Reactions to the January FOMC Transcript

Dan Krieter:

Hello, and welcome to Macro Horizons, High Quality Spreads to the week of January 27th, reactions to the January FOMC. I'm your host, Dan Krieter, here with Dan Belton as we discuss our takeaways from the recent FOMC meeting, and we conclude with a conversation about volatility in the repo market recently, and what it means for swap spreads going forward.

Dan Krieter:

Each week, we offer a view on credit spreads, ranging from the highest quality sectors such as agencies and SSAs, to investment grade corporates. We also focus on US dollar swap spreads and all the factors that entails, including funding markets, cross currency markets, and the transition from LIBOR to SOFR. The topics that come up most frequently in conversations with clients and listeners form the basis for each episode. So please don't hesitate to reach out to us with questions or topics you would like to hear discussed. We can be found on Bloomberg, or emailed directly at dan.krieter, K R I E T E R, @bmo.com. We value and greatly appreciate your input.

Speaker 1:

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Dan Krieter:

Okay, Daniel. Recording this now, just after Chair Powell concluded his press conference. Not much expected heading into the Fed meeting today. And I think that the Fed met the no expectations.

Dan Belton:

Yeah, it didn't get a whole lot from Chair Powell today, either in the statement or the press conference. One takeaway that I had was it seemed like there was a lot more of a focus on the potential for bubbles, and the Fed's macro-prudential policies. Whereas in recent press conferences, there was, I think, relatively more focus on the possibility that the Fed would taper and how they would do that. It seemed to be more about the Fed and its ability to withdraw this accommodation, and whether Chair Powell thought that the Fed was playing a role in inflating asset prices. I thought one part that was interesting from the press conference today was, Chair Powell made the assertion that asset prices in recent months have been driven by fiscal policy in vaccines and not by monetary policy. Well, in a vacuum, that's probably true. I think we would both agree that the Fed has played a significant role in aiding asset prices since the pandemic.

Dan Krieter:

Agree. I think that was the headline takeaway. I think he did say something like, "Well, I realize that central bank policy plays a role in that," or something, but I underlined the same part. That was a direct question from Steve Leischman financing about asset prices. And the response was sort of all over the board, talking about, "We monitor financial stability across this framework, that takes into account asset prices, bank leverage, non-bank leverage, funding risk, and across this whole range. [inaudible 00:03:49] levels were moderate." And then that was kind of it. But the vaccines and fiscal statements are driving values. Yeah, I think it's obviously impossible to divorce what's driving the stock market, in a world where we have unprecedented monetary policy support. That's a clear driver of it. And he sort of acknowledged it. But I think that the point that has to be made is that he just came back to, "We are responding to an unprecedented shock to the economy."

Dan Krieter:

And I think his direct quote was, "Our response was to that." Almost, in a way, saying to me, "Listen, unemployment rate's still at 9%, and it's probably higher than that, according to other measures. We are responding to the biggest economic crisis of our lifetime, and the global financial crisis was just 10 years ago." He didn't say it, but I interpreted it as him saying, "If there are bubbles, there are going to be bubbles. What are we going to do? Not have extremely accommodative monetary policy?" Again, he didn't say that, but that's how it came across to me. Did you get a sort of similar feeling?

Dan Belton:

Yeah, I did. And he talked a few times during the press conference about how their policies had been effective and saved millions of jobs. And he's not wrong about that. And so there is an argument to be made in his defense, that, sure, monetary policy has played a role in supporting asset prices, but more through the impact it's had on the real economy, whereas, I think, there's a little bit of everything going on. The effect of monetary policy has largely been a technical tailwind for asset prices, in addition to the fundamental support that it's given the broader economy. And so I think there's a little bit of both sides going on here. And of course, he's going to play up the impact that it's had on the economy. And like you said, doing what the Fed had to do at the time, which I think no one's going to argue against.

Dan Krieter:

Right. And it sort of segues nicely to what I underlined is what I thought was the second most important thing at the press conference, where he was fielding a question about whether or not the Fed was potentially locked in a corridor, where they're bound by the zero barrier, they can't cut rates any further. But at the same time, we can't think about normalizing or anything like that until proof of the recovery is underway. I thought the [inaudible 00:05:55]'s response there was, he made the obvious point. We shouldn't be talking about normalization. The question was framed in the sense of, "Can you extricate yourselves?" And Powell's response was, "Why are we even talking about that right now," basically. "We're so far away from thinking about extricating ourselves, why would we even bother thinking about how we're going to do it or if it's feasible?" Which is probably right.

