Global Markets Division

Interbank Liquidity

Betting Against the Most Liquid Market in the World by Buying SOFR-EFFR Spread.

Spread Target: 0.500%
Investment Horizon: 3M - 6M

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Team Overview

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Agenda

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US Monetary Policy

US Monetary Stance: Labor Market

W U T I S

Labor Market Strength is Slowly Fading Down in Opening of 2026

Labor Market Developments During 2025

Uncertainty

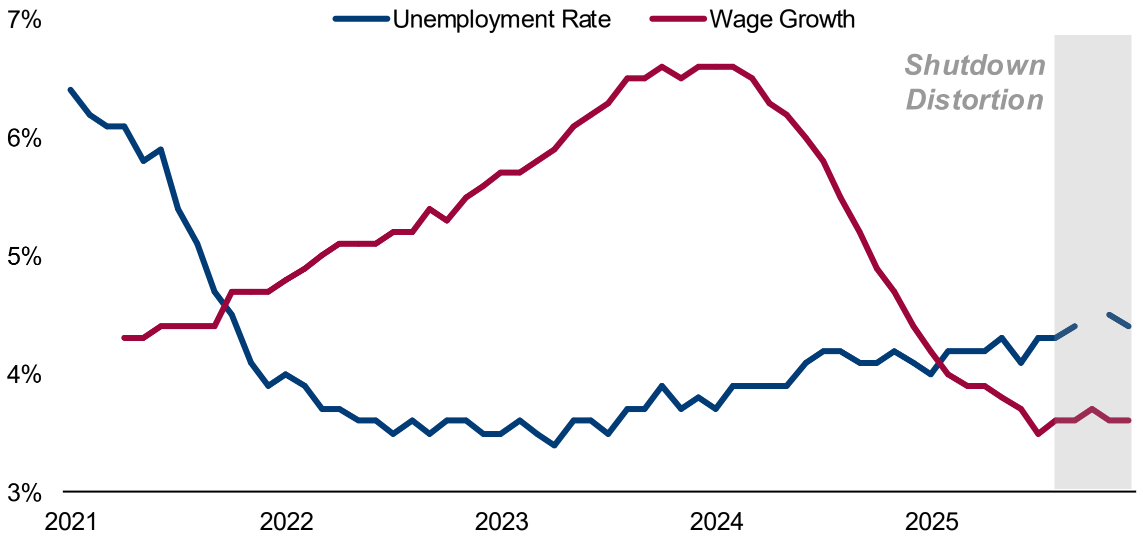
Due to uncertainty, firms are **hesitant** to **hire** new workers and/or fire old ones.

Trumps Labor

Massive deportations and **decreasing** trend in **government employment**.

Capital Intensity

Firms often report same output with **fewer hires**, partially due to **automation**.

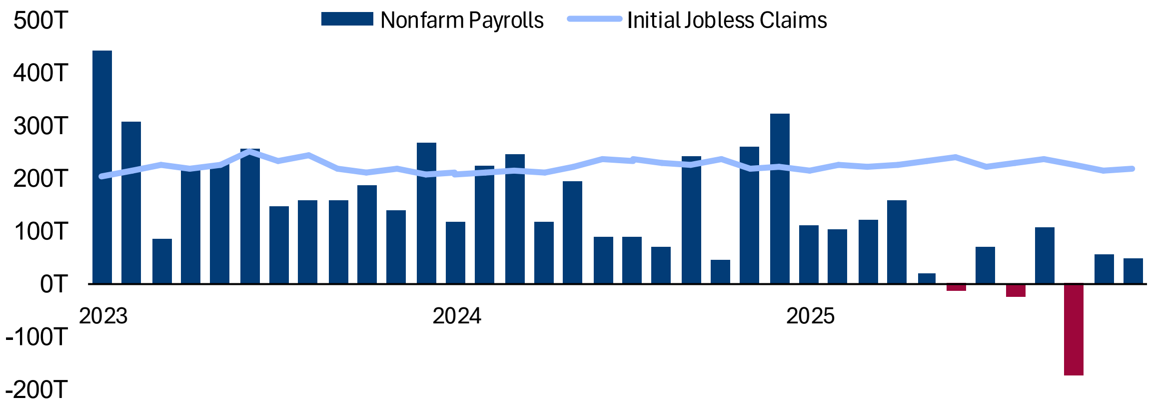


Long Term Structural Weaking Unfolds

Mid- and long-term unemployment rises
27+ weeks unemployment peaks at 26%, weakness is persistent.

16-24 years old unemployment 10.4%
Firms stick to senior workers, hesitating to teach freshmen.

Labor force grows while participation rate is mostly flat
Job growth is not keeping up with labor-supply growth.



Labor market's weakness is becoming a key concern, requiring stimulus and loosen monetary policy.

US Monetary Stance: Inflation

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The Headline Fear of 2025 is Stepping Back

Short Term Considerations Fly in the Air

Tariffs

Late pass-through fears in some consumer discretionary industries (e.g., apparel, automotives).

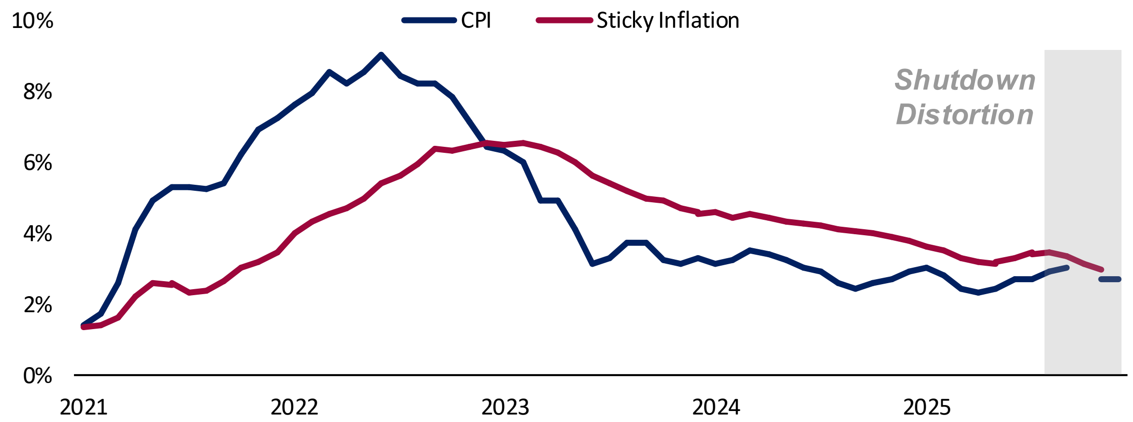
Shutdown

Distortions might have artificially lowered inflation and are expected to fully unwind by April 2026.

