Money Market Fund Yields & the Repo Market

On Tuesday, September 17th, money market fund yields spiked as overnight repo rates surged higher in response to a combination of factors, prompting the Fed to inject liquidity via an open market operation. In response, yields across the Schwab Prime Money Funds and Schwab Government and Treasury Money Funds experienced a temporary spike consistent with the increase in the overnight repo rate. The rate increases the Schwab Money Funds experienced were not unique, falling in-line with what we saw across the entire domestic money fund market. Following the Fed's open market operations the overnight repo market immediately stabilized and is now trading at typical market levels. Conducting open market operations is a tool the Fed employs from time to time to control short term funding rates.

Here is a brief recap of the events leading to the change and the implications to money market fund yields and the repo market:

Causes:

The main driver appears to be the significant decline in bank reserves ("cash"), making banks more reliant on obtaining funding from the repo market.

- Reserves have been steadily declining since the post-financial crisis highs of approximately $2.8 trillion, to the September level of approximately $1.4 trillion.
- At this level, reserves appear to be very close to the minimum required to meet bank regulatory and liquidity needs, making them unwilling to draw reserves down further for intra-day cash needs.
- The amount of securities in the market that needed to be financed exceeded the amount of cash available to finance these securities.

Market Rates:

Repo rates rose to an average of 2.42% on Monday September 16th from an average of 2.20% the week prior. On Tuesday September 17th overnight repo rates spiked to 5.50%.

- In response, the Fed conducted open market operations. The use of open market operations successfully provided stability to the repo market, with rates returning to more normalized levels.
    - The Fed continues to conduct daily open market operations and will do so through January 2020.
    - Prior to the spike in rates, the average overnight repo rate had been 2.14%.
- On October 8th, Fed Chairman Powell announced that the Fed would address the low level of reserves more directly, through the purchase of Treasury bills to add reserves to the banking system. This has added additional stability to the repo market.

Implications / Market Updates:

- The spike in rates was short-lived
    - The rate spike was not driven by a credit event rather, it was a technically driven supply / demand imbalance in the market, which allowed the Fed to quickly and effectively provide stability to the repo market.
    - On October 15th the Fed began their bill purchasing program starting with at an initial pace of purchasing $60 billion in Treasury bills and to a lesser degree, Treasury coupons per month.
    - Going forward, monthly size and auction schedules will be released on the 9th business day of each month. Purchases will continue through Q2, 2020.

    - This program has placed downward pressure on short government rates with Treasury bill rates down ~5 basis points since purchases started.
    - The Fed's purchase of Treasury bills has also provided additional stability to repo rates as reserve levels have slightly increased.
- Steps to address the volatility more permanently include a potential standing repo facility to make reserves more readily available and to function as a ceiling for rates in the repo market.

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