Fed facilities coming on line but Libor drop will be gradual

Dollar Libor continues to drift lower. That is indicative of a situation on the mend. Extrapolation would be great, but there are risks. Collateral economic damage remains an issue as the shutdown continues. We think Libor continues to edge lower gradually, but we expect it to be a very slow process. A one-shot re-opening by early summer would help

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Libor is on the way down - good stuff

Dollar Libor continues to ease lower. It had been a slow grind to start with, but has become more convincing in the past couple of trading days. A few weeks back it was in the 1.45% area, and threatening to go even higher. It's now at sub-1.25%. This may not seem like much, but in the big scheme of things it is quite important as it shows that the plumbing done by the Federal Reserve is helping to make a material difference. It is still well above the risk free rate which is close to zero though, and so still indicative of underlying stresses in the system.

The Fed's facilities are helping, and are still gearing up

The prognosis going forward is good. Already money market funds have a bank balance sheet backstop against prime fund outflows. Dollar liquidity is being made available to both domestic and off-shore players, all fully collateralized. Moreover, some of the programmes that the Federal Reserve has mapped out will get up and running through the month of April. The commercial paper programme is an important one that will provide corporates with a material means to access liquidity, and the primary market corporate facility will facilitate longer-term liquidity (out to four years). These measures in particular should keep Libor gradually easing lower.

In addition, details on the secondary market liquidity facility, which will extend help to fallen angels, was an important catalyst to the inflows seen into high yield (and investment grade) credit last week, the first decent inflows of note in about a month. This also helps Libor to ease lower, as the greater the help for stressed corporate players, the lesser the implied stress on the banking sector and availability of credit. This, in turn, is why Libor will not fall rapidly. Default risk will be kept at bay for as long as these extraordinary measures remain in play (for the most part to September). But the prognosois thereafter will not be pretty.

But here are causes for concern

There are two big questions ahead. First, can a re-opening (mooted to be from May onwards) be successful on its first attempt. If the answer is yes, we move along the market's base case discount. If not, more risk needs to be priced. Second, when we do re-open, what is the likely extent of default risk. That will depend on what kind of socio-economic backstop we have. The basic market discount is for a large recession type default rate. Our credit team pitches the default rate at 7-10%, matching a 7% recession in the US and a 5% recession in the eurozone. If it threatens to be more, then the market would need to de-rate its discount. Let's hope not.

And all of this is pertinent for Libor. We think Libor eases lower, gradually. But we also think the fall will be far slower than implied in the forwards. We hope we are wrong, but it seems the market discount is increasingly clinging to positives. We will go with that for now, but at the same time, be prepared for a tactical de-rating should the base scenario ahead be deviated from at all. The fact that US Treasury rates are not catapulting higher here fits the same narrative.

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