Subsidies

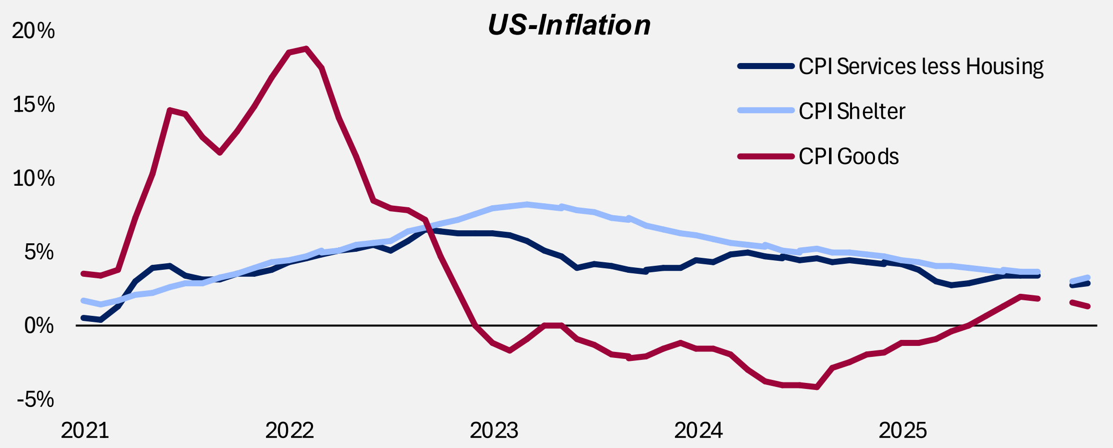
Trump's $2,000tariff dividend worth ~$450b might cause a slight one-time effect on inflation.

Inflation is still above the 2% target.



Fears of an elevated inflation because of ongoing actions of Trumps' administration are still levitating in the 2026 opening.

Long Term Considerations Uncover Trend Change



Pass-through
Anticipated tariff inflation had only minor contribution over 2025.

Sticky Inflation
Sticky components show consistent downward move.

GDP Growth
Observed and projected decline in GDP growth.

2025
Solid labor force and elevated anchored inflation

2026
Weakening labor market and fading inflation

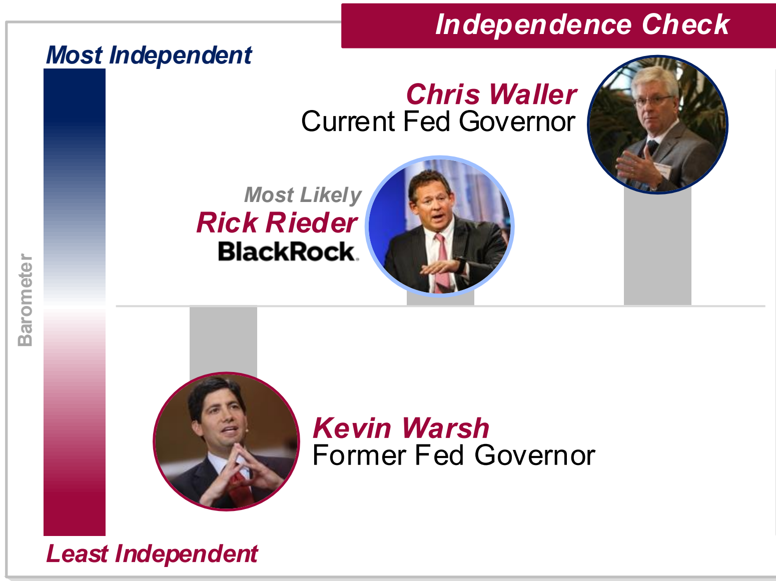
Expected
The room for rate cuts opens amid concerns cooling

US Monetary Stance: Fed Chairman

Goodbye Mr. Powell, Welcome Mr. Trump

Main Candidates for Upcoming Elections

Independence Check

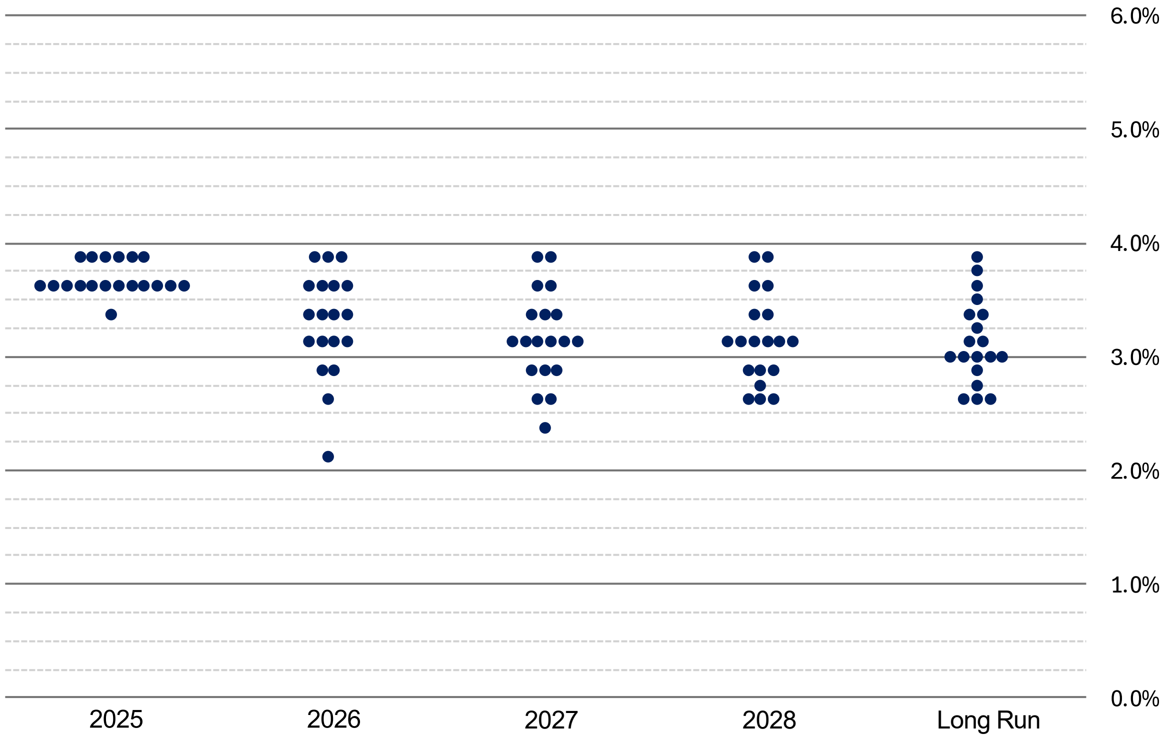


President's Agenda

Confrontations between the president and current chairman, leave a **little chance** that the new appointed official would **not follow** political **interests**.

Market Predictions

Fed Expects Rates to Switch for Dovish



Cooling inflation clears the path for dovish policy to support the weakening labor market, with the new Fed chair acting as an amplifier.

