

Oil, Gold, and LCLo(SP)R

I am stunned every time a client asks me if I am worried about the current level of reserves in the U.S. banking system. The market's search for the level of reserves at which the system "breaks" implies that the market is worried about a repeat of the 2019 repo blowup. Such fears are misplaced. To be clear, there are risks lurking in funding markets, but they have nothing to do with the draining of reserves via QT (watching paint dry). Rather, they have to do with the draining of reserves via geopolitics (Russia responding to price caps).

The fundamental difference between QT during 2018-2019 and QT today is that the first episode of QT happened while balances in the o/n RRP facility were zero. The U.S. financial system didn't have a penny of excess reserves, except for what banks had over and above their lowest comfortable level of reserves (LCLoR). The bid for repo funding was immense and the marginal repo lenders were banks with excess reserves to lend... until they ran out of reserves to lend.

When the reserves ran out, o/n repo rates spiked and the music stopped until the Fed started to print reserves anew and broadcast them using a new o/n repo facility (the SRF). The chances of the same happening today are low. Worrying about how close banks are to their LCLoR is pointless for three reasons.

First, demand for repo funding is weak today, in sharp contrast to demand during 2018-2019 when demand was breaking new highs every single day. Similarly, demand for dollar funding in the FX swap market is weak too, as FX-hedged buyers of Treasuries are now scaling back their positions and economic uncertainty and higher nominal rates are driving a wave of deleveraging.

Second, balances in the New York Fed's o/n RRP facility represent reserves that the financial system did not bid for during the day. In other words, the balances in the o/n RRP facility represent cash the system does not need. Today, that amount is over \$2 trillion. That's \$2 trillion that large U.S. banks sweep off their balance sheets at the end of every day and that foreign banks and dealers don't bid for to fund their loan books, inventories, or market making. That's \$2 trillion of reserves coming out of the market's ears. In plain English, the \$2 trillion in the o/n RRP facility is the system's "cash under the mattress".

Third, if for some reason we still end up in a situation of LCLoR miscalibration, the system has two pools of liquidity to tap: the \$2 trillion under the mattress (see above) or the SRF. The *raison d'être* of funding markets is to mobilize excess cash; today, \$2 trillion is waiting to be mobilized through funding markets...

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...so don't sweat a repeat of 2019. To emphasize:

LCLoR today is a red herring. LCLoR mattered last time because we had no excess reserves in the RRP facility and no SRF. When JPMorgan ran out of excess reserves (reserves > LCLoR) to lend, the interbank market froze up because other banks did not have any excess reserves to lend either. Today, if banks run out of excess reserves to lend, they have two alternatives to tap (the o/n RRP facility and the SRF), so the system is backstopped very well: both at the bottom (lots of cash to mop up) and also the top (lots of cash to call on) – so don't sweat the LCLoR from a QT perspective. But worry about it from a...
...geopolitical perspective.

Year-end turns have their usual rhythm. Balance sheets get optimized and this exercise disrupts markets either because the market is not prepared, reserves get scarce, or collateral gets scarce. Over time, the market develops muscle memory to deal with year-end turns, and provided that there are no new bottlenecks (G-SIB, SA-CCR, SCB) and no wrong-way market volatility, year-end turns should not be anything out of the ordinary. In the recent past, the equity market was a swing factor to year-end funding volatility (see [here](#)). The basic dynamics at work were these: sharp rallies in the equity market drain liquidity from banks and force banks to fund, and sell-offs do the opposite. In the past, whether the equity market was selling off or rallying was a marginal swing factor for funding market dynamics around the year-end turn. Today, equity market sentiment is helping on the funding front. On the other hand, commodity market dynamics might make things more complicated this year...

Within commodities, there are reasons to be concerned about oil and gold.

Instead of worrying about the LCLoR, we should worry about the "LCLoSPR"...

The oil market is tight. Demand for oil exceeds supply coming from oil fields. Were it not for the release of oil reserves from the SPR and OECD inventories and lockdowns in China all year, oil prices would have traded higher this year.