Dan Krieter:

So his answer to that question was, "Are we locked into a corridor? No, there's more we can do. We can change asset purchases." So the Fed's thinking is clearly not that they might have to do less or how they're going to do less, it's more, "We can always do more." And he even doubled down on that, I think, with some of his commentary on inflation. He went so far as to specifically address base effects and a potential temporary increase in inflation as a result of exuberance once people get vaccinated. He said something like, "Yeah, people are going to feel enthusiastic. There could be a short bump in inflation while people go out and are excited to not be in their house." But he described both the base effect and post-quarantine exuberance as transient impacts on inflation that the Fed... Well, his implication was that the Fed would, essentially, look through them.

Dan Krieter:

I don't disagree with any of that. Obviously, I think that's very accurate. But I was surprised to hear the FOMC Chairman basically say that, "Inflation is going to go up. We're not going to really consider it inflation. We're just going to keep everything extremely accommodative, really, for the foreseeable future." He said something to the effect of, "We have the tools to fight inflation. We hope inflation would come. We can deal with that. We can't deal with inflation doesn't come. And we're kind of stuck here in the same low inflation environment, but with extremely accommodative monetary policy."

Dan Belton:

Yeah, I took his comments about inflation to be, in some sense, getting ahead of the fact that, yes, headline inflation will jump once we get to March because of the base effect. And he doesn't want the market to take that as a type of inflation that's going to start to run away from the Fed. Because, I think as we've talked about, that's one of the biggest threats to ongoing monetary policy accommodation, is if the Fed does see sustained inflation, that they're going to have to start to deal with. And Chair Powell was essentially saying that that's not coming in the near term. And so we can keep being accommodative. And he's applied that also to the potential for more fiscal stimulus. He said that that could be inflationary, but that would be a welcome type of inflation to get.

Dan Belton:

And back to the point you made about the Fed being stuck in a corridor, I thought it was interesting how, I think it was on a follow-up question, he was asked about the Fed's ability to stop these policies once it's time to do so. And he said that, "Yes, we've done it before, following the financial crisis. After we increased the balance sheet, we shrank it last time. And we learned some lessons about that, to do it in a gradual and messaged way." And I think that there's kind of a lot to unpack there, but first, it seems to me he's alluding to the unwinding of QE3, where they tapered by about 10 billion per month until they stopped purchases and then let the balance sheet remain constant at its peak. He also talked about shrinking the balance sheet. They didn't get too far in shrinking the balance sheet after QE3. So I think it's going to be an ongoing topic of debate of how far the Fed, if and when they do start to normalize down the road, how far they're going to be able to go with that.

Dan Krieter:

I made the same not while I was listening to the press conference. He says, "We increased the balance sheet and then we ran it down." And in my head, I was like, "Did you decrease the balance sheet? I know they did a little bit." But for me, it goes back to the last press conference, when Chair Powell was asked the question, I forget the exact words, but to the effect of, "Is it a foregone conclusion that the Fed is now having to buy Treasuries?" And he said, "It's not a foregone conclusion."

Dan Krieter:

I just think the Fed is going to have to be around. I don't know how they'll ever extricate themselves from this. And that's before we get the massive Treasury supply that's coming this year and next year to fund these stimulus programs. It's just going to be an extremely, extremely long road. And we're at the second inning, if we're even there yet. So I think some of these conversations are a little far into the future. They touched on taper tantrums. I think there was a specific question on taper tantrums, talking about extrication of the Fed. Those are big, huge questions that are going to have to be answered in the months and years ahead. But I don't think, for right now, that's what the market should or even is focusing on. We should acknowledge it as we-

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Dan Krieter:

... Or even is focusing on. I mean, we should acknowledge, as we record this, equities are having their worst day since October, I think. Certainly the worst that I can remember in the most recent history.