Japanese Economy

Japanese Economy: Key Monetary Trends

From Food Shock to Wage-Driven Stickiness

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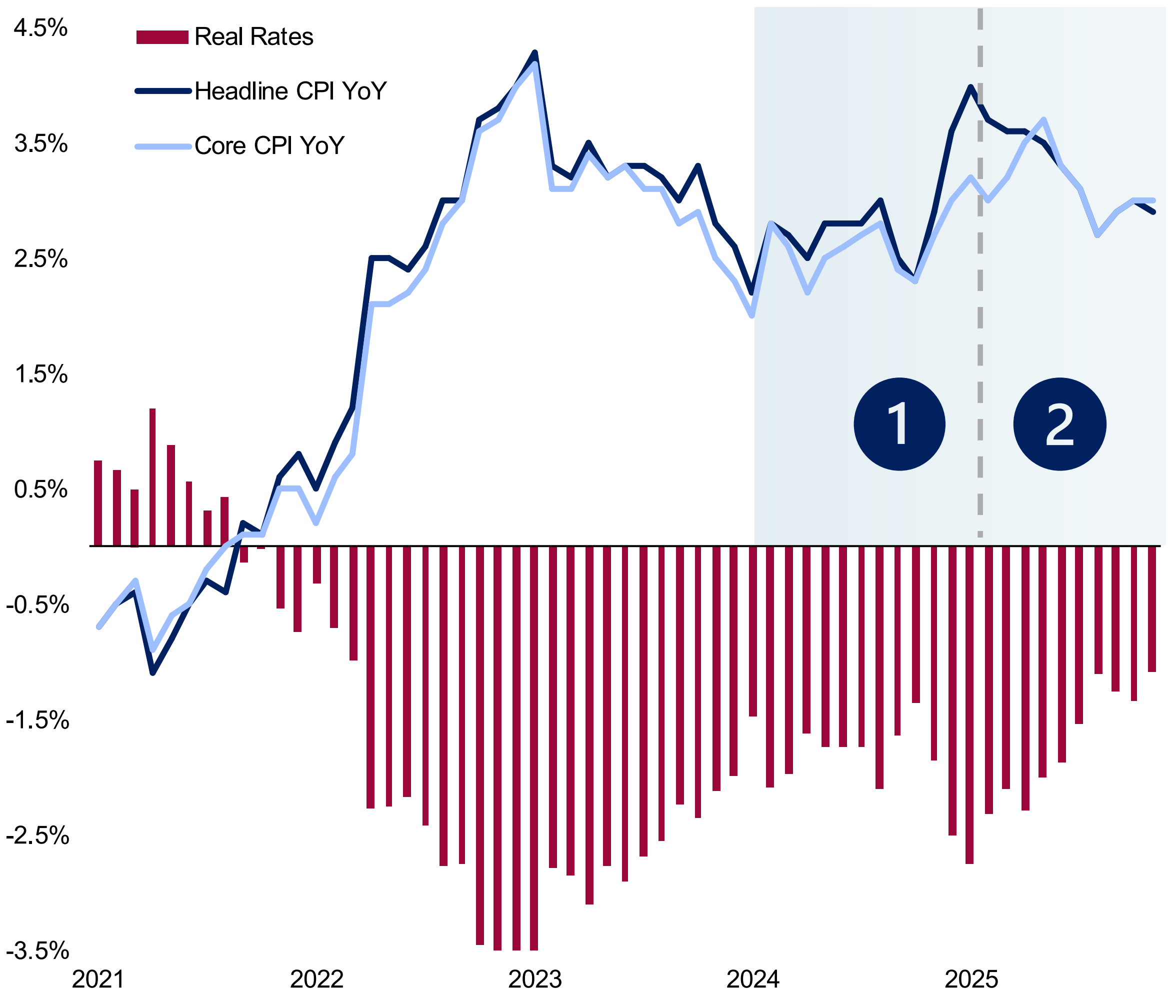
Inflation & Real Rates



Inflation Dynamics and Drivers

1 Pre-peak – Shock-driven

Food / Supply Side

Food (esp. rice) supply squeeze

Higher input costs for firms

Post-peak – Structural 2

Wage Spiral

Tight labor market causes wage hikes

Firms pass costs into prices

2026 Inflation Outlook

Core CPI is expected to cool in early 2026 but stay above 2% overall (~2.1% in 2026).

Purchasing Power

Is it repaired by wage hikes?

Not fully. Current wage growth cannot compensate for inflationary pressure.

Inflation > Wage Growth → **Real Income Weak** → **Spending Cautious**

Weak Yen Worsens the Squeeze

Weaker JPY makes imports more expensive, so firms pass those into prices, making living costs high. PP falls, draining pressure on the consumers.

Japanese Economy: Policy Cross-Currents

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When Higher Yields Don't Help the Japanese Yen

Yen-Yield Divergence

Ueda vs. Takaichi

Cautious Monetary Tightening

In 2025 the BOJ raised the rate to 0.75% and was expected to tighten cautiously into 2026.

Aggressive Fiscal Stimulus

¥21.3 trillion fiscal stimulus raised significant debt concerns due to high spending.

Snap-election speculation (early Feb) and further **fiscal stimulus** plans increased **uncertainty** about Japan's policy direction.

Higher Yields

The nature of rising yields is **political/fiscal risk premium**, not the healthy tightening.

Weak Yen Loop

1. **Low Real Rates**
2. **Weak JPY**
3. **Import Inflation**
4. **Cautious BOJ**
5. **Low Real Rates**

BOJ Policy Projections

- Initially was projected to raise the rates **closer to the 2nd half of 2026.**
- BOJ policymakers see a possible **April hike**, if Yen slides further and adds to inflation pressures.

Market Mechanisms I: Carry Trade

The Reality of Carry Trade

Modern Approach for Carry Basis Trading Extends Risks to FX Volatility

Conventional Approach

Borrow in TONA → **Convert** → **Lend in REPO**

Modern Approach

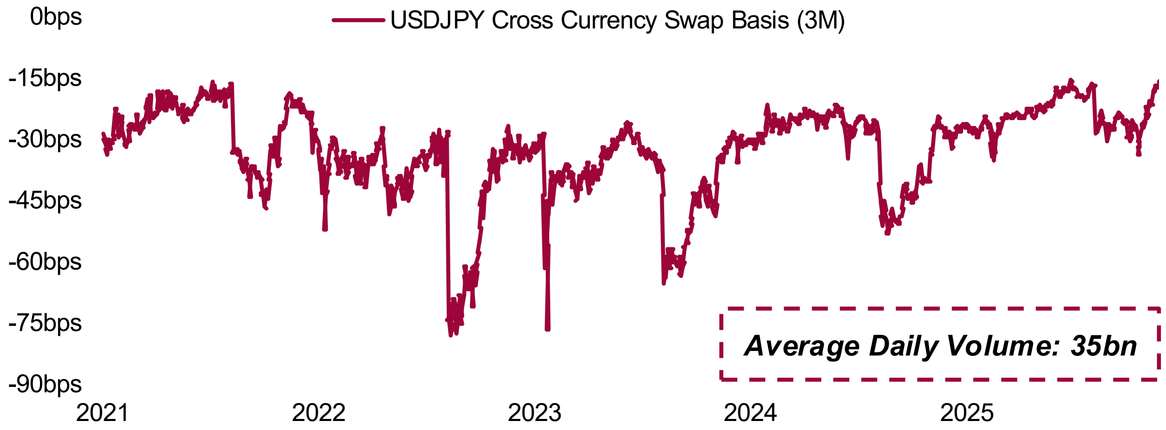
Floating-for-Floating Currency Swap
Parties exchange interest payments based on floating rates in their home currencies.

SOFR vs. TONA
"Basis Swap"
Swapping a loan in a low yield's currency against a loan in high yield currency.

Vulnerability

- FX positioning shares both CIP exposure and currency exposure.
- Spiking volatility in interest/FX rate triggers sets pressure on arbitragers.
- Participants need to cover margin calls in cost of market liquidity.

