

Short-End Notes

Fed extends fixed-rate repo

- **One year extension of Fed fixed-rate repo** – The Fed extended its operational test of the fixed-rate repo facility until January 30, 2015. The overnight repo rate range remains 0-5bp and the counterparty limit has been taken up to \$5 billion. The long extension period may mean the facility stays continuously operational up to and including the rate hike period.
- **T-bills react to debt ceiling** – T-bills maturing in late February and early March moved higher late last week and early this week as investor concerns rose surrounding the debt ceiling. Lawmakers and the media are likely to become increasingly focused on the ceiling beginning next week which could lead to more front-end volatility.
- **Strong demand for FRNs** – The inaugural \$15 billion auction of 2y Treasury floating rate notes showed strong demand with a high bid-to-cover of 5.67 and tight spread of 4.5bp to 3m T-bills. While in our view spreads are fair-to-rich at these levels, we expect they will remain tight.

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Fed extends fixed-rate repo

One year extension of Fed fixed-rate repo

Fed extended its reverse repo facility one year with counterparty limits increased to \$5 billion.

Following the FOMC meeting on January 29 the Fed announced the operational exercise of the overnight fixed-rate reverse repurchase agreement will be extended one year, through January 30, 2015. The facility will continue to pay a rate in a range of 0-5bp at the discretion of the Open Market Trading Desk at the NY Fed. The maximum allotment will also be taken up to \$5 billion per counterparty from the current \$3 billion. Money fund (MMF) counterparties are defined at the individual fund level (large fund families may have multiple qualified funds, each able to leave \$5 billion at the Fed). With 139 approved counterparties (94 MMF, 6 GSEs, 18 banks, and 21 primary dealers) the maximum balance that could be left in the facility is \$695 billion, relative to \$2,523 billion in total Fed reserves outstanding. In the announcement the Fed noted that allotments may continue to be increased. The facility should provide a welcome avenue for surplus cash investment over upcoming month, quarter and year ends.

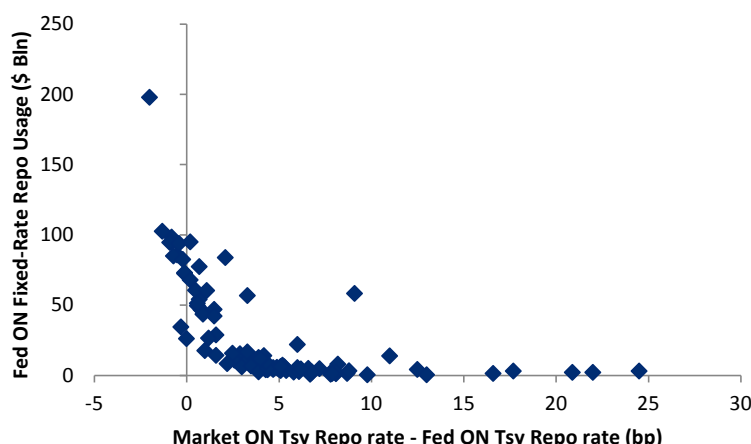
MMF may be more willing to leave larger balances with the Fed now that they have certainty regarding the facility's future.

All else equal, extending the facility for a full year rather than for 3 months, the length of the first facility test, is likely to lead to somewhat higher facility usage. Some money funds may have been hesitant to pull cash from repo with banks and broker-dealers and place the cash in repo agreements with the Fed as they did not want to risk losing room on a counterparty's balance sheet only to have the Fed facility expire. With certainty that the Fed program will remain in place for an extended period, we think money funds will be more willing to substitute the Fed for private sector repo counterparties. As the facility becomes a closer substitute for other short-term cash investments it should provide a firmer floor on for the level of short-term rates.

Sub 5bp rates may fail to attract substantial balances if repo rates rise.

While we had thought the FOMC might give the desk the ability to test the facility at somewhat higher rates, for now the Fed overnight repo rate will remain at 5bp or below. Since the beginning of 2014 market repo rates have remained low, making the Fed's offer at 3bp at the reverse repo facility attractive. After spiking to just under \$200 billion over year end, balances at the facility have averaged \$72 billion in 2014. If market repo rates rise to around 10bp in February and March, as we expect, usage of the facility would likely drop back to very low levels. Usage of the facility might pick up again after mid-April when we expect market rates to fall. We think the Fed avoided raising the range of potential rates so as not to risk markets misinterpreting higher rates as signaling a more hawkish policy stance.

Figure 1. Fed facility usage may fall if market repo rates move higher in February and March



Source: Citi Research, Federal Reserve, Market ON Tsy Repo rate is DTCC GCF rate

Reverse repo facility may remain available indefinitely.

March bills moved higher in yield, consistent with our debt ceiling projections.

