# The plumbing of the capital markets is clogged. The Fed is still working to fix it

By Matt Egan, CNN Business

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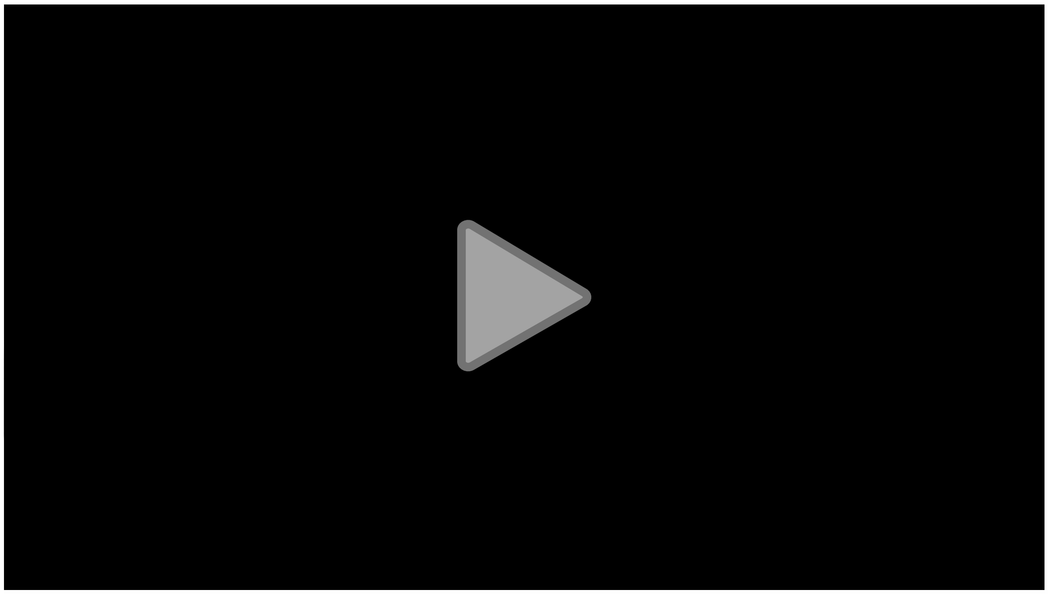

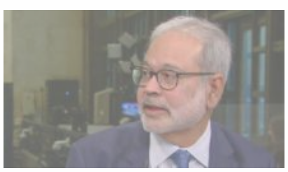

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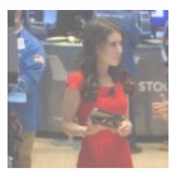

Strategist: M can't absorb war escalati

**New York (CNN Business)**Mayhem in obscure markets, massive Federal Reserve rescues and a mystery over the cause. The cash crunch that emerged in overnight lending markets this week brings back bad memories of the 2008 crisis.

The stress in the overnight lending market, a critical corner of finance that rarely makes headlines, forced the New York Federal Reserve to pump $75 billion into the banking system on Friday. That marks the fourth-straight day of emergency actionfrom the Fed, a level of intervention unseen in more than a decade.

And this is just the beginning of the Fed's efforts to ease the cash crunch.

The NY Fed announced Friday it will inject up to $75 billion into the overnight markets each weekday until October 10. In addition to this short-term capital, the NY Fed will pump in as much as $90 billion through three 14-day operations.

**This can become a confidence issue quickly."**

BILL CAMPBELL, PORTFOLIO MANAGER AT DOUBLELINE CAPITAL

Yet this does not appear to be a repeat of the financial crisis, when banks were too scared to lend to each other. Today, banks are healthy — it's the system's plumbing that is broken.

The spike in overnight lending rates earlier this week set off a guessing game on Wall Street as to its cause, with everything from corporate tax payments and $1 trillion deficits to staff turnover at the NY Fed getting blamed.

Regardless of the spark, the episode reflects a liquidity squeeze--there simply isn't enough cash in the financial system. The Fed is urgently trying to fix the problem before it erodes faith in the central bank's ability to maintain order.


For a second day, the New York Fed spent billions to calm the financial market

"Currently, it's a plumbing problem," said Bill Campbell, a portfolio manager at DoubleLine Capital. "This can become a confidence issue quickly."

The sudden stress caught many by surprise because it's occurring during a period of relative calm in financial markets, outside of dramatic swings in oil prices.

"If the Fed can't maintain orderly cash markets in quiet times, what might happen during chaotic ones?" Nicholas Colas, co-founder of DataTrek Research, wrote in a note to clients on Wednesday.

## 'Carnage' in overnight market

Although it doesn't get much attention, the overnight market plays a vital role in finance.

It's a major part of the money market, made up of short-term debt that matures in less than a year. The overnight market allows banks to quickly and cheaply borrow money for short periods of time, often to buy bonds such as Treasuries.

"Overnight lending markets are essentially the plumbing of US capital markets," Colas wrote, "and the volatility over the last few days feels like walking into a luxury hotel only to find that the toilet won't flush."

The problems began Monday when the rate on overnight repurchase, or repo, agreements hit 5%, roughly double the Fed's target range.

The spike in borrowing costs continued Tuesday morning, with the rate hitting a high of 10%. That's when the NY Fed stepped in.