Short-term Carry Basis on Peak



Yen Downside Compression is Fragile

BOJ Hawkish / ***Dovish FED***

Decreasing nominal interest rate spread.

Japan fights deflation and rapid inflation. Weak yen is a potential threat of stability.

BOJ would intervene to support Yen.

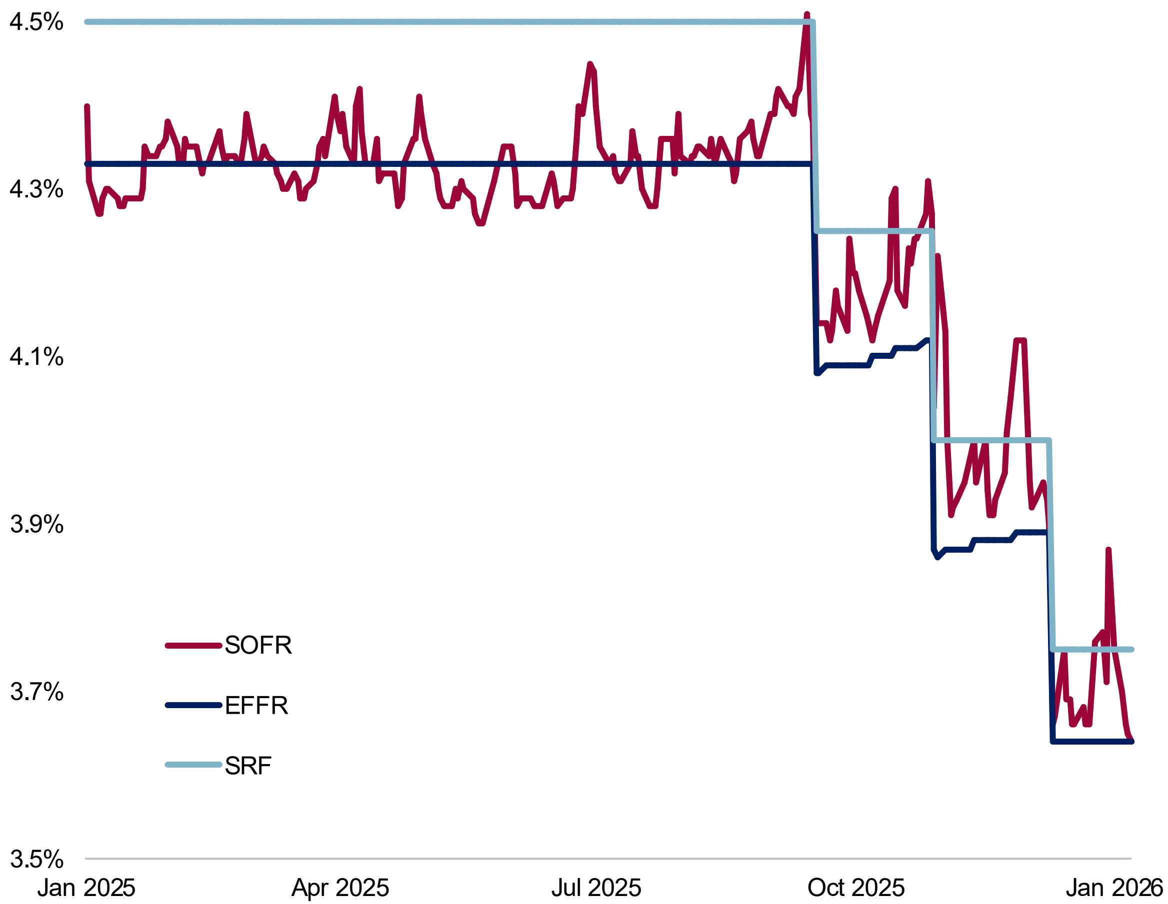
Carry trade conditions tighten
\+
Yen stays weak, causing issues for the economy
=
Yen strengthening is a breaking point.

US Interbank Liquidity

US Interbank Liquidity

Shift to Volatile Conditions in Overnight Rates Suggests New Liquidity Regime

Overnight Lending Corridors



Interest Rates Dynamics Brings Concerns

Normal Conditions		Current Conditions
A permanent facility to borrow cash overnight against Treasuries - ceiling for repo rates.	**Standing Repo Facility (SRF)**	SRF is not acting as a binding ceiling & repo rates approach it without triggering SRF usage.
Transaction-based benchmark of overnight Treasury repo that reflects price of cash in secured markets.	**Secured Overnight Financing Rate (SOFR)**	SOFR is systematically elevated and spiking outside quarter-end.
Unsecured overnight rate for interbank lending, less prone to stress than SOFR.	**Effective Federal Funds Rate (EFFR)**	The wider SOFR-FFR spread indicates systemic liquidity tightness.
Facility allowing MMFs to lend excessive cash to the Fed overnight at a fixed rate.	**Overnight Reverse Repo (ON RRP)**	During 2025 the SOFR is not trading at the “liquidity excess floor” anymore.

Interbank liquidity operations try to ”grasp” liquidity, which does not seem to exist.

US Interbank Liquidity

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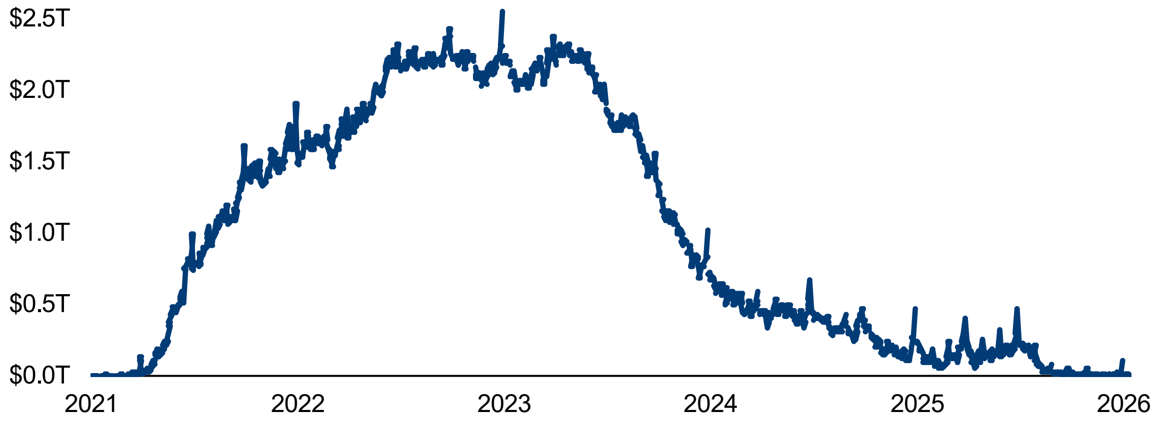
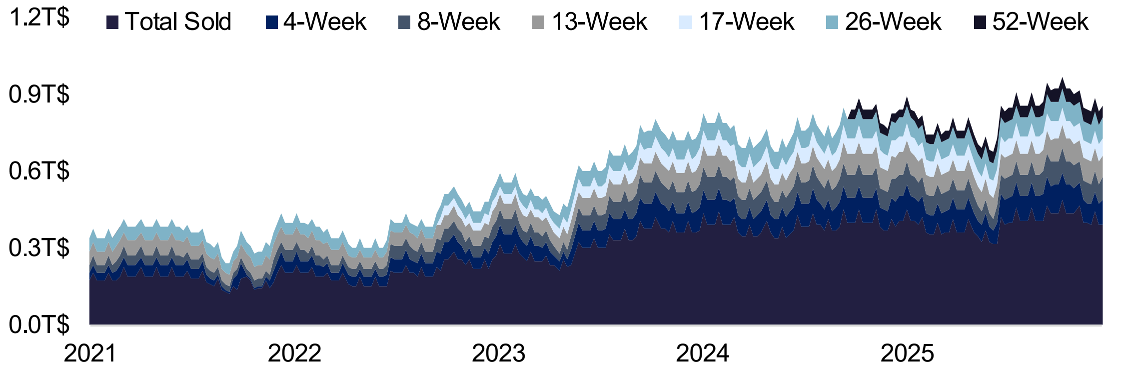
Excess Liquidity Redundance Spurs the Intermediation in Repo