Dan Krieter:

So what's going on in equities today? Is the market reacting negatively to the Fed? I don't think so. I don't think he could have been much more dovish than he was. I mean, he did recognize some things we sort of already knew; bars restaurants at 400,000 jobs are lost. These people are at risk of permanent displacement. Even in the statement that economic growth is moderating now. All stuff we sort of knew. I mean, I think he was about as dovish as you can be while at least acknowledging the realities of what's going on.

Dan Belton:

Yeah. I had a similar read. I think it's easy to conflate dovishness with having a negative outlook on the economy. I thought he made some comments that were pretty negative.

Dan Belton:

First he said that the pandemic still provides considerable downside risks, nothing particularly groundbreaking there, but I think that could be explaining some of the equity markets weakness. He also played up the uncertainty and the amount of time that the recovery is going to take, saying that we're a long way from a full recovery. So yeah, again, nothing groundbreaking, but still I think highlighting some of these risks and as we've talked about in the past, risk assets have typically underperformed during Chair Powell's, FOMC press conferences since the pandemic and this to me is just a continuation of that trend.

Dan Krieter:

If I were to try to make the case that risk sentiment has turned lower since the Fed's meeting, I think that I would focus on what you began this conversation with, which was what seemed to be a spotlight on financial stability. Whereas in previous press conferences, and we do a podcast episode like this after every one of them, there's like a throwaway question, maybe one on financial stability and a lot of times Powell will give a vague answer and they move on.

Dan Krieter:

This one was about financial stability from the get-go and I think the first question was on GameStop, or game stock, as they kept calling it throughout the press conference, which I for some reason found funny, but it was about GameStop and I think that there's some truth to this fear that GameStop and Bitcoin, not in the last week or so, but up until very recently, GameStop has literally asset prices going higher without any fundamental justification for it. And I get that the stock market sell off today might be more technical in nature that we have to close out our short positions, or there maybe margin calls, or whatever it is. And so maybe this is just a tactical move lower as these, whatever you want to call Reddit, pressuring shorts are closed out, but is that in itself, not an indication of potential asset bubbles that people are trading this way.

Dan Belton:

Yeah. I think that certainly is one interpretation of it. There are some parallels that people have drawn to the dot-com bubble on the back of what we've seen in certain stocks this week. So I think you could certainly make that argument, yeah.

Dan Krieter:

Given this focus on financial stability, I don't think we actually mentioned this in our first pass on the topic. What I highlighted is the most important portion of that press conference was that after Liesman's first question, I think he followed up by saying something like, "Will the Fed ever adjust policy to deal with asset bubbles," or however he worded it, a decrease in financial stability? I thought that was the most important question that was asked because really at the end of the day, all of these questions are on financial stability. What really needs to know is, is the Fed actually going to change their policy as a result of a decrease in financial studies.

Dan Belton:

Yeah and what Chair Powell said there and what I think has been the longstanding view at the Fed is that monetary policy is for the economy, it's for job growth and inflation control, but they have other tools that they can use for financial stability. Specifically, they have macroprudential tools that they would use for something like that and they wouldn't necessarily raise rates because they feel that a bubble is forming in some asset class and I think that's the way that this Fed is going to continue to operate. So I don't expect them to start to use monetary policy to respond to potential asset price inflation.

Dan Krieter:

And that's probably the most important takeaway from everything the Fed talked about today. To me, that's the number one takeaway. Like, yeah sure, we can change regulations. We have macroprudential policy. Other people can regulate the non-financial sector, like he talked about all those other possibilities. He didn't say we will never do it. He said we wouldn't rule it out, but it's something we don't want to use. We've never done it. We don't envision it.

Dan Krieter:

Bottom line; Fed's not going to adjust their policy in any way because their asset bubbles and that's even if they see them. He didn't even go so far as to say he did. He said it was sort of moderate today. So at the end of the day, Fed's not going to change their policy anytime soon and for me, that means the music can keep going. Whether or not valuations make sense, it's a personal opinion, but I think that the Fed, into the extent that Fed liquidity plays into things, it's going to stay there and that maybe steers the conversation towards corporate bonds a little bit more directly, because I think corporate bonds were referred to directly as a bubble at one point in the press conference and Chair Powell addressed them.

