

## Short-End Notes

### Repo rates refuse to rise

- **Repo rates floored** — Despite two weeks of close to \$70 billion of positive net T-bill issuance, repo rates have remained pegged against the fixed-rate offered by the Fed's overnight reverse repo facility (ON RRP). This reflects the fact that repo rates would likely have been trading at lower levels absent the ON RRP floor.
- **Treasury issuance likely to moderate** — We think the majority of positive net issuance for this tax refund season is over and that Treasury is unlikely to need additional cash management bills. This should keep repo rates below 10bp through mid-April, although they may rise a few basis points above current levels. After cash management bills mature on April 17 and 24, we expect repo rates to return to close to the ON RRP floor rate.
- **Expect increased allotments for ON RRP** — We think the Fed will increase allotment sizes for the ON RRP facility over the course of 2014. The Fed will likely vary the rate between 0-5bp, the currently approved range, but will not take rates above 5bp in 2014.

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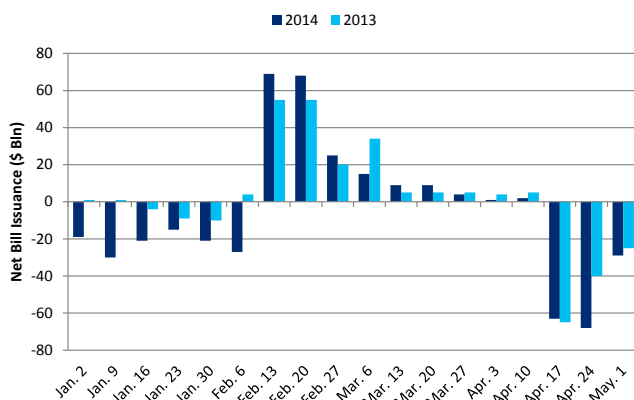
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## Repo rates refuse to rise

**Positive net T-bill issuance has failed to take repo rates higher.**

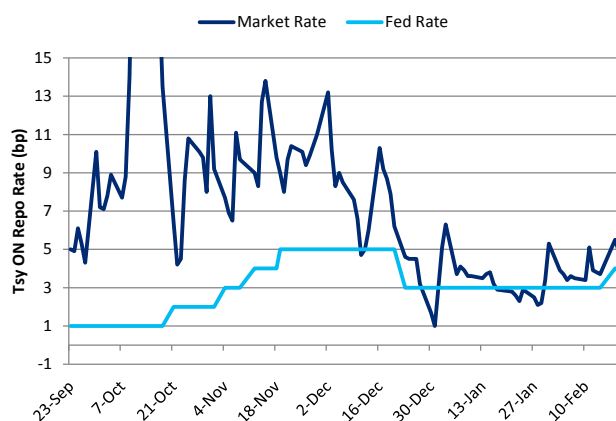
Market overnight repo rates have remained floored around the level the Fed pays on cash placed in its overnight reverse repo facility (ON RRP). (Figure 2) This is despite the substantial uptick in seasonal T-bill issuance as Treasury seeks to raise cash to cover tax refunds. (Figure 1) As we had expected, repo rates are failing to move higher because absent the floor provided by the ON RRP, market short-term rates would have been beneath the 3bp floor coming into February. With peak positive net issuance out of the way, next week the Treasury will issue \$25 billion each of 3m and 6m bills, down from \$45 billion two weeks ago. After two weeks of close to \$70 billion in net bill issuance, net issuance fell to \$23 billion this week and we are forecasting lower positive net issuance in coming weeks. (Figure 1) Given our cash flow projections, we think Treasury will likely be able to cover remaining tax refund outflows without issuing additional cash management bills.