ON RRP Outstanding Facility Volume



Breakdown of T-bill Issuance



Increase in T-bill issuance is attractive to MMFs, which reduces demand for ON RRP.

ON RRP Failure

ON RRP exploded in 2021/22 due to QE, Treasury's decline in bill issuance, and zero-rate environment, **absorbing excess liquidity**.

Balances are rapidly falling, because MMFs shifting into higher-yielding T-bills and private repo, **reducing demand for ON RRP**.

It's a floor only when it is large enough to anchor MMF behavior. Now, **MMFs are rate takers** in private repo markets, where dealers gain pricing power.

Overnight Cash Scarcity is More Complex

QT drained reserves from 3.6T to 2.8T. Banks and dealers **push back from repo intermediation** as cash supply shrinks.

Balance-sheet **constraints suppress** dealers repo **intermediation** function, shrinking available cash.

ON RRP collapse and heavy Treasury issuance dampen settlement flow causing **mid-cycle stress.**

The SOFR spike reflects a **structural contraction in liquidity**, not a seasonal or technical balance-sheet effect caused by window easing.

?

US Interbank Liquidity

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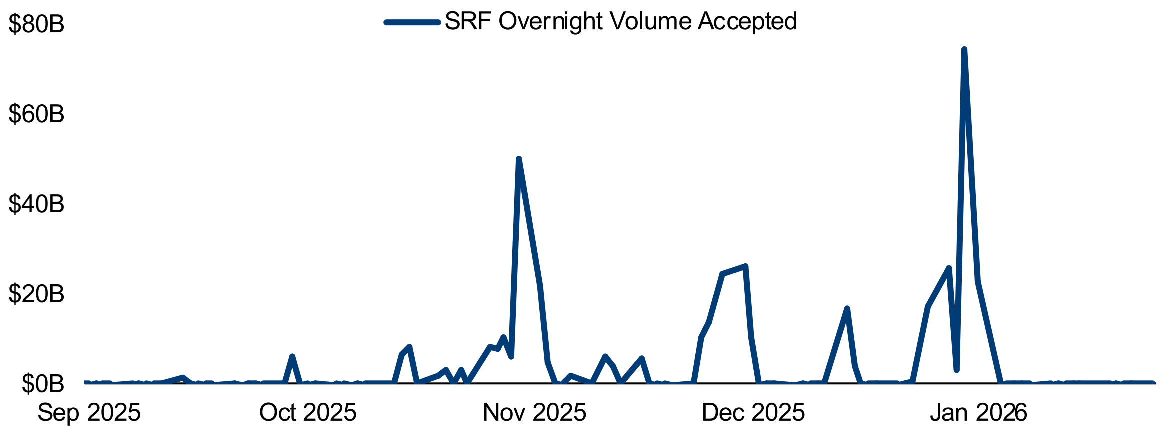
Strong Feeling of Weak Protection is Dominating the Markets

Prime Dealers Turn to SRF More Often



Feds' Support is not Strong Enough

Reserve Management Purchases

Fed to restarted RMP to **rebuild an "ample" reserve buffer** of around $50-100 billion after gradual QT.

RMP adjusts slowly, **failing to prevent sharp funding stress**. In fact, SRF usage surged, as a backstop.

RMP appears not enough to mitigate settlement-driven tightening, acting as **trojan horse**.

SOFR still moves higher during stress, despite ongoing RMP and active SRF, creating an illusion of safety for the money markets.

Why is Ceiling Failing

SRF acts as "emergency", allowing to borrow from Fed signals funding stress, leverage & liquidity issues or balance sheet shortages.

Only primary dealers and banks with reserve accounts **can access SRF** (excludes MMFs) setting challenges to stabilize the whole market stress.

SRF usage expands balance sheet, increasing GSIB surcharge score and capital requirements, **worsens liquidity & leverage ratios**.

Balance sheet pressure → Private repo rates rise → SOFR moves higher → SRF is neglected SOFR amplified

Markets Shift into a New Structural Mode

Extensive Treasury issuance and QT drained excess liquidity.

To fulfil intermediation, dealers turn to SOFR due to constraints.

SRF is not acting as a ceiling and ON RRP collapsed.

SOFR pushed toward the SRF ceiling, exceeding EFFR.

Full-scarce liquidity regime is in the markets.

The Repo-Treasury Connection

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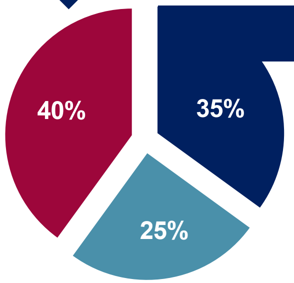
Calm Markets and Flexible Funding Accumulate Excess Leverage

What Makes the Repo Treasuries Synergy Important for Operations

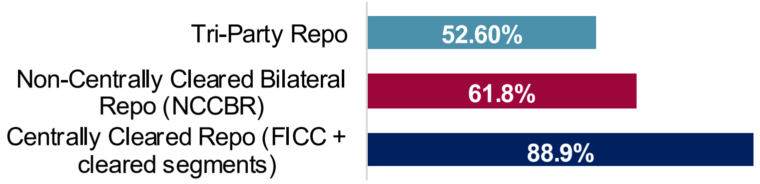
1. **Repo turns Treasuries into short-term funding:**
Post Treasuries, receive cash and repurchase later.

2. **That funding allows Treasury positions to be held:**
Dealers and investors use repo to **hold inventory and run trades**.

3. **Repo directly affects Treasury trade operations:**
The repo rate and terms determine carry, therefore **allowing leverage**.



Shares of Exposures Collateralized by Treasuries



While **Non-Centrally Cleared Bilateral Repo (NCCBR)** is preferred for its flexibility, it is the least transparent. This **reliance creates hidden risks**.

