The Repo Market: Making Sense of the Headlines

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- An early-March dislocation in the repo market has been primarily confined to one area: the overnight rate for borrowing 10-year Treasury notes, which went negative.
- Borrowers of 10-year Treasurys have been willing to pay interest (rather than earn interest, as they normally would, on their cash collateral), signaling that investors expect yields will continue to increase.
- Because this dislocation is tied to the cost of borrowing a single security type, not the cost of borrowing cash, it has not led to notable pressures in the broader money markets.

An early-March dislocation in the repurchase-agreement (repo) market appears to have reached investors' radars and then fell off rather quickly. News headlines that reference the repo market tend to garner attention because it is such a crucial component of the U.S. financial system.

Yet headlines rarely, if ever, capture the full story—particularly when it comes to pinpointing or conveying the complex ramifications of a repo market dislocation, which involves multiple counterparties and exchanges of cash and securities.

First, what's a repo?

Repurchase agreements are short-term borrowing transactions that involve an exchange of cash and securities between two counterparties.

One counterparty borrows securities and gives cash collateral to secure the transaction. The other counterparty lends securities in exchange for cash collateral—and is normally obligated to pay a rate of interest on the cash collateral when the borrower returns the securities.

When engaging in a repo transaction, the securities borrower gets temporary use of securities, while the cash borrower receives cash—and can potentially earn an additional return by re-investing this cash elsewhere. This two-way flow of cash and securities is a vital mechanism in facilitating financial transactions and supporting market liquidity.

What happened?

In early March, the overnight rate for borrowing 10-year Treasury notes went negative. This means that securities borrowers are now *paying* interest on the cash collateral that they put up to borrow the notes instead of *receiving* interest on that collateral.

Unlike past headline-triggering anomalies in the repo market, this one is primarily confined to a single area. As such an unusual occurrence, this has captured the attention of financial news media.

What does it mean?

The dislocation associated with the rate to borrow 10-year Treasury notes highlights outsized demand for this security type. This demand has been driven by investors increasingly taking short positions on 10-year Treasury notes—signaling their expectation that yields will continue to rise along with the U.S. economic rebound, which strengthened following the passage of the latest stimulus package.

Doesn't the Federal Reserve (Fed) usually help alleviate imbalances in the repo market?

Yes, the Fed has intervened in the past, both when such imbalances were specific to the repo market (as was the case during September 2019) and when they were part of a broader financial panic (as was the case in March 2020).

This time, however, the Fed has been limited to its regular securities-lending operations due to the isolated nature of the dislocation. Still, the central bank has made an effort to help—lending 10-year Treasury notes from its portfolio—which has supported the borrowing rate to a degree.

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SEI's view

The repo market usually makes headlines for funding stresses; during periods of illiquidity, for example, securities lenders (like banks) have to pay increasingly larger rebates to borrow cash (from money market funds). However, in our view, the recent dislocation in the repo market has not been indicative of any such stresses—largely because it has not been a product of increasing borrowing costs for cash, but for a specific security.

In fact, since the onset of the pandemic last March, the Fed has injected so much liquidity into the system that money markets have been contending with ample liquidity and diminished Treasury bill supply (resulting in ultra-low interest rates). Banks have not faced issues with borrowing money given the significant liquidity in the system.

Moreover, and perhaps most importantly, the dislocation in 10-year borrowing rates has not led to notable pressures in the broader money markets. This may not be the last we'll hear about repo markets for a while; bets on higher interest rates have been a key contributing factor, and these bets could persist for a while.

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