

Rates: Honey, call the plumber

Ever get that inadequate feeling when your better half asks you to call the plumber? You shouldn't of course (unless you actually are a plumber). Here, the Fed has done an impressive job at reacting swiftly to a growing crisis. But there are some plumbing issues that are yet unresolved, requiring some savvy solutions. We lay out some of the issues



The good and the bad from the Fed

In the past couple of weeks the Federal Reserve has not only cut rates by 150bp (to zero). But is also providing the money markets with practically as much liquidity as it can handle, and on top of that is back in the bond buying game with a new US\$700bn quantitative easing (QE) programme. Surely that should be enough to ease any pressures in the money markets? Well, yes and no.

On a positive note, the prime brokers have easy access to the Fed's repo facilities, which allow them to swap bonds for liquidity. And the cost of such funding has collapsed as the funds rate has been cut. That's the good news. The bad news is that still leaves many other players without easy access to liquidity, and this is where the stresses are present.

The credit spread implied on moving from 3mth to 6mth (bp)

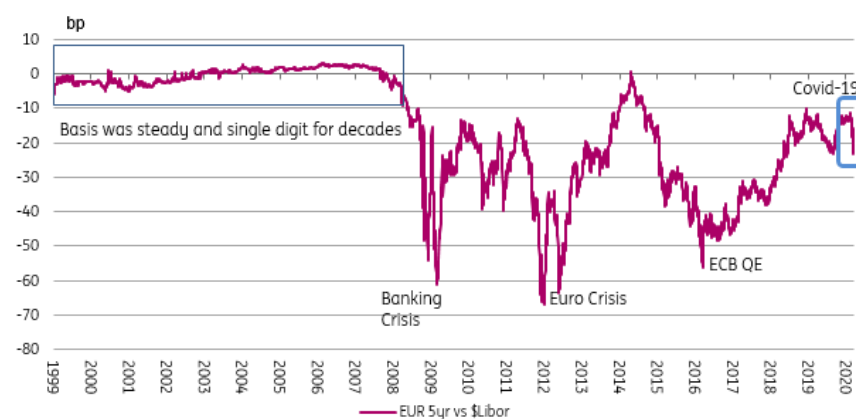


Evidence of Dollar funding stresses in cross currency markets

Take a look at the graph above. Simplistically, it is a measure of an extra cost that must be applied when borrowing in Dollars or Euros. What you see is a spike in Dollar costs versus a virtually equal and opposite fall in Euro costs. This is indicative of a scenario where some players are willing to pay up to get their hands on Dollars. And hence evidence of some funding stress.

And we see the same in the cross currency swap between Dollars and Euros. The graph below shows the additional cost attached to getting access to Dollar liquidity when swapping from Euros (it is actually measured as a discount to the Euro side, but amounts to the same thing, ie, it makes Dollar funding more expensive). The chart also shows that the implied premium being attached to Dollars is not as aggressive as it was during the run of other crises in the past number of years. That's good, but we need to keep it that way.

The discount applied to Euros on a swap to Dollars



EURUSD cross currency swap basis

The Fed's FX swap solution

When we look at what the Fed did over the weekend, one of the more important targeted steps

was to offer FX swap lines against some of the most actively traded currencies, including the Euro. This is an echo of the banking crisis when international players in particular had difficulty in getting access to Dollars. The Fed's swap line at that point was an important tool to help to maintain the integrity of the international movement of the global reserve currency. The swap lines never went away, but have now been re-tweaked and made fit for purpose for today's needs. This is an important step.

And the Fed advertises its discount window

The other interesting aspect of the Fed's communication has been on advertising the discount window. This is also important. In days gone by accessing the discount window was tainted as a sign of weakness. But that has not been the case since the banking crisis. It is open to a wider number of financial market players beyond the prime brokers. It also has different rates to reflect different actual or implied ratings, and is collateralized in the sense that players that need liquidity must post bonds. This access completes any liquidity requirements that a vast number of financial institutions might have.

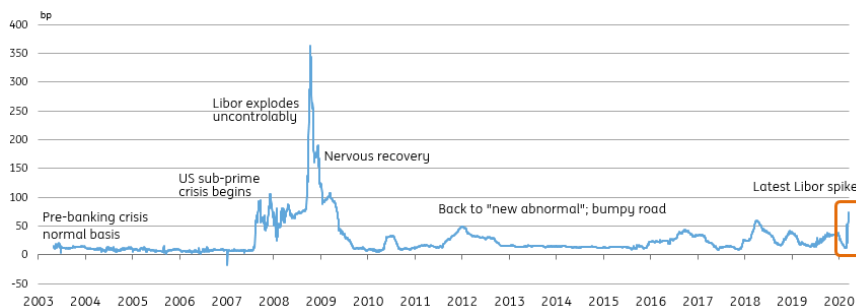
But what about non-banks; we've been here before

All well and good. But one of the issues we face is there is a significant rump of non-banks that are in fact big players on the money market. These can include not just money market funds themselves, but also some corporate treasury functions, off-shore players in Dollars of all guises and other smaller players that can at certain times create stress to the system by being short of either collateral or liquidity. On top of that, a rump of fast money bond trading is done funded, which means they are also system players, or can be impacted by creaks in the market. This is where the real complication can be (as we saw in September 2019).

And the pressure in high yield

There is one final part of this complex picture to address – stressed corporates. We know that high yield corporates are under particular pressure right now. We also know that we are in shutdown territory for business on a global scale spanning airlines, to hotels to entertainment to broad business functions to SMEs, and all the way to mom and pop stores. These will have lines of credit in place that could come under risk of default, and/or have a need for credit extensions to pull through a virtual wipe-out of profitability. Here, there is a need for some clever plumbing, else we have a sizeable tipping point.

Spread between the 3mth risk free rate and 3mth Libor



Evidence of pressure on the system in Libor

And by the way there is already some evidence of implied future pressure on the banks coming from the relative elevation of 3mth Libor. Libor these days is not where banks borrow and lend to each other (as volumes dried up here post the banking crisis), but is instead broadly where banks print commercial paper. So they fund themselves at or about these levels, and they use these realised funding rates as an estimate for where Libor should be. The problem here is the funds rate is zero-25bp and the 3mth risk free rate is at 15bp, but the 3mth Libor rate is at 85bp. That 70bp spread compares with a 12bp spread before the Covid-19 crisis began (see the chart above).

The graph also illustrates the risk from a further Libor spike. We doubt this will happen as the Federal Reserve is on the case and eyeing all such risks. But that is not to say that it can't spike. To finish on a positive note, we find that the graphs shown here identify some stresses. But they at the same time don't signal unmanageable stress. The discount window and FX swap lines will help greatly, and a Fed overlying this with easy availability of liquidity and zero rates all helps. We just need a skilled plumber to help tidy up some potentials for concern ahead among non-bank players that need access to Dollars and a vulnerable corporate high yield sector.

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