The Calm Before the Storm

Heavy Issuance

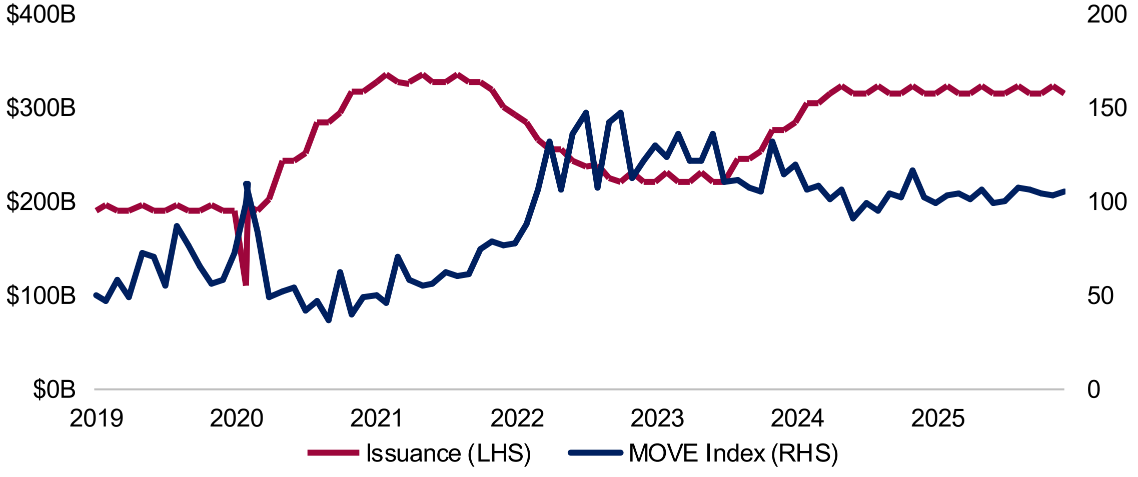
Persistent deficits mean a steady flow of new Treasuries.

Stable Volatility

Compressed volatility allows for accumulation of momentum trades.

Hidden Leverage

Calm markets often hide crowded positioning.



Oversupply

Huge issuance should be absorbed, otherwise it will amplify volatility.

Liquidity Segmentation

Liquidity is concentrating and thinning, making the market more fragile.

Depth & Limits

Concentration in a few intermediaries can quickly turn shocks into crises.

Treasury Activity Overseas

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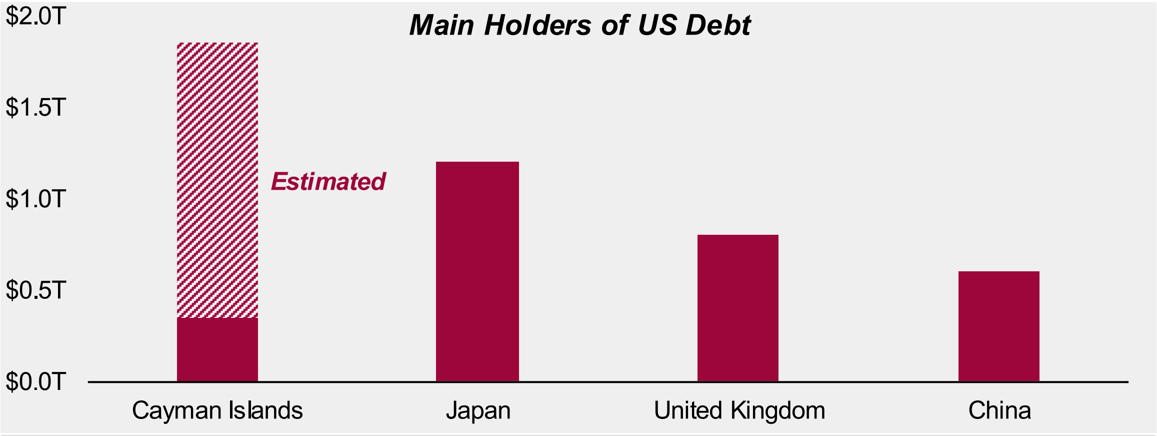
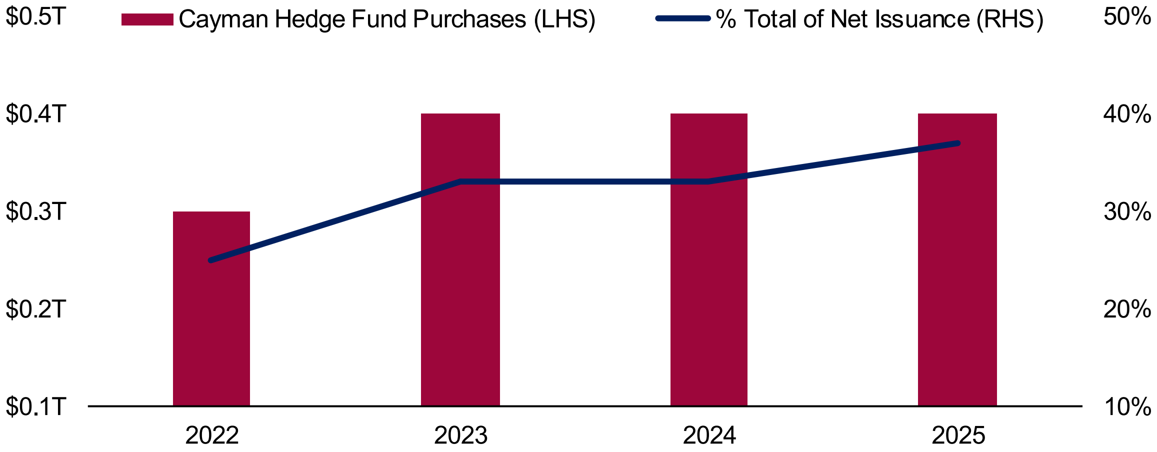
The Cross-border Trail of the Treasury Basis Trade

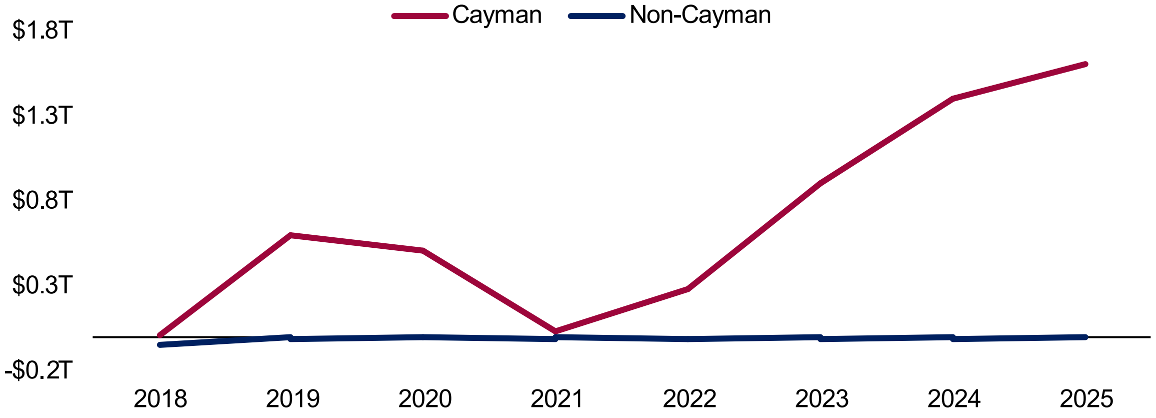
Official Statistics Can Downplay the Role of a Key Market Player



Cayman Hedge Funds Purchased Approximately 37% of Net Issuance



US Treasury Net Repo Signals Leverage Accumulation



Treasury Trading Overcrowdness

Caymans' Treasury exposures have surged since 2022, that can unwind quickly when risk appetite changes.