Dan Krieter:

He said, "They're sort of tight," and he said, "We don't really have any control over that, but you can sort of view it as a good thing," he said, "Because that means these companies stay in business, these companies are able to access capital markets to keep their workers at work."

Dan Krieter:

So credit spreads are very narrow. We've talked about that a lot. Our expectation is for them to continue narrowing, even though I've hit a bit of a rough patch here. I don't see any major change to that view. In fact, it's sort of been reinforced by the chairman, although like you said, there is more emphasis, there is more concern, over asset bubbles at this point.

Dan Belton:

Yeah, absolutely. I think that's the biggest takeaway I had from today's press conference and it's not surprising, but the market narrative, I think has decidedly shifted to market participants, watching for the potential for asset bubbles in various sectors of the market.

Dan Krieter:

So, does that change your view on being bullish credit here? Do you think maybe that saps some of ability for spreads to keep narrowing or do you keep your view in place?

Dan Belton:

No, it doesn't change my view. I think there's other pockets of the market where the potential for asset price inflation could be reversed, but I think credit stands out still as you know, not unattractive relative to other classes. So, I remain bullish on credit spreads, at least in the medium term.

Dan Krieter:

It goes back to that, it's all relative argument, that I think we talked about last week. Like, okay, you don't like corporate spreads, so what are you going to do? Go to equities? Those are even more overvalued, high yield, very narrow. Or you're just going to sit in cash? Like it's a relative situation and credit spreads still look relatively attractive in our view.

Dan Krieter:

So I don't think any, any changes to the view there. Why don't we just touch on one more point here with the Fed. Chair Powell was asked a question on 13(3) facilities, expected to expire on March 31. And I wrote down facilities were successful. I put, were in quotes in case that was somehow implying that he was referring to them in the past tense. Turned out really not to be the case. He just meant at the time of the crisis, those were extremely instrumental in keeping credit flowing and keeping the plumbing of the financial system clear.

Dan Krieter:

He basically just didn't really give an answer. He said, they're going to continue to monitor financial conditions and if there is an emergency, facilities will be available. So just saying, no matter what happens on 3/31 or afterwards, and also in reference to the facilities that have already been allowed to expire, we can bring them back if they need to and then he just concluded by saying that we haven't had any meetings with Treasury. He sort of really harped on the fact that they haven't met yet.

Dan Krieter:

I mean, remember though that the facilities that expired on December 31st, Treasury really made that happen because Treasury invests in those facilities and Mnuchin said that they were no longer to invest in those. So, that wasn't necessarily the Fed's decision to make those facilities go away. It was driven by Treasury and sort of trying to read the tea leaves here, he says we haven't had any means with Treasury yet, which implies to me that he wants them to keep going, unless Treasury doesn't desire that if he thought that they should end, he'd just say, "Yeah, we don't think we need them anymore." Instead he said, "We haven't really talked to Treasury yet." That's obviously my conjecture. Any thoughts on that?

Dan Belton:

Yeah. Well, I think in general, a Fed Chair is going to have the preference to keep around these facilities, particularly in a time when there is this economic uncertainty. Whereas, the Treasury Secretary has a little bit of a different mandate in terms of protecting taxpayer dollars and I agree with you that I think Chair Powell probably would prefer to have these facilities around, but at the end of the day, it's probably not his call and I wouldn't be surprised to see them expire at the end of March.

Dan Krieter:

I wouldn't be surprised either. I agree with your general assessment of the situation that the Fed may be more willing to have them. I mean, I think it's also fair to say that Yellen will be more willing to keep them around than Mnuchin was. It's hard to think it matters too much either way here.

Dan Krieter:

The one maybe that might actually end up being the most important thing to set to expire on March 31st, is the temporary exemption that Treasuries were granted in terms of leverage calculations for the big banks. We've talked about massive Treasury supply a couple of times. If that exemption is taken away and suddenly Treasuries now are entering back into the calculation for leverage for most banks, that would increase the concern over where are all these Treasuries going to go?

Dan Krieter:

So that's probably a conversation for a different day. Actually, I think we're talking a lot about Treasury supply in our cross sector market podcasts that we're going to be doing next week with the whole team. So look out for that next week, for more in-depth conversation there.

Dan Krieter:

All right, Dan, well, before moving on, any of thoughts on today's Fed meeting or the press conference?

