

Federal Reserve: Coffee break for the plumber

Credit where credit is due, the plumbing job has been effective. Libor is down and continues to fall. Credit spreads have been contained. Last week the Fed found itself able to ease back on some facilities. Even secondary market credits have not had to be supported. But there is pressure ahead, and a big bill to pay too. Looks like the Fed is taking a coffee break

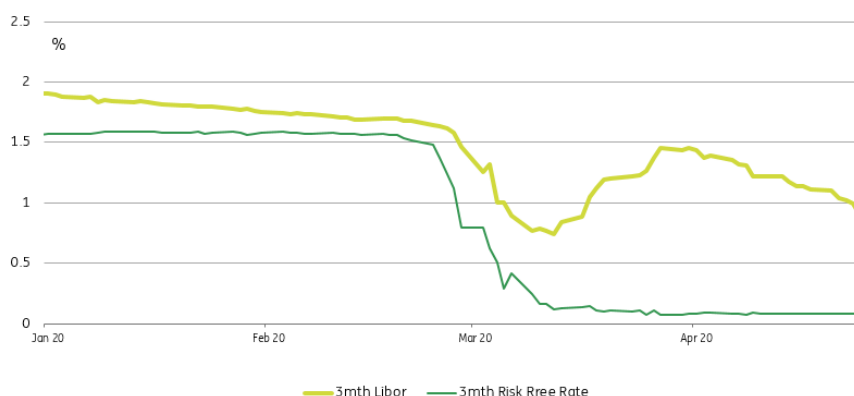


The plumbing is working - Libor now below 90bp

The massive plumbing operation initiated by the Federal Reserve in the last few weeks has been reaping good outcomes.

The most striking evidence of this has been the fall in 3-month USD Libor. This had topped 1.45% at the end of March, at a time when the Fed had coaxed the risk-free rate down close to zero. USD Libor began to fall slowly at first but has more recently made more pronounced bounds lower. It is now below 90 basis points. In consequence, all loans and products linked to USD Libor have the capacity to see their rates fall too, and share the benefit from the lower Fed funds rate. That's the good news.

Libor falls back towards the risk-free rate



The not so good news is that 3-month Libor is still some 80bp above the risk free rate. By way of a guide to a more normalised rate, the 5-year median spread between 3-month Libor and the secured overnight financing rate (Sofr) in arrears is around 27bp. The bottom line is, even at 80bp, dollar Libor is very elevated versus what could be considered normal.

This relative elevation on Libor reflects pressure on banks generally. Libor is, after all, the implied cost of funding for banks. The fall in Libor actually overstates improvement here, but credit here to the Fed's plumbing exercise that has facilitated the fall in Libor in the first place.

A positive vibe in credits has helped - without the Fed's SPV, yet

One of the important background influences has been the wider credit market. Here there has been a material improvement in sentiment, from the functioning of the primary market to stabilisation in secondary market spreads.

We are in a period now where the apex of the infections rate curve is in the rear-view mirror, and extrapolation into the summer can paint a re-opening process that is credible. The problem is, the quality of that re-opening and risks beyond that (extending into an elevated default risk) will mean that exceptional Federal Reserve support will remain very necessary in the months ahead

Remarkably, the Fed's SPV set up to buy secondary market corporate credit has not been put to much work, so far. The fact that it is has been there in the wings has been a clear positive though, as just the knowledge that the Fed has the firepower to buy secondary market corporate credit helps spreads through anticipation of future buying.

There has been some USD 34bn spent on primary market support, but this is down some USD 6bn from the previous week. At the same time paper held by the Commercial Paper Funding Facility at

the Fed is running at some USD 2.7bn, which is not a particularly high number. All in all, these data points gel with a less panicky set of circumstances.

Other forms of help has been pared back, but don't extrapolate it

The support provided for money market funds has also been reduced, and this was an area of particular stress at the end of March as the implications of the shutdown for corporate America became more evident through stressed calls on such funds for emergency liquidity. Fed support through the Money Market Fund Liquidity Facility is running at close to USD 50bn but is down some USD 2bn in the past week. Even the support provided through the Primary Dealer Credit Facility is down some USD4bn (to USD31bn), again in tune with an easing of the exceptional support being shown by the Federal Reserve.

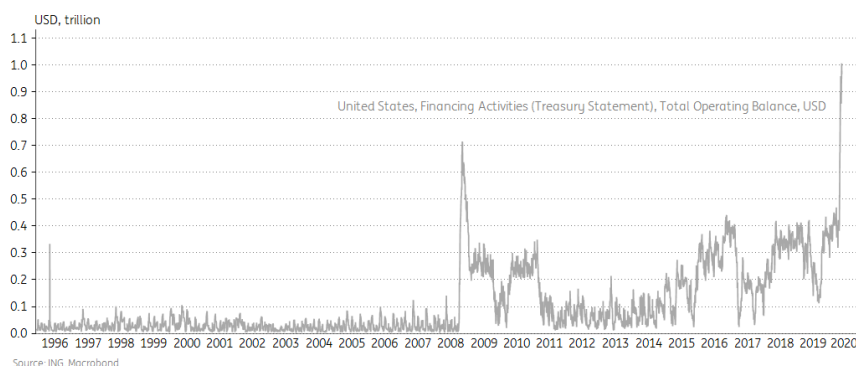
This is not to suggest that this is the beginning of a trend. Far from it. It should be seen more as an easing of the need for immediate emergency support, but against a big picture backdrop where the call for such support could well re-accelerate in the weeks and months to come.

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And there is still a large hard bill to be financed by the US Treasury

The other important aspect for the rates markets is the cost of financing the macro shutdown. The Congressional budget office has set out a financing estimate in the area of USD 3.7 trillion, practically four times a more typically annual issuance requirement. So far the bulk of the pressure has been on the bills market, which has helped to build a USD 1 trillion Treasury cash balance. The extra issuance pressure will need to be filtered into longer duration product during future re-fundings.

The biggest Treasury cash balance, ever



US Treasuries will continue to offer a robust off-set to default-risk impacted credit exposure, but expect bond prices to eventually fall to reflect the extra supply.

As the summer heats up and the immediate health crisis pressure eases back, investors will be asked to take down much more duration. Ultimately this will pressure rates higher. Not just yet though, as Fed buying plus robust investor demand still dominates.

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