The new front in the war against gilt market dislocations

There is a new front in the war against gilt market dislocations: the repo squeeze and short-dated gilt shortage. Pressure is building on the Bank of England and Debt Management Office to intervene on the repo market

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Problems in the transmission of BoE rates

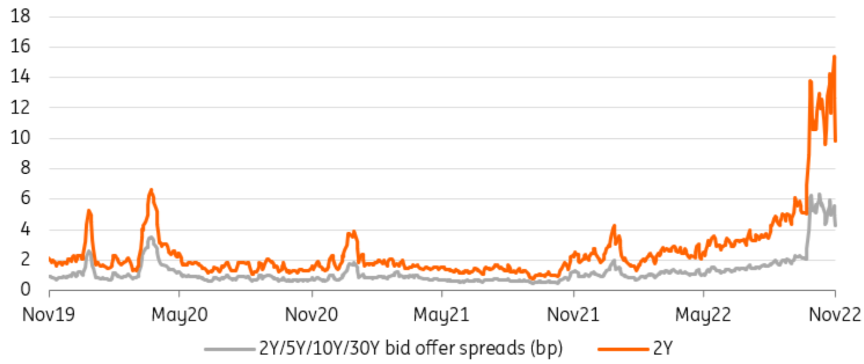
It is becoming increasingly difficult to buy short-dated gilts, or to borrow them via repurchase agreements (repo). The crisis has been brewing for some time due to increased market volatility and investors' risk aversion, but it worsened when pension funds and other market participants decided to increase their liquidity holdings in anticipation of the September/October gilt crisis. This abundance of liquidity is typically used to buy safe short-dated securities, such as gilts, or lent out against high-quality collateral on the repo market.

On the repo front, the squeeze is visible in the drop of the RONIA index, a measure of overnight repo rates, relative to the Bank Rate, now 42.5bp below. Apart from quarter-end dislocations, this is a new record. On the gilt front, this is visible in ever-widening front-end swap spreads: 2Y gilt yields are now 125bp below 2Y swaps. The results of the first BoE gilt Quantitative Tightening sale also highlighted that demand is strongest for the shortest bond on offer (3Y), reinforcing the impression of a shortage of bonds at the front-end.

> *Hikes are only partially transmitted to markets, and so to the economy*

This could become an issue for the BoE. Firstly because this means hikes are only partially transmitted to markets, and so to the economy. There is also a market functioning issue: squeezed repo and swap spreads suggest liquidity in short bonds is worsening. And indeed, we've observed that liquidity (as measured by bid-offer spreads) in short-dated gilts has been most affected by the recent turmoil, even when most of the attention was on the long-end of the curve.

Gilt liquidity is bad, but worse at the front-end



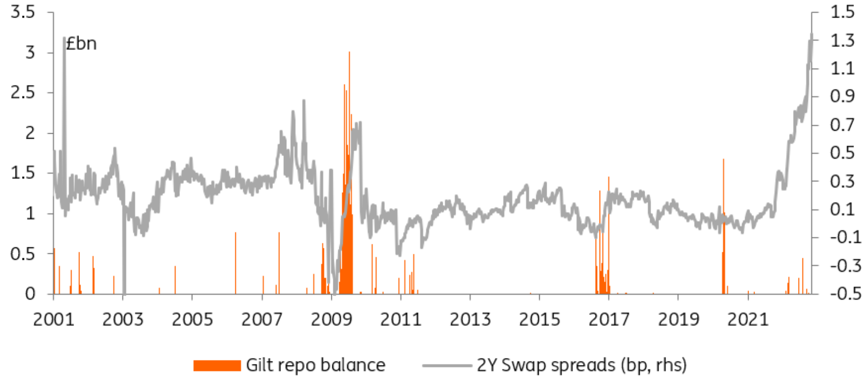
Source: Refinitiv, ING

Towards greater intervention in the repo market

What can be done about this? The DMO has standing and special repo facilities where it can lend out gilts to market participants (typically dealers, called GEMMs) on repo for a week. These bonds are most often created by the DMO for that purpose, but also sometimes made available by the BoE from its APF (QE) portfolio as was, for instance, the case in the spring of 2020 during the 'dash for cash'.

Use of these facilities has been limited (compared to the scale of the repo and gilt markets) in the past, however. The reason for this is that counterparties can typically borrow the bonds at 75bp below the Bank Rate, a punitive rate, even in light of the recent drop of Ronia (42.5bp below). The DMO may also be reluctant to create bonds on such a large scale at a time of increased market scrutiny on public borrowing.

Uses of the DMO's repo facilities is limited due to punitive pricing



Source: Refinitiv, ING

There are many long-term solutions possible, as discussed, for the Fed, SNB (Swiss National Bank), and ECB (European Central Bank) previously (reverse repo facility, creation of central bank bills etc.) but one more immediate fix is simply to make more APF bonds available to lend, and to lend them at a higher rate (say Bank Rate -10bp). Note also that Quantitative Tightening (QT) should help on the gilt scarcity front, by releasing more bonds into the market. Note however that the 'replacement' of maturing bonds is effectively done by the DMO by issuing bonds at longer maturities, so it doesn't help much. As for 'active' QT, gilt sales, the shorter maturity of the bonds on offer is 3Y.