The sharp rise in **net repo financing** suggests more of the positioning is **leveraged**, increasing sensitivity to funding conditions.

In a **crowded, leveraged environment** even a modest change in funding conditions can trigger **synchronous self amplifying deleveraging.**

Basis Trade

Market Mechanisms II: Basis Trade

Implications for the Basis Trade and Global Liquidity Markets

Basis Trade Explanation and Vulnerabilities

Futures Contract Sell + **Treasury Bond** Buy

- Collect the premium.
- Deliver converging prices.
- Remain delta neutral.

Hedge fund trader

- Buys the CTD bonds $500mn bonds, despite possessing lower margin.
- Sells the 3M future contract of the same worth of T-Bonds.
- Pays the bonds at the end of the day with repo financing.

Repo dealer

- Lends the $500mn less the haircut (safety margin).
- Receives $500mn worth of treasury securities.
- Charges SOFR on the debt, while paying the coupons to the borrower.

Hedge fund trader

- Rolls the repo debt overnight until delivery date.
- At the delivery date asks for bonds – delivers them for a future contract – repays the repo loan.

Free Lunch?

$$Profit = (Futures\ Price - Cash\ Price) + (Coupons - SOFR)$$

Yes and No

Arbitrage strategy based on futures contango, needs a **huge leverage to profit.**

Stable repo funding conditions keep profits stable allowing **more leverage**.

Low treasury volatility, allows for price convergence & **lower haircuts**.

Accumulation of positioning is self amplifying.

If conditions tighten, hedge funds would need to repay debt & offload securities.

Intermediaries must process a ton of securities, turning to search for liquidity, triggering **extensive SRF usage**.

The volumes of the unwind are bigger than outstanding cash reserves, dealers would either decline or **exploit the repo**.

Unwind of positioning is also self amplifying.

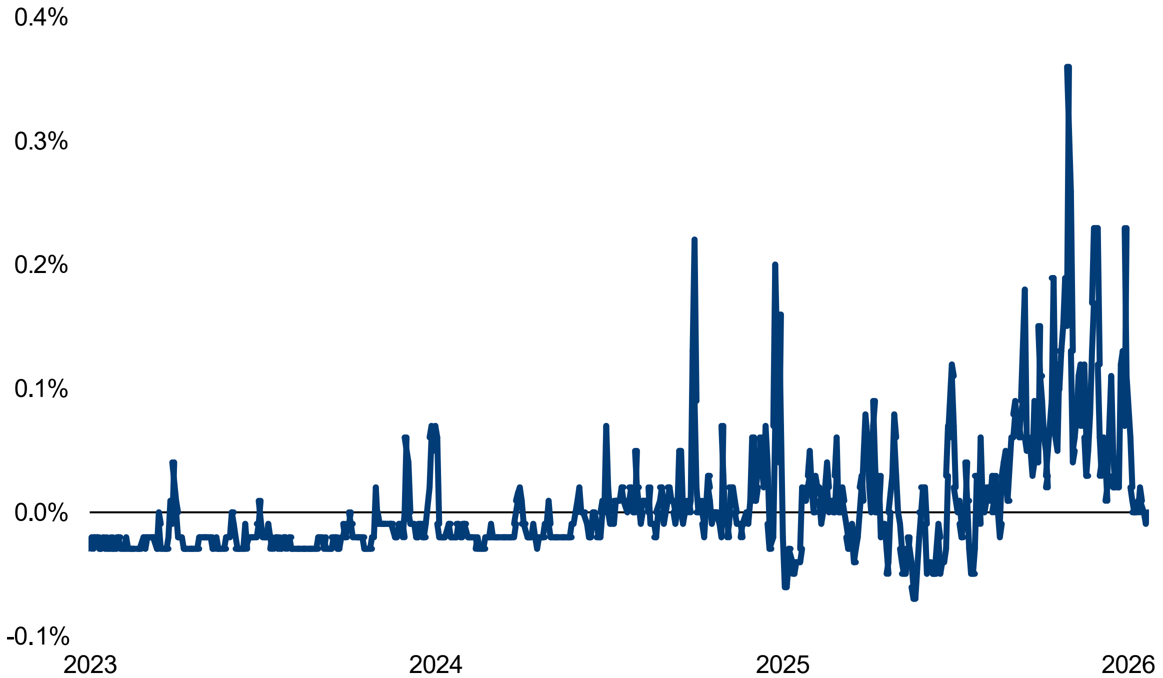
SOFR spikes extensively due to liquidity squeeze in a scarcity conditions.

Trade Structure

Trade Structure

Capturing the Spread Widening & Parallel Shift Higher

SOFR-EFFR Spread Position



EFFR

Contract Size: $4,167.0 x IMM Index*/100
Value of 1 pt.: $4,167.0
Tick Size: 0.005
Margins: $615.0 per contract

***IMM Index**: 100 - EFFR

SOFR

Contract Size: $4,167.0 x IMM Index**/100
Value of 1 pt.: $4,167.0
Tick Size: 0.0025
Margins: $615.0 per contract

****IMM Index**: 100 - SOFR

Ratio-to-Hold 1:1

Trade Structure

Spread widening – going long the SOFR rate or short the futures while shorting the EFFR rate or long the futures, all with the same settlement in March 2026. Margins would be calculated as inter-commodities spread, lowering the requirement (~85% lower). Since these are monthly contracts, their ticks' DV01 is the same.

Direct exposure to widening.

Mitigation of parallel shifts.

Purest bet on funding conditions.

Positions	CME Ticker	Settlement	Price
BUY EFFR	ZQH6	1st April 2026	$96.385
SELL SOFR	SR1H6	1st April 2026	$96.340
Margin per one spread	~$184.5	**DV01 per one spread delta**	~$41.67 per bps

