Drivers behind the benign USD funding conditions at the year-end in the FX swap market

ECB MMCG
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US Dollar Funding over year-end

In 2018 the premium for USD vs EUR (and other major currencies) over year-end touched the maximum levels much earlier (Oct/Nov) than in previous years.

The sharp widening experienced in both 2016 and 2017 in last weeks of the year probably prompted market players to cover their USD funding needs in 2018 much sooner than previous years.

In 2016 and 2017 there were specific technical factors that caused volatility in the market; in 2016 foreign banks were severely affected in their USD funding by the USMMF reform and in 2017 there was big uncertainty on US Tax Reform and possible effect of Repatriation on Eurodollar market.
The US Debt dynamics have frequently caused significant volatility in the funding market; when Treasury cash balance goes down that means that there are more US dollars in the market and easier funding conditions.

For example in Q1 2017 there was a sharp reduction in US Treasury cash balance that contributed to a significant tightening of USD Libor – OIS spread; the opposite in Q1 2018.

The US debt limit suspension until 1 March 2019 has caused a sharp reduction of Treasury balance and contributed to easier funding condition in the first part of 2019; a normalization of US debt dynamics later in the year could produce a widening of Libor-OIS in Q3-Q4 2019.
USD funding markets for foreign banks in 2018

The MMF Reform in 2016 dramatically changed the landscape of US market; Prime MMFs typically investing in CD/CP issued by financials decreased their net assets by 70% in less than 1 year, putting big pressure on foreign banks and consequently on the FX swap market.

After flattening out in 2017 with total assets just above US$ 400bn, Prime MMFs have experienced a boost in H2 2018 and early 2019.

The Trump Tax Reform in 2017 had big effects on investment strategies of US offshore corps, incentivising profits repatriation; they significantly reduced the duration of their liquidity portfolio, decreasing corporate bonds and buying more CD/CP (causing widening of Libor-OIS and tightening of FX swap basis). BEAT (Base-Erosion and Anti-Abuse Tax) was also a factor, obliging US branches of foreign companies to reduce their funding dependence from parent companies (USD borrowers via FX swap markets).

Source: Bloomberg Data

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Even if the constrains on G-SIBs still create big volatility in repo markets on technical dates (i.e. year/quarter end), it seems that aggregate amount of balance sheet available for repo intermediation is growing in the US market, especially among foreign banks.

In H2 2018, foreign banks have increased their role of absorbing MMF liquidity via repo (Govt and Agency collateral); market data are reporting significant increase for Canadian and Japanese banks.

A big boost to the repo market might be linked to the surge of FICC centrally cleared sponsored repo. FICC, a subsidiary of DTCC, has become in November 2018 the number one counterparty for repo trades backed by US Treasuries, largely used by foreign counterparties.

For the first time SOFR daily volume grew over US$ 1trillion in early Jan 2019.