Excess reserves in large banks' HQLA portfolios (reserves > LCLoR) are like excess production capacity for large oil producers. Similar to how JPMorgan ran out of excess reserves in 2019, Saudi Arabia is low on spare capacity today.

The SPR is like the o/n RRP facility. It can be tapped when oil levels are tight. But the SPR is finite, and recent releases have brought reserves down to levels we haven't been at since the 1980s. The 400 million barrels left in it isn't much: it could help police prices for a year if we released 1 million barrels per day (mbpd), half a year if we released 2 mbpd, and about four months if we released 3 mbpd.

Think of these releases in the context of OPEC+'s recent decision to cut production by 2 mbpd and also that according to some estimates, the re-routing of Russian crude oil from Europe to Asia has so far led to a loss of 0.5 mbpd of lost output and risks are that that production losses will grow to 1.5 mbpd once the price cap on seaborne Russian crude goes into effect today.

Now that SPR releases are over, production cuts by OPEC+, re-routing, and price caps (not to mention the risk of China re-opening due to protests), the question for the U.S. becomes what to do with the SPR? Release more? Refill?

Releasing more has its limits: supply lasts only about four months at 3 mbpd, but given the lack of "spot" spare capacity in Saudi Arabia and the UAE, declining shale production in the U.S., headline production cuts by OPEC+, a loss of production due to a re-routing of Russian oil shipments, and the risk of more demand in China, future SPR releases will have to be big to have an impact.

Thus, in the worst case, the SPR is empty by spring (next April), at which point the oil market is in the same spot as the repo market in 2019: zero balance in the o/n RRP facility to tap. And unlike reserves, which the Fed can easily print, “you can’t print oil to heat, or wheat to eat” (see [here](#)). You can frack new wells, but that takes time and until new production comes online, oil prices will spike.

Refilling the SPR could lead to different dynamics.

President Biden noted that he plans to refill the SPR when oil prices get down to \$75 per barrel. That plan is hard to reconcile with OPEC+’s price target near \$100 per barrel. Yes, we are headed toward a recession, but unlike in 2008 or during Paul Volcker’s reign, oil prices aren’t collapsing as production capacity hasn’t grown recently (shale is fantastic, but production is not growing; shale was a sugar high and we are coming off the high, slowing on the margin) and so getting to \$75 per barrel will be hard. So how will the U.S. refill the SPR?

Could a price on Russian oil be a part of the strategy? Consider the following...

First, Russian crude already sells at a steep \$30 discount relative to Brent. It is widely known that the big purchasers of Russian crude are China and India. Both countries have both state-owned and privately owned tanker fleets that the state can insure. In the case of India, it is widely understood that Indian refiners are turning some of the imported oil into diesel for re-export. Buying Russian crude at \$60 per barrel (pb) and selling diesel at \$140 pb makes for a nice crack spread, the petroleum market’s equivalent of 100 bps of spread in the land of OIS-OIS cross-currency bases. India and China thus serve as matched-book commodity traders (instead of Glencore or Trafigura), the former dealing in oil and the latter in LNG, keeping commodities in circulation.

Second, the risk of sanctions for buying Russian oil has certainly changed a lot for some countries: *“the United States is happy for India to continue buying as much Russian oil as it wants, including at prices above a G7-imposed price cap mechanism, if it steers clear of Western insurance, finance, and maritime services bound by the cap”*, Treasury Secretary Janet Yellen said last week (see [here](#)). Gone are the days when the U.S. Deputy National Security Advisor warned India and other countries of sanctions if they bought Russian crude oil. The change in tune could be one backdoor mechanism to refill the SPR, and given the \$30 dollar discount to Brent that India is paying for Russian oil, this would be below President Biden’s \$75 target. In a related news item – [Indian refiners becoming wary of buying Russian oil as EU sanctions loom](#) – it seems like crack spread harvesting (import oil, export diesel) will soon end, but then if we are “happy” for India to import, exports will serve a different goal.