Dan Belton:

No, I think that pretty much covers it for me.

Dan Krieter:

All right. Well then before signing off today, I did want to at least touch on possibly the most exciting topic in the spread market in the past week or so and that is that swap spreads are actually moving a little bit, at least more than they have for the majority of the post-crisis period.

Dan Krieter:

Dan, what's driving the widening in swap spreads.

Dan Belton:

Yeah, so we finally gotten a little bit of volatility in swap spread, it feels like for the first time, in quite a while and it doesn't feel like it's attributable to LIBOR or LIBOR really hasn't moved in months. It's been stuck in this 20 to 25...

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Dan Belton:

Really hasn't moved in months. It's been stuck in this 20 to 25 basis point range since September. There are theories that the libor cessation fallbacks have something to do with it. I don't think that's likely the case, because there's not really any new information on that front this week. Fall backs have been responsible for some of the longer term trudge, wider, and belly and long end swap spreads, but I don't think that's behind the move this week. Rather, this week, it seems to be more of a repo story. So last week, we saw a repo traded briefly negative, and then it found a little bit of footing, at least temporarily, as the GSE cash left the market late last week. But yesterday, it moved back down to three basis points, which is the lowest level since May. We've also seen fives and 10s trade special and repo. Those have been a couple of the tenors that have outperformed in swap spreads. So Dan, the question, I think, becomes what is going on in the repo market this week and last week? And where do we expect it to go from here?

Dan Krieter:

Yeah, I agree with you. I think it is a repo story. We did have ISDA’s consultation on libor cessation and just two days ago. So I guess you could make an argument that that has something to do with it. But again, they're going to make their cessation announcements probably in the weeks ahead, but there's not going to be anything new there. So the question of why now, it just doesn't make sense. Repo does seem to be a bit of a smoking gun. You talked about SOFR at its slowest print in a long time. Repo is actually quoted at and even below zero at times. So it does look like repo is the culprit. And why is repo so low? There've been a few different theories we've seen on what's going on with repo rates and where the genesis of this cash is coming, from ranging from heavy sec lender activity and Treasury repo, given elevated equity shorts.

Dan Krieter:

We've seen some theories that increased usage of sponsored repo is to blame. I think the most common one though has been this notion that GSE cash is the reason why, heavier than normal GSE cash. And for any who maybe aren't familiar, typically, we have this period in the middle of the month every month called the float period, where GSE cash is in the repo market. And it's just the time period between when GSEs receive cash from their mortgage servicers. And for those that aren't familiar, we typically have this couple day window leading up to the 25th of the month, called the GSE float period, where GSE cash is in the market. It's really just GSEs building up cash balances that they then forward on to MBS holders, in the form of principal and interest on the 25th. So there's always GSE cash in the market at this time. And repo rates always come under a little bit of downward pressure.

Dan Krieter:

Well, this month, it was reportedly heavier than normal. And most importantly, on the 25th of the month, that cash is supposed to come out of the market once they send those PNI payments to bond holders. Anecdotal reports indicate that this time, that didn't happen, and the GSE cash remains in the market on the 26th and the 27th as well. So there've been some attempts to explain this phenomenon with GSE cash remaining in the market. One popular theory making the rounds yesterday was that heavy GSE cash was the result of some proposed by the FHFA in December, that would basically require the GSEs to hold HQLA portfolios, similar to how GSE banks have to comply with LCR ratios. Now, the key difference would be that the definition of HQLA, and they don't call it HQLA, I'm just going to, for the purposes of understanding, their definition of HQLA would be even narrower than what GSE banks are allowed to use, because the GSEs would not be allowed to hold mortgages for that requirement.

Dan Krieter:

Given some pro cyclicality concerns with mortgage companies, Fannie and Freddie holding mortgages, they didn't want that. So really, the GSEs were limited to holding basically just cash, repo, Treasuries, and some unsecured bank deposits. But even those deposits were limited to just US banks and capped at 10 billion, a very small fraction of the presumptively very large GSE HQLA portfolio. So really, we're talking cash, repo, and Treasuries, which lends credence to the notion that maybe repo actually is a significant portion of this portfolio. And maybe that is why we're still seeing GSE cash. But that's not a story we believe, is it Dan?