"Tuesday morning could only be described as carnage," Rick Rieder, BlackRock's chief investment officer of global fixed income, wrote in a note to clients on Wednesday.

Overnight borrowing rates returned to earth after the NY Fed injected $53 billion into the system on Tuesday through what's known as an "overnight repo operation." These cash injections are aimed at preventing borrowing costs from creeping above the Fed's target range.

"The fact it came down shows it's not a widespread liquidity crunch," said Zhiwei Ren, portfolio manager at Penn Mutual Asset Management. "In 2009, there was a systemic risk."

Yet overnight markets were stressed enough that the NY Fed pumped $75 billion into the system on Wednesday, Thursday and Friday.

"It's very bad optics to have to come in with emergency anything day in and day out," said Danielle DiMartino Booth, CEO of Quill Intelligence and a vocal critic of the Fed.

## Powell: No impact for the economy

The overnight repo operations on Wednesday and Thursday were significantly oversubscribed, signaling a continued cash shortage that may require still more injections. However, the operation on Friday was not oversubscribed.

Federal Reserve Chairman Jerome Powell on Wednesday acknowledged "elevated pressures" in markets but downplayed the real-world impact.

"While these issues are important for market functioning and market participants, they have no implications for the economy or the stance of monetary policy," Powell said.

There here would be serious implications if investors felt the Fed was no longer fulfilling its role as the traffic cop of financial markets.

In recent days, the Fed has failed to keep the effective Fed funds rate, which is set by the market, within its own target range. That's alarming because this is how the central bank is supposed to transmit its policy into the economy.

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>
> NICHOLAS COLAS, CO-FOUNDER OF DATATREK RESEARCH

The effective federal funds rate climbed to 2.3% on Tuesday, which is above the 2% to 2.25% range set in the late July meeting. The Fed on Wednesday cut its target range to 1.75% to 2%.

Numbers released on Thursday show that the effective federal funds rate dipped to 2.25% on Wednesday, though that is still above the new target range. This key rate dropped down to 1.9% on Thursday.

"If they lose control, that would be extremely problematic for markets," said DoubleLine's Campbell. "That's where the confidence shock can happen."

The Fed has announced a series of steps aimed at regaining control. The central bank Wednesday lowered the interest rate it pays on excess bank reserves, known as IOER, to 1.8%.

Powell said the Fed is willing to keep injecting cash into the system through the overnight repo operations. And he also opened the door to increasing the size of the Fed's balance sheet in line with the growth of currency, a tacit admission that the Fed underestimated how much cash is needed to keep the financial system running smoothly.

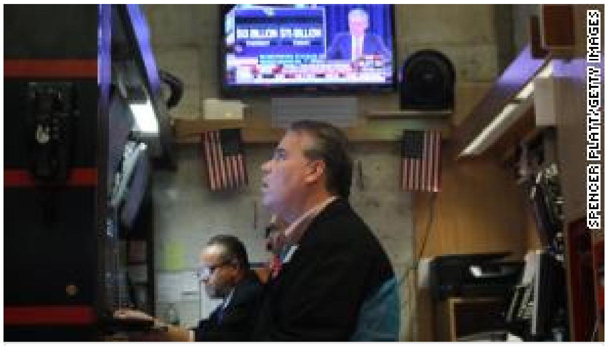
## Debate over the cause of market stress

There is uncertainty over why these market strains have emerged now. And that mystery is a bit unnerving to some.

"This is part of the market that is supposed to be invisible," said DataTrek's Colas. "This is the equivalent of having to go to three different ATMs to get your cash. You begin to wonder, 'What's going on?'"

Powell on Wednesday threw his weight behind the idea that the problems were caused at least in part by US companies withdrawing large amounts of cash from banks to make quarterly tax payments to the US Treasury Department. That forced banks to yank reserves parked at the Fed.

And he also pointed to the fact that this week a large amount of purchases of US Treasuries settled, further draining cash from the system. Those bonds were issued in recent weeks to help fund the $1 trillion federal deficit.




The Fed is cutting rates. Here's how to invest

Yet those factors were well known ahead of time, suggesting markets and the Fed should have been prepared.

Some have speculated that the market turmoil reflects the loss of key staff at the NY Fed, which conducts market operations for the central bank. Simon Potter, the longtime head of the NY Fed's markets group, left in June. The NY Fed is still searching for a permanent replacement.

Asked about the NY Fed's handling of the situation, Powell said: "I'm not concerned about that."

## How will markets hold up during the next recession?

Others argue that the market stress shows how post-crisis rules have backfired by limiting the ability of banks to provide liquidity when it's needed most.

"Mostly due to post-crisis regulation banks are no longer taking the risks necessary to keep the plumbing of the financial system open in times of stress," Philip Marey, US rates strategist at Rabobank, wrote in a note to clients.

No matter the cause, the worry is that the stress in overnight markets is part of a larger liquidity problem that will cause problems during the next recession, whenever it strikes.

"If the US economy slides into a recession, liquidity problems could pop up everywhere," Marey said. "In the worst case, it could turn a run-of-the-mill recession through a financial crisis into something worse."

And that, of course, would cause problems for the real economy, and threaten to create a repeat of the 2008 crisis.