First Trust
Monday Morning OUTLOOK

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Repo Turmoil

In Ronald Reagan's famous *A Time For Choosing* speech in 1964, he said "…the more the plans fail, the more the planners plan." We were reminded of this recently after pundits freaked out when the New York Federal Reserve injected reserves into the banking system to keep some short-term rates from rising.

A few things to keep in mind:

1) The jump in the overnight repo and federal funds rates was at the "tail" of the market. Most trading in the market was "normal," with average rates rising just a little, but some small amount of trading went off at a higher bid. In other words, this was NOT a serious system-wide shortage of reserves.
2) The reason most trading saw little impact is because there are $1.4 trillion of "excess reserves" in the banking system. So, contrary to much of the press coverage of this issue, the NY Fed repo operations were not due to a shortage of reserves.
3) The actual amount of reserve operations, somewhere between $45 and $75 billion per day, is well below the level of daily trading in reserves in previous decades. During the 1990s, for example, $150-250 billion in federal funds traded each day. In the 2000s, it went above $300 billion.

The recent turmoil is because two things have changed since 2008 that have created new problems for the banking system and the Fed. First, the Fed decided to stop managing policy like it used to. Second, new banking regulations have created liquidity problems in the banking system even when banks have ample capital, liquidity, and profits.

Central banks used to add and subtract reserves in order to stabilize overnight rates. Now, central banks globally have injected massive amounts of excess reserves into the system and attempt to manage those reserves by moving interest rates directly. Excess reserves are potential money supply growth, and the Fed believes it can simply pay banks to hold those reserves, avoiding inflation. In Europe and Japan, central banks are trying to use negative rates to "force" banks to lend. In other words, central banks have upped their influence over the banking system through control of even more assets.

At the same time, post-2008 banking regulations have handcuffed banks in significant ways. Central banks may have injected massive reserves, but they then offset this by forcing banks to comply with the Liquidity Coverage Ratio (LCR), which forces banks to hold enough liquidity to last a month in a significant financial and economic crisis scenario where unemployment climbs to roughly 10%.

The result? In spite of excess reserves in the system, banks can still run into liquidity problems even when they are in great financial shape.

This leaves the Fed with a dilemma. Will they relax these overly strict rules, even during short periods of stress, or will they use the repo craziness of recent weeks to justify even more Quantitative Easing?

Jerome Powell, at his press conference in September said, "I think if we concluded that we needed to raise the level of required reserves for banks to meet the LCR, we'd probably raise the level of reserves rather than lower the LCR." Once the planners fail, they end up planning and micro-managing even more. Student loan problems and the government's role in subprime loans suggests this isn't a great idea.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-30 / 8:45 am	Chicago PMI - Sep	50.0	**47.2**	47.1	50.4
10-1 / 9:00 am	ISM Index – Sep	50.2	**50.6**		49.1
9:00 am	Construction Spending – Aug	+0.4%	**+0.2%**		+0.1%
afternoon	Total Car/Truck Sales – Sep	17.0 Mil	**17.0 Mil**		17.1 Mil
afternoon	Domestic Car/Truck Sales – Sep	13.2 Mil	**13.2 Mil**		13.0 Mil
10-3 / 7:30 am	Initial Claims – Sep 29	215K	**212K**		213K
9:00 am	ISM Non Mfg Index – Sep	55.0	**55.1**		56.4
9:00 am	Factory Orders – Sep	-0.5%	**-0.2%**		+1.4%
10-4 / 7:30 am	Non-Farm Payrolls – Sep	145K	**120K**		130K
7:30 am	Private Payrolls – Sep	125K	**105K**		96K
7:30 am	Manufacturing Payrolls – Sep	4K	**-4K**		3K
7:30 am	Unemployment Rate – Sep	3.7%	**3.7%**		3.7%
7:30 am	Average Hourly Earnings – Sep	+0.3%	**+0.3%**		+0.4%
7:30 am	Average Weekly Hours – Sep	34.4	**34.4**		34.4
7:30 am	Int'l Trade Balance – Aug	-$54.5 Bil	**-$54.5 Bil**		-$54.0 Bil