AVISON YOUNG

DECEMBER 2019

Debt Market Monitor

Debt Capital Markets Services

What's going on with the $3-trillion repo market?

The repurchase, or repo, market is a vital part of the financial system that keeps markets running smoothly. A repo agreement is a short-term contract to sell securities – a dealer sells government securities to investors, usually on an overnight basis, buying them back or repurchasing these securities back at a slightly higher price. Repos serve two main purposes: they provide short-term capital liquidity and they are a tool used by the central bank to affect money supply and short-term interest rates. Repos have been around in one form or another since 1917. The repo market is not a bottomless pit and it is affected by supply and demand.

Recently, the repo market went through an unbalanced period, experiencing a hefty cash shortage due to significant demand which boosted rates to nearly 10% in September. For context, the repo rate averaged 2.39% from 1995 until September 2019. In order to restore liquidity, the U.S. Federal Reserve (the Fed) increased its overnight repo operations (i.e. cash injections) from $75 billion to $120 billion per day (all figures USD). Bank of America estimates that the Fed will need to undertake a further injection of $400 billion next year to maintain rates and liquidity. Some analysts are calling these injections of capital a bailout to those who are largely exposed to the repo market. Without the Fed's repo market operations, the financial markets could face a liquidly crisis that could slow or shut down lending, impacting the economy directly.

The blame for the spike in the repo rate was spread among a number of participants; however, as predictable as it may have seemed, the bump in demand for repos was largely unforeseen. The contributors to the problem include those who rely on leverage to run their operations, such as firms that finance long-term commitments with short-term debt. Others include the quarterly corporate tax and even government bond auctions. All these so-called contributors to the repo-rate spike certainly appear foreseeable and quite predictable. Peel back the onion to the next layer and some observers think that banks themselves are the culprits. Banks earn about 1.8% interest on money kept on reserve with the Fed – not just mandated levels, but also excess reserves. As a result, more than $1.3 trillion in excess reserves is collecting at least $19.5 billion in interest each month, with no risk. When repo pays 1.75% to 2.0%, banks may prefer to park all the excess with the Fed and collect the guaranteed interest. The Fed's unwinding of its balance sheet also places more stress on the natural balance in the repo market.

The repo market is the basis for much of the U.S. financial system, providing liquidity to banks so that they can meet their operational needs and minimum reserves. With $3 trillion worth of trades happening daily, it must function smoothly – and recently it has not, indicating that changes are needed. Stay tuned.

Fiscal Snapshot

Bank of Canada

	Bank Rate	Bank Prime Lending Rate
November 2019	2.00	3.95
October 2019	2.00	3.95
November 2018	2.00	3.95

Government of Canada Benchmark Bond Yields

	5-Year	10-Year	Long
November 2019	1.49	1.46	1.55
October 2019	1.42	1.42	1.50
November 2018	2.20	2.27	2.39

Indicative Commercial Mortgage Spreads* Over Government of Canada Bond Yields

Conventional	5-Year	10-Year
November 2019	1.55 - 2.00	1.65 - 2.10
November 2018	1.75 - 2.10	1.85 - 2.35

Insured	5-Year	10-Year
November 2019	0.90 - 1.10	0.85 - 1.10
November 2018	0.90 - 1.10	0.90 - 1.10

*Spreads are indicative of high quality real estate in major Canadian markets.

Source(s): Bank of Canada

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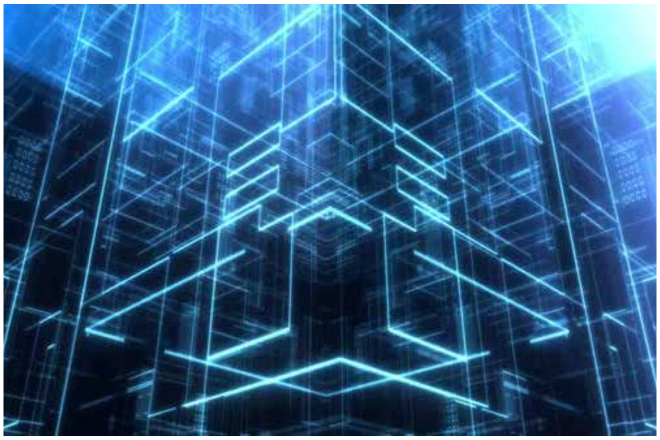
Highlighted Transaction

Asset Type	Development Land
Location	Major Canadian city
Facility Details	A demand facility for a term of 24 months in the amount of $10,000,000.

Intelligent Debt Financing Solutions



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Our years of combined debt/equity capital markets experience has created meaningful relationships that we can put to work for you.

Please contact our Debt Capital Markets team for more details related to debt financings or real estate transactions.

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