Figure 1. Most positive net bill issuance may be behind us



Source: Citi Research, US Treasury, 2014 numbers are Citi forecasts

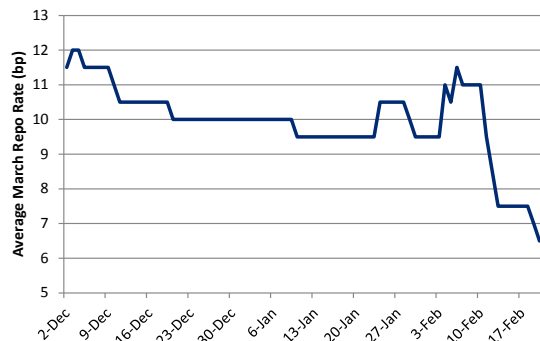
Figure 2. Repo rates have remained floored at Fed ON RRP rate



Source: Citi Research, Federal Reserve

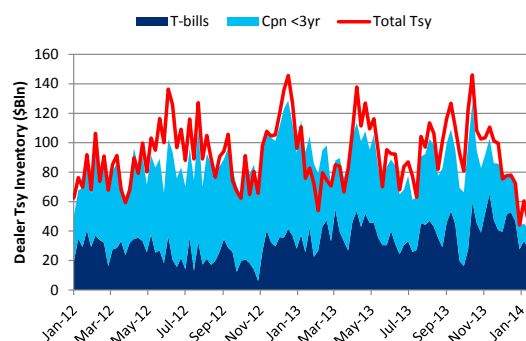
With most of seasonal T-bill issuance out of the way and repo rates only moving higher due to the Fed raising its ON RRP rate from 3bp to 4bp, we continue to think that repo will trade sub-10bp between now and mid-April. Market pricing looks fair given these expectations as expected ON treasury repo rates for March implied by futures have declined from around 10bp to 6.5bp. (Figure 3) When CMB mature on April 17 and 24, cash will come back into the market, which should push repo rates back against the Fed's ON RRP floor. While dealers likely added to Treasury inventories in the last two weeks (for which data has not yet been reported) given the low level as of Feb. 5 (Figure 4) we think dealer financing needs will remain moderate which also argues for repo rates to stay relatively low.

Figure 3. Market expectations for March repo rates have declined



Source: Citi Research, Bloomberg

Figure 4. Light dealer financing needs argue for low repo



Source: Citi Research

**FOMC minutes indicate members are weighing benefits of testing ON RRP against potential costs.**

Following the January 28-29 FOMC meeting, the Fed announced it would extend the operational test of its ON RRP until January 2015.<sup>1</sup> The minutes indicated that “most participants” supported extending the test as a way of generating useful information regarding the effect of the facility on short-term interest rates. However, the minutes also indicated that committee members will weigh this benefit against the potential costs of either influencing short-term rates in unexpected ways or creating confusion regarding the Fed’s policy stance and eventual plans for removing accommodation. We think these concerns were behind the fact that “A number of participants...indicated a preference for retaining a cap on the per-counterparty bid limit until the Committee has discussed possible approaches to medium-term policy implementation, and a few of these participants preferred to extend the exercise for a shorter period.” Dallas Fed President Richard Fisher and Philadelphia Fed President Charles Plosser dissented from the decision as they preferred maintaining the cap on size, with Plosser preferring a shorter extension.

**ON RRP allotment increases likely, rise in rates above 5bp in 2014 unlikely.**

Regarding the future of the program, we think increases in the maximum per-counterparty allotment are likely whereas an increase in rate above the 0-5bp range is unlikely in 2014. Given our outlook for sub-10bp repo rates over the remainder of 2014, even at 5bp or below we expect the Fed to see significant cash balances placed in the ON RRP facility during the majority of the year. Also, at expected low short-rate levels any significant increase in the ON RRP rate is likely to be transmitted to market repo rates and other short-term lending rates, something the FOMC probably wants to avoid until the likely first rate hike date is much nearer on the horizon. Finally, it’s notable that FOMC Chair Janet Yellen has the authority to increase the maximum per-counterparty allotment unilaterally, whereas increasing the rate above 5bp would involve agreement by the majority of the FOMC.

**Full allotment and rates over 5bp likely in 2015.**

Taking these factors into account, we think the most likely path forward is a series of increases in the allotment size during 2014. Full allotment and any increase in the Fed’s ON RRP rate above 5bp will likely be reserved until FOMC members believe the first rate hike is more immanent. Based on our forecast of a first Fed rate hike well into 2015 the Fed’s ON RRP rate will likely stay at 5bp or below for the remainder of 2014.

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<sup>1</sup> See [Short-End Notes from January 31, 2014](#).

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