Answer first: The bid side of the term repo market, particularly for Agency MBS and non-Agency MBS securities, seems to be tracking LIBOR, which is continuing to move higher. By contrast the offer side of the repo market seems to be tracking OIS, which has bull flattened. However, we think that trend will reverse, and bids will come back to levels seen prior to debt ceiling crisis.

Much of this widening can be explained by fear factors changing the dynamics of supply and demand in the term GC markets. Overnight spreads between GC Treasuries and GC AGCY MBS have remained relatively stable with the one notable exception in early August at the climax of the debt ceiling debate where mortgages widened from an average of 3bps to 12 bps. This widening quickly subsided and we are back to the long term norm in the O/N market. But this may have been the proverbial straw that broke the camels back and cemented liquidity fears amongst leveraged MBS portfolios, cash investors in repo markets, and managers of matched book repo portfolios. "Hot money'" or cash from money managers pulled back from the repo market during the debt ceiling debate and moved into bank deposits, causing a degree of fear for repo desks managers, about losing liquidity. Levered portfolios were looking to lock in liquidity to protect against any further funding disruptions.

As a result, a more drastic dislocation has shown up in the term repo markets for Agency MBS versus US Treasury GC and OIS. We have heard and confirmed with several dealers, who were previously running mis-matched repo books (buy in collateral on term, lend o/n) that they are now being told to match-up all funding. This has caused a premium for term funding and has resulted in a rather drastic widening of rates between o/n and term, in particular, for Agency and non-Agency mortgages.

Some other observations that may have led to this term premium:

- European crisis and pressure on European banks: As the crisis has gone on over the summer, and as it has expanded from Greece and Portugal to Italy and Spain, investors have been more reluctant to lend cash to European banks. Some examples are the shortening of CP tenors issued by European banks and money fund redemptions out of prime funds (credit risk) with inflows into government-only money market funds. Since the beginning of July, Prime funds have had net outflows ($52B) and Government-only funds net inflows +$22B(source: iMoneyNet).
- Debt ceiling crisis: As the standoff got closer to D-day, money funds did something that they were unable to do in the past. Money funds pulled cash away from the repo markets and parked their cash at the bank, where now under Dodd-Frank they receive an unlimited amount of FDIC guarantees on non-interest bearing accounts. Indications are that most of the cash has come back but the speed at which the money left and the fact that money funds were willing to earn 0% with bank deposits woke up repo desks to this new wrinkle.
- S&P downgrade: Although widely expected (and supposedly priced in), this event more than anything else is what sent accounts scrambling to quickly fund for longer. The downgrade was on US treasuries, but in the end, treasuries still became the flight to quality bid that they have always been. Add to that a couple of nasty articles in the WSJ implying that haircuts would increase, and you essentially have your fear factor pushing accounts to fund for longer. Well, haircuts didn't increase… Why? The explanation for that is in the following piece from July 29,

2011 release:
http://www.avmsolutions.com/Repo_Market_Insider_110729_Fallacy_of_Rising_Haircuts.pdf

- Mortgage REITs (leveraged players) continue to raise capital and finance collateral that may not have been previously on dealer balance sheets. It is also possible that the mortgage REITs are aware of the same funding issues and have been looking to term-up more of their holdings.
- 3M Libor, a traditional proxy for term MBS funding, has been backing up (6bps since 8/1). 1M Libor has also increased, but only by 2bps over the same time period.
- Dealers with little internal funding that rely heavily on inter-dealer market funding got hurt during the few spikes in overnight funding in the week leading up to the debt ceiling showdown. With o/n backing up through the 30's and into the 40's and 50's, they started hitting term bids in the inter-dealer markets and getting funded wherever they could.

What does this all mean for Agency MBS repo?

Term bids at times can be inelastic, but given that overnight Agency MBS averaged 10 bps last week and it's getting closer and closer to zero this week, it stands to reason that the term bid will also come in. The question is when… We finally saw signs this week that things might be loosening up. The feeling here is that when it all shakes out, 1m Agency MBS repo bids will settle in a few bps above the lows seen in July, probably somewhere around 0.23% – 0.25% at some point in the next month. For the time being, we would prefer staying on the short end of the repo curve avoiding what we see as expensive premiums for term repo.

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