

Stress in Short-Term Lending Markets is Worth Monitoring

By: Ricci L. Reber, Ph.D.

(443) 470-8000

www.TheSimmonsPartnership.com

Ricci@TheSimmonsPartnership.com



Equity market momentum has decelerated and markets are on pace for their third down week in a row. The declines have been modest and are not yet cause for concern. **But it's interesting that this pause in equity market momentum has coincided with liquidity strains in short-term lending markets.**

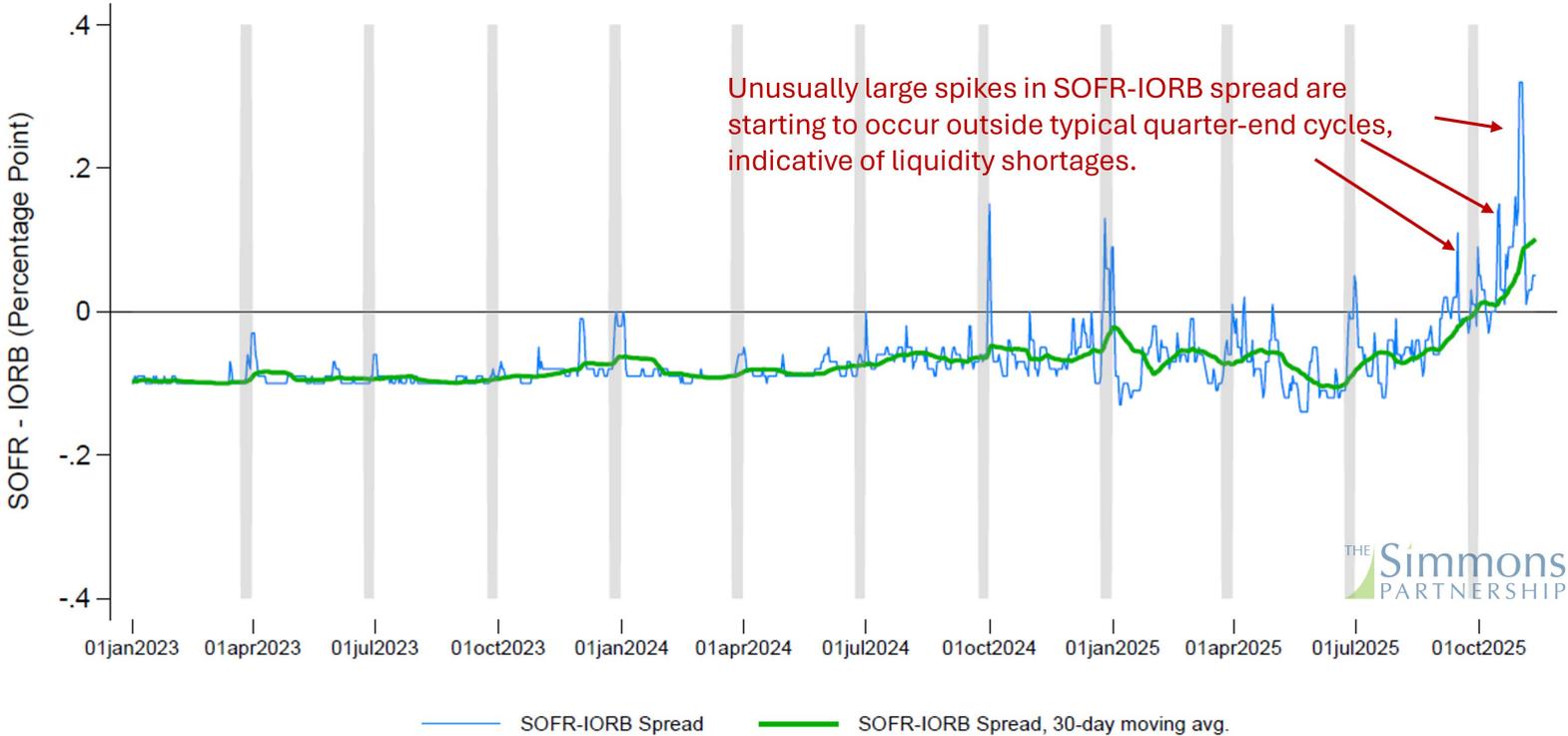
The Fed has cut rates twice since September and markets seem to be pricing in another 25 basis points in cuts in the next few months. At the end of October, the Fed also announced it would end its balance sheet runoff, also known as “quantitative tightening”—it’s policy of allowing billions in Treasuries and mortgage-backed securities to mature each month, rather than rolling them over—by December 1.

