



Don't Fear The Repo | September 2019

“If you consider the contribution of plumbing to human life,
the other sciences fade into insignificance.”

James P. Gorman (CEO Morgan Stanley)

The repo market is often referred to as the plumbing of the financial system. And much like the plumbing in your house, it functions in the background unnoticed, that is, until something goes wrong.

That something wrong happened last month, with financial institutions finding a clog in their funding pipes. As a result, boring old repos made headlines and sparked fears of systemic problems in the plumbing infrastructure.

This has many asking what the heck a repo is, what happened, and how worried we should be.

Repo is market slang for a repurchase agreement. It is a common type of short-term borrowing where the underlying ‘collateral’ is government securities. In a typical repurchase agreement, a financial institution sells government bonds to raise cash today and agrees to buy them back tomorrow. The next-day repurchase is at a higher price, which implies an overnight interest rate referred to as the repo rate.

Usually, the repo rate is marginally above the central bank overnight rate (i.e. low 2% range at current levels). But on September 17th, it spiked to 10%. Despite the opportunity to earn large premiums on overnight cash, financial institutions were unwilling or unable to lend to each other.

As with most clogged pipes, it was due to a confluence of factors building up over time. A growing deficit has meant a greater supply of US Treasuries. And with the Fed pulling back from their purchasing program in 2017, the slack has been picked up by the banks, where primary dealers are forced buyers. Since 2008, the amount of US government debt held by commercial banks has tripled.

Often these purchases are funded through the repo market. Consider a bank buying Treasuries and then selling them in a repurchase agreement to raise the cash. The following day they enter into a new repo and thus continuously borrow the money to finance their purchase. This is an extension of the old bank game of ‘borrowing short and lending long.’

In September, these factors came to a head and created an imbalance in the demand and supply of cash. On the 16th, a large amount of new Treasury purchases settled, and money was due. At the same time, companies were making withdrawals from banks to pay taxes. This left more Treasuries sloshing around the system than cash on the other side.

In such crunches, there is usually money tucked under the mattress in the form of reserves. And while the \$1.3 trillion in storage at the Fed seemed sufficient, the cash was not being lent out. On closer inspection various regulations have made the cash immobile. As JP Morgan CEO Jamie Dimon noted, the banks ‘have a tremendous amount of liquidity but also have a tremendous amount of restraints on how they use that liquidity.’

So the Fed had to step in and play the role of plumber and get the pipes flowing with an injection of cash. This took care of the immediate issue, with more permanent solutions being explored. Some of the options up for discussion include the Fed administering a standing repo facility, a revival of Treasury purchasing programs, and changes to regulations, i.e. allowing banks to treat Treasuries and cash as equal for reserve purposes.



For those of us scarred by 2008, all of this has an unnerving familiarity. But for all the noise that repos made last month, the impact to rates, credit, and equity markets was negligible. Banks are better capitalized and stronger than a decade ago, and the funding crunch was the result of immobile money, not the lack thereof.

So while nerds and traders debate the nuanced impacts this could have for bank inventories and liquidity, the rest of us needn't get our underwear in a bunch. Unlike the financial crisis, there is not a lack of confidence in the banking system. The pipes needed some maintenance and attention, but we don't see the need to rip apart the entire plumbing.

As they say in the army, "it's the bullet you don't hear that will get ya." So perhaps the incident last month serves as a welcomed warning shot of a design flaw in the post-crisis system. If not remedied, a blocked pipe could create unnecessary panic in fragile markets. Thankfully, central bankers and regulators are working to ensure the repo market operates smoothly. Unlike in poker, when it comes to plumbing, a flush beats a full house.

The Fund

Rumours swirled in August about a tidal wave of issuance to come in the fall. September didn't disappoint, as corporate treasurers, thrilled with the prospects of cheap financing, lined up to issue debt. The final tally registered as Canada's fifth-largest supply month with approximately \$14 bn of new corporate bonds issued.

Videotron broke the record for the largest domestic high-yield deal at \$800 mm and used the proceeds to retire existing bank debt. Gibson Energy (recently migrated from high-yield to investment-grade), Pembina, Transcanada, Brookfield, GTAA, Equitable Bank, VW, Bell Canada and BNS also came to market last month.

As we had anticipated, cash levels had been building up in fixed income portfolios, and the flood of supply was met with even greater demand. Portfolio managers were left disappointed with their new deal allocations and were forced to scramble in the secondary market for scraps. Overall, credit spreads narrowed approximately 4 bps (5 bps in the US), which is remarkable given the volume of deals.

We were well-positioned to selectively participate in new deals and to capitalize on the trading activity around the new supply. Active trading, the general performance of spreads, and carry contributed to a solid gain of 1.02 % (0.91% F Class) in September.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	2.03%	1.15%	0.36%	1.54%	0.15%	1.04%	0.80%	(0.83%)	1.02%				7.46%
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%	0.46%	0.52%	0.47%	(0.34%)	(1.57%)	(0.81%)	(0.13%)
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	0.50%	8.46%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.



Credit

Concerns of looming issues in credit markets are resonating with investors, who are becoming far more discerning about who they finance. Stelco couldn't do a bond deal even with a hefty 9% coupon. Meanwhile, WeWork saw their bonds drop 25% and \$40 bn trimmed off the company's valuation in just a few weeks. People reconsidered whether a negative cash-flow company is truly worth the same as, say, Caterpillar. The message is clear. Investors are no longer willing to throw their hard-earned money to finance speculative companies (debt or equity) that rely on miraculous growth or at the very least, a strong economy.

While the investment bankers will be whinging about how their bonuses will be affected, the rest of us should be pleased that investors are finally showing some discipline. This could lead to a slight increase in defaults as investors refuse to bail out poorly run companies. Oddly enough, we think this could be a good sign. While defaults will raise some fears, the increased pressure means corporate executives will be forced to focus on strengthening their balance sheet ahead of a downturn.

With the ongoing fall issuance calendar and the overhang of trade, Brexit and some lousy economic numbers, we don't believe aggressive exposure is warranted. We will continue to hold our modest position, which allows us some flexibility to exploit opportunities that arise from a market sell-off.

Rates

Purchasers of sovereign debt experienced a bit of 'buyer's remorse,' as markets reassessed how low central banks need to take rates. As a result, the Canadian 5y yield increased by 22 bps in September after having fallen 27 bps in August. The markets see-saw as investors attempt to decipher the economic data and geopolitical risks.

On the one hand, economic growth is slowing as business and consumer confidence wanes. But if the US and China reach a deal (any deal really) and the UK and Europe work something out, central bankers will be reluctant to add further stimulus in hopes that growth rebounds.

Both the Federal Reserve and the Bank of Canada are treading a fine line with the trade war. First, there is the ever-changing dynamic in the trade negotiations. Then there is the uncertainty of the impact and overhang from the loss of business confidence that this spat has created. And since progress on these issues is painfully slow, central bankers would like to keep some firepower in reserve.

Given that most central banks around the world are currently biased towards lowering rates, we think that sovereign yields will remain anchored within a well-contained range for the balance of the year.

Contact

Algonquin Capital Corporation
1 King Street West, Suite 1502
Toronto, Ontario, M5H 1A1
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 214-3493

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