Take Profit
Spread Value: (at least) 0.500%
Profit: $2271.02

Stop Loss
Spread Value: -0.100%
Profit: $230.29

+0.545%

Risk-to-Return 9.86

-0.055%

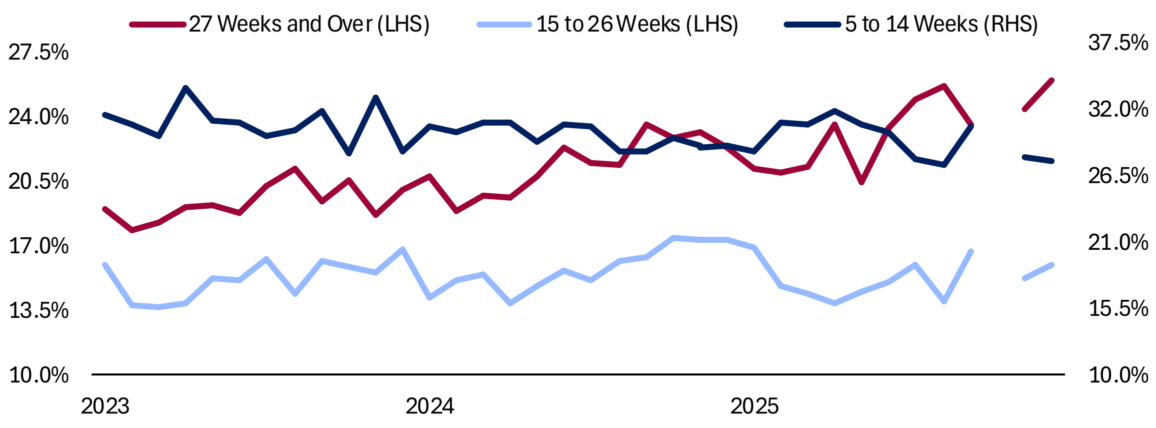
Sources: FRED, CME Group

Appendix

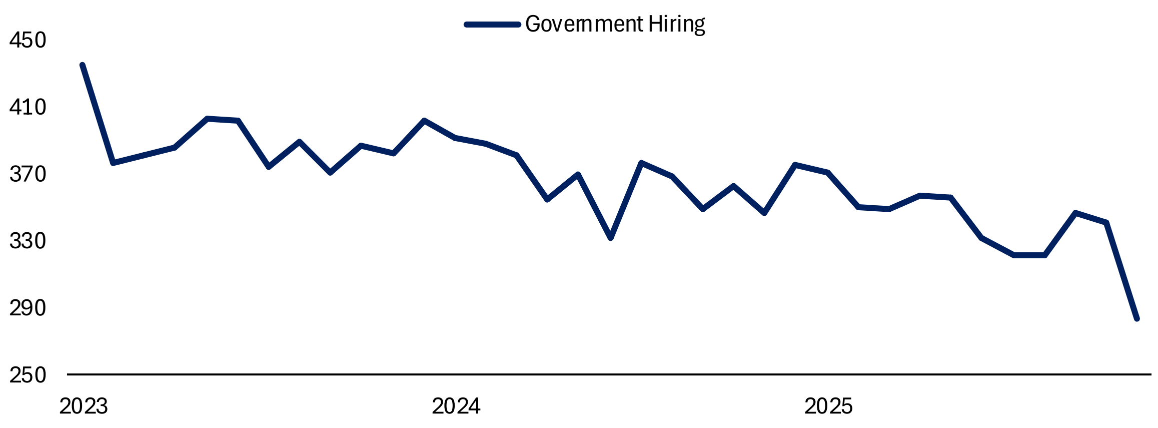
Appendix

US Labor Market Data

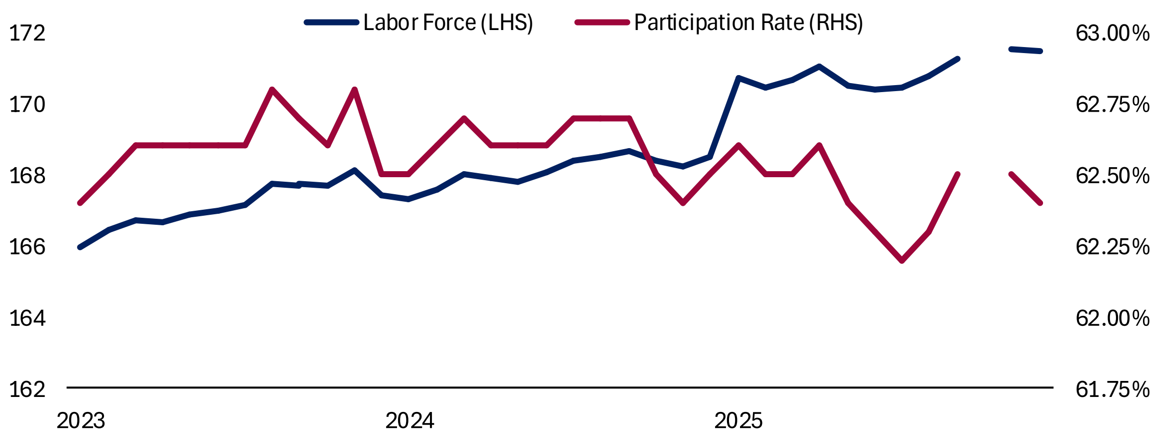
Unemployment Durations (% of total unemployment)



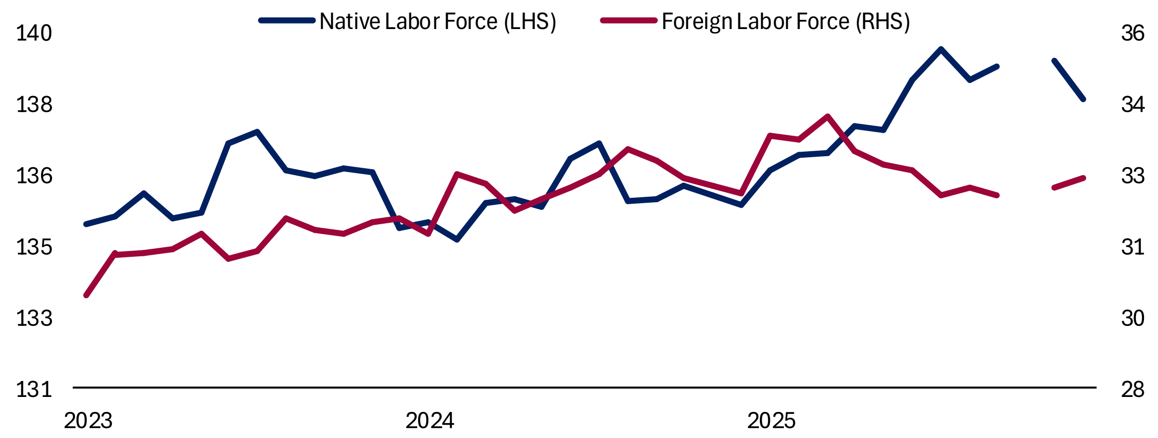
Government Hiring (thousands of people)



Labor Force (millions of people) & Participation Rate



Native & Foreign Labor Force (millions of people)



Appendix

Sources

Source Name	Link	Date of Retrieval	Used for
Bloomberg Finance L.P.	Software	Continuous Work	Research and Data
FRED	Link	Continuous Work	Research and Data
MacroMicro	Link	08.01.2026	Fiscal Concerns in Japan
Mizuho	Link	07.01.2026	Japanese Inflation
Polymarket	Link	10.01.2026	Fed Chair Probabilities
ING	Link	12.01.2026	BOJ Policy Projections
BOJ	Link	14.01.2026	Nature of Rising Yields in Japan
Andersen Institute	Link	17.01.2026	Tariffs Pass-through
Yale Budget Lab	Link	17.01.2026	Trump Tariff Dividend Cost
BIS	Link	17.01.2026	Hedge Fund UST Exposures
Federal Reserve	Link	21.01.2026	Fed Target Rate Dot Plot
CME Group	Link	26.01.2026	Trade Calculation & Securities Pricing

Appendix

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Sources

Econ	Link	Date of Retrieval	Used for
Financial Stability Oversight Council	Link	28.01.2026	Overnight Interest Rates
The Global Treasurer	Link	28.01.2026	Overnight Liquidity
CME Group	Link	28.01.2026	SOFR Spikes
The Financial Analyst	Link	28.01.2026	SOFR-ON RRP Spread
Econ Reporter	Link	28.01.2026	SRF Usage
Reuters	Link	28.01.2026	SRF Usage
New York Fed	Link	28.01.2026	Fed Monetary Policy

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