Third, we now know that the price cap is set at \$60 pb, the same price at which Russia sells oil to India and China. But there is a difference between a tough bargain and an administered price. Europe needs oil at capped prices, but President Putin is not interested in selling at capped prices out of principle.

He said in the past he wouldn’t.

On the other hand, the U.S. needs to re-fill the SPR at some point because if it doesn’t, it might not be able to control domestic oil prices in case oil gets caught up in geopolitics. If Russian oil is re-exported from India for that end, President Putin probably won’t like that out of principle either. Russian oil shall not age in giant, underground salt caverns along the U.S. Gulf Coast, or, if it were to, then payments will be accepted only in gold, not dollars or rupees.

This is nonsense you say. No it is not. Look at the tit-for-tat measures so far: you invade Ukraine, I freeze your FX reserves; you freeze my FX reserves, I make you pay for gas in rubles; the West boycotts my Urals, I'll ship it east...

...the West caps the price of Urals, let them, but I'll make them pay in gold. And if some countries re-export Urals to the West, I'll make them pay in gold too.

To use Pippa Malmgren's terms, **World War III already started, it's just that it is a hot war in cold places (in space, cyberspace, underwater, and Svalbard) and a cold war in hot places (militarizing islands in the Pacific and mines in Africa).**

Hot wars in cold places also involve corridors of power that determine who gets to use cutting-edge technologies (the U.S.'s technology blockade of China), who gets paid how much for commodities (the G7's price cap on Russian oil), and how commodity trades get settled (Moscow's demand to get paid in gold as an analogue to Moscow's demand this year to get paid in rubles for gas).

War is not about gentlemanly conduct...

The cap of \$60 per barrel for Russian oil equals the price of a gram of gold (at current market prices). Let's imagine this set up as a peg. The G7, led by the U.S., effectively pegs the U.S. dollar to Urals at \$60 per barrel. In turn, Russia pegs Urals to gold at the same price (a gram of gold for a barrel of Urals).

The U.S. dollar effectively gets "revalued" versus Russian oil: "a barrel for less". The Western side is looking for a bargain, effectively forcing a price on the "+" in OPEC+. But if the West is looking for a bargain, Russia can give one the West can't refuse: "a gram for more". If Russia countered the price peg of \$60 with offering two barrels of oil at the peg for a gram of gold, gold prices double.

Russia won't produce more oil, but would ensure that there is enough demand that production doesn't get shut. And it would also ensure that more oil goes to Europe than to the U.S. through India. And most important, **gold going from \$1,800 to close to \$3,600 would increase the value of Russia's gold reserves and its gold output at home and in a range of countries in Africa. Crazy? Yes. Improbable? No. This was a year of unthinkable macro scenarios and the return of statecraft as the dominant force driving monetary and fiscal decisions.**

I am often asked about the next LDI blowup.

Those questions are missing the point. The lesson about the mini-budget and the gilt sell-off that followed is that states sometimes do irresponsible things, or things that seem responsible but may backfire. Russia's decision to link gold to oil could bring gold back as a settlement medium and increase its intrinsic value sharply. Banks active in the paper gold market would face a liquidity shortfall, as all banks active in commodities tend to be long OTC derivative receivables hedged with futures (an asymmetric liquidity position). That's a risk we don't think enough about and a risk that could complicate the coming year-end turn, as a sharp move in gold prices could force an unexpected mobilization of reserves (from the o/n RRP facility to banks) and expansions in balance sheets (SLR) and risk-weighted assets. That's the last thing we need around year-end.

Basel III was designed to keep banks from doing things that could hurt them, but as the mini-budget has shown and Russia's response to the cap might show, Basel III won't protect from states doing things that could end up hurting banks.

Just as the German industrialist who built a successful business over a lifetime and outsourced only one thing to the German government – energy security – banks have been managing their paper gold books with one assumption, which is that states would ensure gold wouldn't come back as a settlement medium.

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