Dan Belton:

No. So if you really dig into the financials of the GSEs, which we did, it seems like they've been compliant with this minimum, as you call it, the HQLA requirements, since at least September. So just from the Q3 financials from Fannie Mae, they said that in June of 2020, FHFA instructed that we and Freddie Mac comply with updated prescriptive liquidity requirements. We expect the effective dates for these requirements to be December 1st, 2020. FHFA requirements require us to hold more liquid assets than are required under our current metrics. And here's the important part. We estimate that our liquidity position as of September 30th, 2020 meets these new requirements.

Dan Belton:

So it seems that the GSEs were already compliant with these requirements as of the end of the third quarter. So it stands to reason that this is not a significant development, which would explain the impact on the repo market that we're seeing. And just to provide a little bit of further credence to this idea of the GSEs becoming compliant with new requirements, the discount note program that the GSEs had, used to be in the tens, and for times, the hundreds of billions of dollars, these portfolios have dropped to zero last fall and are expected to remain there. And that is, in our view, reflective of compliance with liquidity and stable funding requirements from the FHFA. And it's likely not a coincidence that these two things happened at the same time.

Dan Krieter:

It does seem like the evidence that the GSEs are already complying with these regulations, even though they're still just officially proposed, the evidence seems overwhelming. So I don't see the argument that that is suddenly why we're seeing GSE cash in the market. That's not to say though, that GSE cash isn't having any impact. I think it is. We've talked about numerous times, at least in our written work, in the past couple of months, about how uncertainty on the cash front of the GSEs is probably near all time highs, for a few reasons. There's the forbearance programs that are still going on, and the GSEs have to be sending PNI payments to bond holders that they're not getting from their services. There's also the introduction of this adverse market refinancing fee, which is basically just a 50 basis point cash fee put on any refinancings going forward, that goes to the GSEs to help try and cover the cost of some of those forbearance programs.

Dan Krieter:

You remember that fee was originally scheduled to go into effect in September, but after some industry pushback, it got delayed until December, which is typically a light closing month as people don't want to be closing mortgages around the holidays. So to some extent, January is really the first time they're getting that fee in full. But the big factor here is likely the potential that loans will have to be purchased out of GSE MBS trusts, at some point in time in 2021. That's the driver of potentially big cash balances.

Dan Krieter:

And so I'll take a step back and we'll explain this one from a high level, for anyone that maybe isn't as familiar with the inner workings of the GSEs. But basically, when the GSE buys a mortgage, they then put it into an MBS trust, and they sell a mortgage backed security to an investor, who is then entitled to the principal and interest cash flows from that mortgage. So it's helpful to think of it as basically just an SPV. The GSE takes in the loan, puts it into a special mortgage pool, and then all the cash flows of that pool are sent on to MBS holders after some servicers take their clip and things of that nature.

Dan Krieter:

Now, everyone is familiar with the concept of a pre-pay. When someone moves, or they sell their house, and they prepay their mortgage, they send the entire principle value to the GSEs, who then send that entire value onto the mortgage holder, and that's a prepay. The loan is paid off, it comes out of the trust, and it's retired. Well, a default works the same way as a prepay to an MBS holder. When a mortgagee actually goes into default, remember, Fannie Mae and Freddie Mac actually guaranteed the MBS holder their PNI. So when the GSEs see a defaulted borrower, they have to, as we say, purchase that mortgage out of the trust, which is actually just sending the MBS holder the entire principal for that mortgage. And then they take that mortgage back onto their balance sheet out of the trust. And they put it in the retained mortgage portfolio as they work with the borrower on loan workouts or modifications to try to get that borrower back to paying.

Dan Krieter:

But this is the concern for the GSEs, is the potential to have to suddenly purchase a lot of mortgages out of trust, which requires the full principal of that loan. And obviously, this comes from forbearance programs. After CARES, thousands of homeowners entered into mortgage forbearance programs, with a maximum life of 12 months. So unless that forbearance program is extended in president Biden's next fiscal stimulus, you're going to see those forbearance programs start to expire around April, May, June, of 2021. When that happens, the borrower will either start making payments again and basically go current, or they will become delinquent. And if they become delinquent, the GSEs may have to purchase those loans out of trusts in the process I just described. So if that happens, if you suddenly have a large wave of delinquent buyers who don't come back to paying their mortgage once forbearance ends, obviously, the GSEs are going to have to have a lot of cash on hand to purchase those mortgages out of MBS trusts.

