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Specials, Remember Those?

We have fielded several calls from clients about yesterday's Bloomberg article "Bond Anxiety in $1.6 Trillion Repo Market as Failures Soar." For the most part, we feel the article exaggerates the extent of the failures and the media continues to paint repo with a negative connotation. This was more a quarter-end story than anything else, although the results are a prelude of what to expect going forward. Given that most banks will begin to disclose their SLR ratios in quarterly earnings (not actually required until Q1 2015) and that starting in Q3 2014, banks subjected to the Fed's Comprehensive Capital Analysis Review ("CCAR") test will need to report balance sheets as daily average, rather than monthly average. Given these changes, we expected to see a particularly tighter quarter-end on June 30. In fact, the repo market handled the most recent quarter end rather well, maybe due to the fact that everyone is now micro-managing balance sheets and there are fewer surprises as a result. Yes, there were greater than normal repo fails on a few issues for a few days in June, but in general, the quarter-end came and went rather quietly and we have already seen cheapening in securities post quarter end.

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This is a supply issue:

- Fed is only buying issues >4yr maturities and does not buy issues that are trading special, hence the Fed did not have any supply to lend to dealers via their SOMA securities lending program during this most recent run on 2s/3s/5s/10s.
- Regulatory pressures can be blamed for the increased repo volatility caused from supply shrinkages:
  - Banks are not as willing to lend securities as it grosses up balance sheets.
  - Increased scrutiny on the Securities Lending business model from Shadow Banking reform.
  - Increased needs to hold treasuries (high quality liquid assets) by non-lending accounts to meet certain regulatory ratios.
  - Basel III and Triparty Repo Reform pushing cash investors to demand US Treasuries on repo.
  - MSRB new rules curbing lending from municipalities to broker dealers.

What we expect going forward:

- On-the-runs should richen in repo relative to off-the-runs.
- Increased volatility in repo specialness. Although repo specialness in general has been quite dormant under the ZIRP/QE regime.
- More extreme quarter end repo specialness due to regulatory pressures on supply.

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