity for the Fed to drain collateral out of the market, which essentially decreases the demand for funding. To me, that sounds essentially like reintroducing a quantitative easing program, even if it's not on a large scale, where they would start to purchase securities directly from the Treasury in order to reduce the demand for the cash that's available from an excess reserve standpoint. Would you agree with that?*

CC: Yes. I think so. And, obviously, how you expand the balance sheet is a much bigger conversation and it's something that I think we'll see more debate on in the coming weeks and months.

CB: *Did anything else stand out to you about the press conference specifically?*

CC: Actually, what stood out to me most was something he didn't really mention, and it's something that came up in our last podcast. He talked at the last press conference about the rate cut being a mid-cycle adjustment. It seemed fairly obvious to me that today he was trying to avoid referencing a mid-cycle adjustment.

In fact, he went out of his way to emphasize that, from here, it's data dependent and everything is meeting by meeting. So, that was the most interesting part to me of the press conference. Obviously, he continued to reference global weakness, muted inflation, and obviously the impact of trade policy on both economies and how the Fed looks at that.

CB: *Another thing that strikes me is that he seemed to de-emphasize, on a couple different opportunities, the meaning of the dot plots; that is, the fact that, potentially, they aren't even meant to be predictions, that they're essentially estimates, and that substantially—as he said in multiple press conferences leading up to this one—the Fed intends to be data dependent.*

CC: I would agree. And the last thing [that stood out] to me—he used the phrase organic balance sheet growth, so I think this is something we're going to probably hear market participants discuss quite a bit here in the next few weeks. He didn't go into a lot of detail, and I think he was pressed on it a little bit by a follow-on question, but he didn't talk too much about it.

CB: *To wrap up, can you give us some highlights from the market's reaction post press conference?*

CC: Overall, the market reaction has been very muted post-Fed. As far as rates go, the curve is a little bit steeper, largely led by a front-end sell-off, equities were modestly lower, and we saw some strength in the U.S. dollar, although again relatively muted.

CB: *It sounds like, in the end, this will be somewhat about the Fed sorting out true economic signals from market noise. We'll look forward to joining you again in six weeks' time and, until then, best of luck.*

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