What Is Looser Than Loose?

The Repo Market Signals A Declining Demand For Funds

If, as the late Jacqueline Susann wrote, once is not enough and the even more late James M. Cain established the postman always rings twice, does this mean Ben Bernanke will write a steamy tell-all entitled "To Ease In Threes" following the long-anticipated but yet-to-be-consummated introduction of QE3? I hope not, but then again I did not imagine on a sultry morning back in August 2007 that a surprise 50 basis point rate cut prior to the opening on an option expiration day would lead to three and one-half years of near-zero short-term interest rates and a $2 trillion expansion of the Federal Reserve's balance sheet. Yes, we have passed through to the other side of midnight and if it is wrong, I do not want to be right.

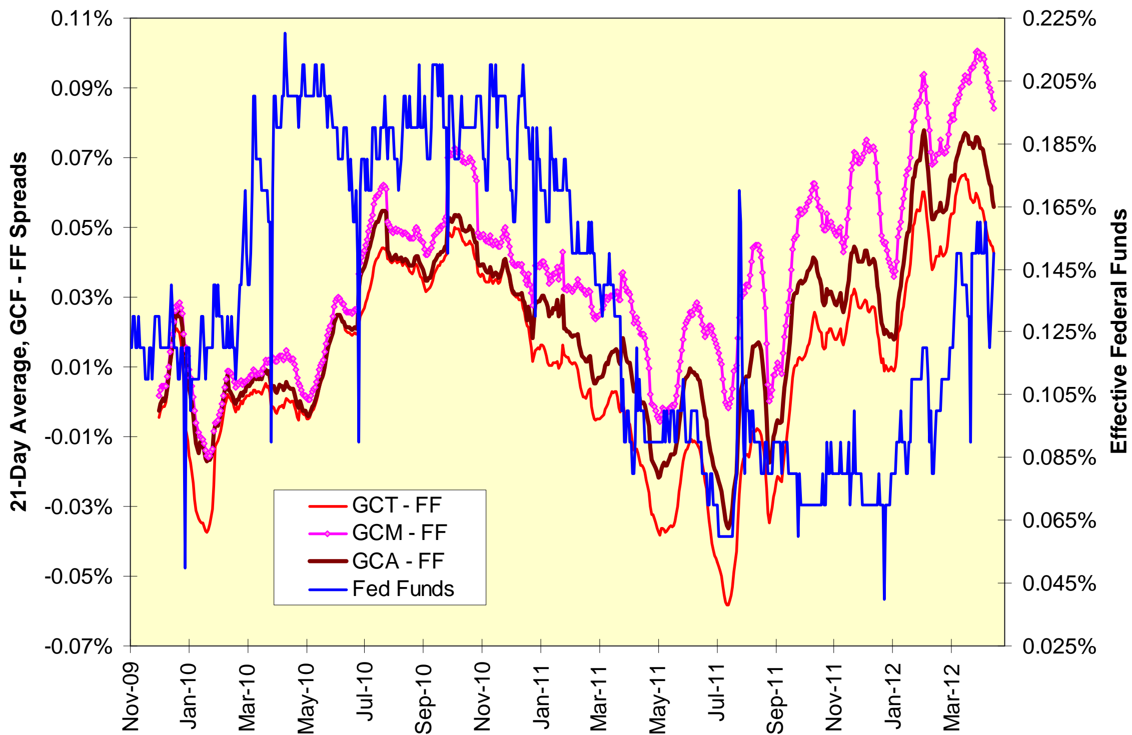
General Collateral Repo Financing

I can turn up the dial on Wall Street's version of the bodice-ripper any time I want just by mentioning the subject of general collateral financing (GCF) repo rates. These are tracked and indexed by the Depository Trust Clearing Corporation for repurchase agreements on Treasuries, Agencies and mortgage-backed securities. Real repo men work for auto lenders; these repo men finance operations by pledging securities and then repurchasing them at a higher price at a later point in time, often the next business day. Like other hot-blooded activities, you can repo in reverse.

These repo rates increasingly are driving short-term financing operations as the federal funds market lapses into desuetude: Banks are over-reserved courtesy of the Federal Reserve's Operation Strasbourg Goose, and the simple introduction of paying interest on those excess reserves back in October 2008 eliminated the need for trading around the day's open market operations. If we add a few regulatory speed bumps such as the FDIC's liability-based fees and the Basel III credit valuation adjustments and toss in the diminished credibility of LIBOR in interbank operations, we find the GCF repo rates are emerging, Fabio-like, as the last man standing.

Spreads Tell The Tale

The effective federal funds rate has been struggling and heaving around the midpoint of its target range since the GCF indices began in November 2009, but if we are willing to over-analyze its minor undulations we can see how it declined between QE2 and September 2011, only to rebound into March 2012. The GCF spreads fell and rose alongside it, signaling a declining and then an advancing demand for short-term funds. Those spreads have been declining since the reignition of the Eurozone's sovereign debt problems in March even though the underlying federal funds rate has remained firm.



As those spreads have been declining in the one short-term interest rate market with active trade, the implication is availability of funds is overwhelming demand once again. Restated, we have a de facto loosening of monetary policy and are now living in a world looser than loose regardless of whether QE3 arrives or not.

The conclusion here is what is has been for the better part of three years: The excess money will find its way into risky assets and do almost nothing for the real economy. Those who buy will be rewarded; those who sit on the sidelines bellowing this is wrong will get good pulmonary exercise.

Finally, futures on these GCF indices will be launching in June on NYSE Euronext (NYX). These will provide an excellent way for you to track and participate in this market.