Markets are likely to become more focused on debt ceiling in the coming weeks.

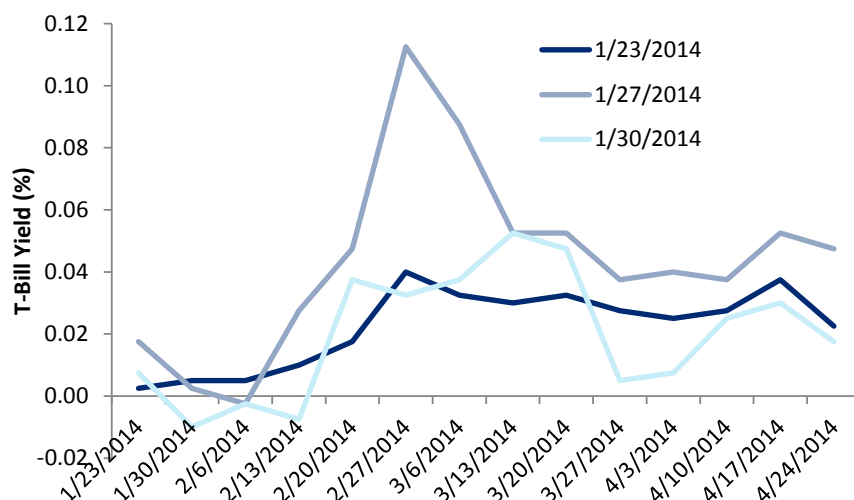
Prior to hiking rates, we think the Fed will use the reverse repo facility to return short-term rates to closer to 25bp from their current level around 0bp. Given that the operational test expires in January 2015 and first rate hikes are likely to occur sometime in 2015, it is increasingly likely that the fixed-rate reverse repo facility will remain continuously in operation. While the Fed may tweak the parameters of the operational exercise, including increasing the counterparty limit or increasing the range of possible rates, we think the Fed will clearly announce when the facility is no longer being used in a test-phase. It is probably only at this point, sometime in 2015, that the facility will be made truly full allotment.

T-bills react to debt-ceiling

Beginning late last week we saw the first rumblings of concern over the debt ceiling as T-bills maturing in late February and early March moved from under 5bp to above 10bp. (Figure 2) According to our projections, and consistent with Treasury guidance, extraordinary measures that allow Treasury to raise cash by issuing debt will last until late February. Following the exhaustion of extraordinary measures, Treasury will begin running down its cash balance to meet obligations. We think cash will last until no later than March 3 when substantial social security and other payments are due. T-bill prices reflect this timing with investors demanding higher yields for bills maturing Feb. 27 through March 27. While existing debt can always be rolled over without violating the debt ceiling, some investors will seek to avoid securities that could potentially be subject to a delay in principal or interest payments.

Republican lawmakers are reportedly formulating their debt ceiling strategy, including what conditions to potentially attach to an increase in the debt ceiling, at their retreat being held yesterday and today. We expect that this will generate more focus on the debt ceiling in the press which would likely lead Feb. and March T-bills to continue to move higher in yield if an agreement does not seem immanent. As with all past debt ceilings, it's extremely likely that lawmakers will act ahead of the exhaustion of extraordinary measures to raise the debt ceiling. However, the closer we get to late February without an agreement, the more reaction we can expect from short-term rates.

Figure 2. T-bills maturing in late Feb. and early March react to debt-ceiling concerns



Source: Citi Research, Bloomberg

Strong demand for FRNs

Demand from money funds likely was behind the strong FRN auction.

The inaugural offering of \$15 billion in 2y US Treasury FRNs indexed to the 3m T-bill rate was met with strong demand, stopping at a spread to 3m T-bills of 4.5bp with a bid/cover ratio of 5.67. This is high relative to 3m T-bill bid/cover ratios that have averaged 4.49 over the last year with a 3.94 bid/cover ratio in the last auction. The auction saw strong participation from indirect bidders – likely money market mutual funds – who took down 38% of the auction relative to the on average 21% awarded to indirect bidders in 3m T-bill auctions over the last year. This left primary dealers with only 53% of the auction, much lower than the on average 72% of newly auctioned 3m T-bills awarded to primary dealers.

Spreads may stay around the 4.5bp auction level.

With money fund assets just below multi-year highs at \$2.7 trillion and a limited supply of short-term securities, it is not surprising that the first auction was very strong. On the back of this heavy demand, the spread at auction came at the tighter end of the 5-10bp range we had expected. The FRN spread has held in at tight levels in post auction trading, and even though the sub 5bp spread is slightly rich in our view, it's unlikely to widen in post-auction trading. Not only should the positive demand dynamics hold in spreads, but the buy and hold nature of FRN investors may make the issue hard to borrow in repo markets, making short positions unattractive.

Appendix A-1

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