Watch: How the Fed effectively hiked rates without many even noticing

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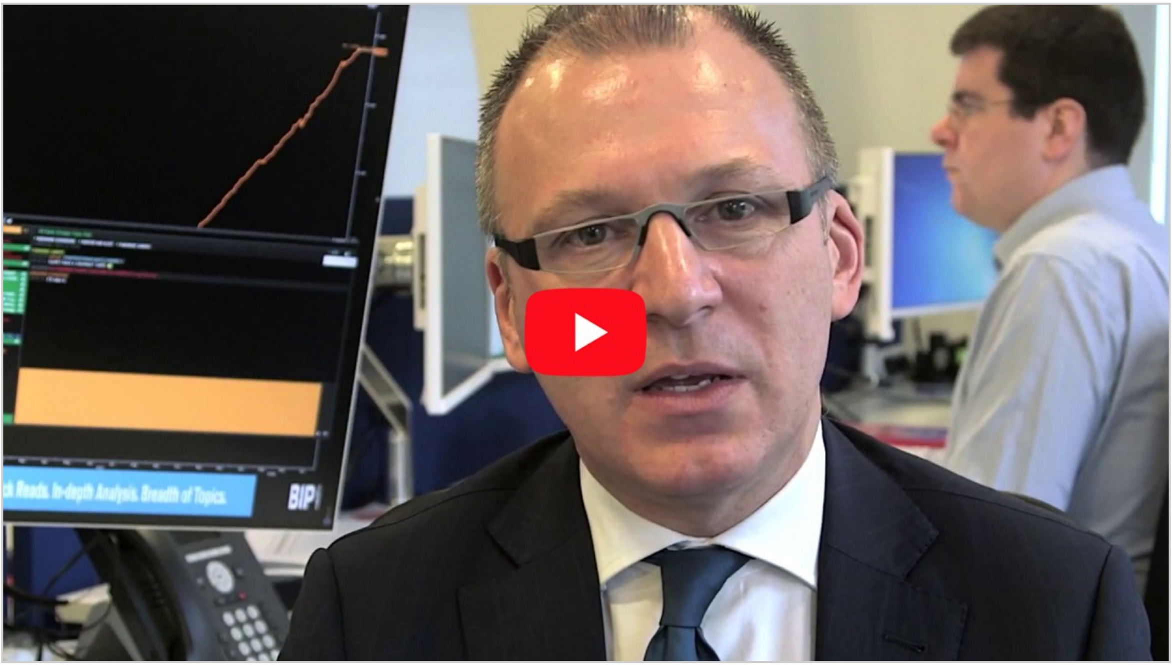

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Watch video

Financial conditions are certainly looking decidedly tighter and a lot has to do with the London Interbank Offering Rate or 'Libor'. As Padhraic explains in the video above, the most important driver of Libor is where the Fed pitches the funds rate, which is effectively an overnight rate. Why is Libor important? Not only is it a central input to the pricing of financial markets products, but it also impacts about two-thirds of variable rate mortgages and a whole host of other things, including the likes of student loans.

The most important driver of Libor is where the Fed pitches the funds rate, which is effectively an overnight rate. Most loan products, especially retail are not marked overnight but instead may have a monthly or quarterly reset. At the very front end of the curve, there is very little difference between the overnight rate and Libor, but there are deviations as we move a little longer on the curve. Take the 3-month rate, which is something of a US benchmark tenor. In recent years the spread between 3M Libor and 3M OIS been steady in the 0.15% area. However, it has shot higher and breached the 0.5% level in recent months.

The implication of this is the effective rate used in many loan products is some 0.35% above what would have been if Libor had not spiked. This is the equivalent of at least an additional 25bp Fed funds hike. In a sense, the market has added an extra hike on top of what the Fed has delivered.

Why has this happened? It essentially reflects gyrations on the commercial paper (CP) market, as a consequence of tax reform which is tempting US corporates to move cash back on onshore. As liquidations of offshore USD holdings are mooted, commercial paper rates have increased. This has impacted where banks can print CP, which has placed direct upward pressure on Libor fixings. This will abate in due course, but that could take some months. In the meantime, it effectively will act as an additional rate hike in disguise, and we may well see the Fed comment on this issue in this week's minutes.

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