Both actions are aimed at loosening financial conditions and could be mildly stimulative to the economy and financial markets heading into the end of 2025 and the first quarter or so of 2026. In theory, Fed rate cuts should flow through to longer-term market rates, thus making mortgages, car loans, commercial loans, etc. cheaper. (Though, as I noted in a previous post, the Fed doesn’t directly control longer-term market rates, so that relationship isn’t as straightforward as you might think). Additionally, as the Fed shifts from shrinking to maintaining the size of its balance sheet, it will begin reinvesting maturing securities into Treasuries, providing additional liquidity to markets and putting further downward pressure on rates.

Still, we are seeing signs of liquidity strains under the surface that are worth watching. Take, for example, the spread (difference) between two important short-term rates: the **Secured Overnight Financing Rate (SOFR)**—a key short-term rate that reflects the cost of overnight borrowing using U.S. Treasuries as collateral—and the **Interest Rate on Reserve Balances (IORB)**—a key short-term rate administered by the Fed, which reflects the rate the Fed pays banks on their reserves held at the central bank. When market liquidity is abundant, this spread is negative—SOFR is typically below IORB. As liquidity tightens, this spread narrows. As shown in the graph below, not only is the spread now positive, but it has been expanding and trending upward since the Fed cut rates at the end of September, indicating liquidity shortages. (As an aside, SOFR is important for individual and commercial borrowers because it is commonly used as the benchmark rate against which other variable rates—such as adjustable-rate mortgages, HELOCs, credit cards, etc.—are set.)

As highlighted in the graph, these temporary liquidity events are fairly common at the end of calendar quarters (grey bars), as financial institutions take advantage of short-term funding markets to window-dress their balance sheets. **What's worth watching are the large and increasingly common spikes in spreads that are happening outside these windows, which point to more structural liquidity strains.**

Signs of Stress in Short-Term Funding Markets



Source Board of Governors of the Federal Reserve System (US), Interest Rate on Reserve Balances (IORB Rate) [IORB], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/IOBRB>. Federal Reserve Bank of New York, Secured Overnight Financing Rate [SOFR], retrieved from FRED, Federal Reserve of St. Louis; <https://fred.stlouisfed.org/series/SOFR>. Shading indicates the last week of calendar-year quarters.

IMPORTANT NOTE FROM THE SIMMONS PARTNERSHIP INC.

The Simmons Partnership Inc. ("The Simmons Partnership") is an investment advisor located in Maryland. The Simmons Partnership and its representatives are in compliance with the current registration requirements of those states in which The Simmons Partnership maintains clients. The Simmons Partnership may only transact business in those states in which it is registered, or qualifies for an exemption or exclusion from registration requirements. The attached selected materials are aggregated by The Simmons Partnership for your information only. The Simmons Partnership is not representing that the views in the attached materials are the only views on the subject matter, or that the views or conclusions depicted in the materials represent guaranteed outcomes. Many of the materials include charts or graphs prepared by third parties. These third parties prepared such charts and graphs using their own information or information they believed to be reliable. The Simmons Partnership has not independently verified either the underlying data or any of the intimated or directly stated conclusions of such materials. The Simmons Partnership does not make any representations or warranties as to the accuracy, timeliness, suitability, completeness, or relevance of any information prepared by any unaffiliated third party, whether linked to The Simmons Partnership's website or incorporated herein, and takes no responsibility thereof. All such information is provided solely for convenience purposes only and all users thereof should be guided accordingly. The distribution of the attached materials should not be construed by any consumer and/or prospective client as The Simmons Partnership's solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation. Any communication by The Simmons Partnership with a client or prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the person resides. A copy of The Simmons Partnership's current written disclosure statement discussing The Simmons Partnership's business operations, services, and fees is available from The Simmons Partnership upon request. Past performance may not be indicative of future results. Historical information about investments or financial markets is not necessarily indicative of future market behavior or the wisdom of any particular investment, investment strategy, or asset allocation. Therefore, no current or prospective client should assume that future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by The Simmons Partnership) or product made reference to directly or indirectly by The Simmons Partnership will be profitable. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client or prospective client's investment portfolio. Historical performance results for investment indices and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. The investment discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Additional information is available upon request. When participating in a covered call strategy, the investor is at risk of having to sell the stock if the stock's price rises above the strike price. Remember, in exchange for receiving the premium of having sold the calls, the investor is obligated to sell the stock if the option is exercised. Past performance is no guarantee of future results. Add Simmons general disclosure to bottom