Dan Krieter:

Now, looking at most recent Q3 financials, Fannie Mae and Freddie Mac combined had almost $200 billion worth of loans in forbearance programs that were more than 30 days delinquent. So you can sort of call that their risk. Obviously, not all of those loans are going to go delinquent. Probably well less than half are going to go delinquent at least right away. But the point we're trying to demonstrate here is that there's a lot of uncertainty over whether or not these homeowners are going to eventually begin paying their mortgage again once forbearance periods end. And the GSEs have to be preparing for that possibility that they do not.

Dan Krieter:

So we've seen GSE cash balances rise over 150 billion in just the past year, up to November, 2020. That's the most recent data we have. And that's probably the largest reason why. And we have no reason to think that that's going to stop in the near future. So it's true that GSE cash is likely influencing repo rates lower, but GSE cash balance have been high for months now. It's not some magical thing we've reached in January, 2021, that suddenly the market is overwhelmed with GSE cash. That's not it. GSE cash is just one symptom. There's also, in a financial market, just a wash, in central bank-

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Dan Krieter:

Symptom there's also in a financial market, just a wash in central bank reserves. There are many market participants that have to invest in government collateral to shorten the GSEs are just one, but then you have all your money market funds, the banking system, it's across the board. You have a lot of demand for short and treasury collateral, and that cash is just overwhelming the amount of collateral there is now. And the collateral side is important to comment upon as well. Just looking at T-bills. In the past six months, we've had negative 240 billion in net supply and BMO's repo desk notes this morning that the calculation basket that's released by the fed that underpins their tri-party general collateral rate ends the SOFA rate both have fallen significantly recently and the SOFA basket actually fell to its second lowest level since October. So we just have an imbalance where cash in the financial system is outnumbering collateral on the financial system.

Dan Krieter:

And the GSE cash trade we just went through is one of the reasons why, and the important takeaway here is that GSE cash, it's probably not going anywhere. Neither is a lot of these other sources of cash looking for short-term investments. It's going to stay there, which implies that in the short-term, repo rates don't necessarily have to come back up to where they were prior to even just a month ago, they could stay low and swap spreads could stay high, at least in the very near term. But if we look further out to the medium and long-term, it doesn't appear to be as much of a concern.

Dan Belton:

Yeah Dan, I think looking on to the medium and longer term, there's reasons to expect that this is going to be a short lived phenomenon even if it's not just a calendar based thing, like you mentioned. So first of all, the repo and fed funds stay at the bottom end of the Fed's target range. It's possible that the fed does a five basis point IOER tweak higher as they've done many times in the past, but also I think more likely the natural longer-term solution is going to be treasury issuance. We're going to have a flood of treasury supply come in 2021, and we're expecting about 1.7 trillion after fed purchases if fed purchases don't increase in conjunction with the heavy treasury supply. That will more than solve the lack of collateral problem. And I think it's a reason to expect that over the longer term, swap spreads are going to normalize from these levels.

Dan Krieter:

So high level, I guess, altogether, I agree with you. I think that we could see some near term upward pressure on swap spreads. In the very long-term, these are probably going to be attractive sale levels, particularly in the belly where spreads have actually performed their best, as you said earlier, because that's where repo rates have been special. It may not be a coincidence that we had a five-year auction yesterday, five-year repo rates no longer being special and five-year spreads narrow over basis points so far today.

Dan Krieter:

So I think looking at some of those points along the curve that have benefited from special repo rates in particular, these might be attractive sell levels ahead of all the treasury supply that's coming later in the year.

Dan Belton:

Well Dan I think that basically wraps up this episode of Macro Horizons high quality spreads. We'll be back in two weeks. Next week, we have our monthly cross-sector podcast that supersedes ours. We'll be talking about some of this heavy treasury supply and what it might mean for various asset classes, including credit spreads. So look out for that. We'll be back in two weeks, and as always, thanks very much for listening everybody.

Speaker 2:

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