Rodney's Take

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Today, Repos Show Cash Is Trash

As I wrote in the June issue of *The Rodney Johnson Report*, the Fed offers institutions with cash the opportunity to invest the money overnight through repurchase agreements. In such transactions, the Fed or anyone else with Treasury bonds sells the securities for one night, with a preset agreement to buy them back the next day. The price of the transaction is expressed as an annualized interest rate. Today, institutions that buy bonds from the Fed in the overnight repurchase (o/n repo) market will earn an annualized interest rate of 0.05%. Amazingly, the Fed set the rate *higher* at the last Fed meeting, moving it up from 0.01% to 0.05%.

While the o/n repo market has existed for decades, the Fed began offering securities in the o/n repo market in 2013 as a safety valve in case the cash market seized up when too few securities were offered, which has happened from time to time. Before this year, Fed repos peaked at about $480 billion, even though the outstanding balance was minimal most of the time. At the end of June, investors placed $990 billion with the Fed through repos, which showed the tremendous demand among investors to put their cash somewhere, anywhere, overnight that offered a positive yield, as well as a lack of securities available in the market.

Any bond can be purchased or sold in the o/n repo market, as long as the two parties agree. Institutions that hold 2-year, 10-year, or even 30-year bonds can sell them as if they are one-day securities. The repos are still backed by the U.S. government; they "mature" in one day per the repo contract and pay the buyer 0.05%. Most o/n repo agreements are

automatically renewed, which turns these one-day transactions into much longer arrangements that still earn the measly 0.05% annualized interest rate.

Think about that for a minute. As an institution, if I buy 10-year Treasury bonds at 1.4%, I can sell them to someone else at 0.05%. I then earn the spread of 1.35% between the two annual rates, and I have the original cash back in hand to invest. That's a deal!

This situation gives us some idea of why anyone would want to buy 10-year Treasury bonds at 1.4% at a time when inflation is at 5% and GDP is expanding by an estimated 7%: so they can repackage the bonds as overnight securities, sell them at 0.05%, and keep the spread. In a perverse way, the Fed is holding down rates on two fronts, by purchasing bonds in the open market and by creating so much cash that we're running out of places to put it, giving Treasury bond owners the ability to repackage long bonds as overnight securities and sell them in the o/n repo market.

The fact that institutions placed almost $1 trillion with the Fed through o/n repos at the end of June and still have more than $780 billion outstanding today shows that there aren't enough private institutions holding Treasuries that will offer them in the o/n repo market to satisfy demand from money market funds and other institutions that must hold very short, liquid, and safe securities. We simply have too much cash floating around with nowhere to go.

Some of the pressure on bonds, pushing yields lower and prices higher, might ease this week as the U.S. government auctions more securities, but the Fed is still buying $120 billion per month, taking bonds out of circulation and pumping more cash into the system. As long as that's the case, we can expect cash to be trash.

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