

Rates: System risk is on the floor. Here's why it matters

How markets feel about risk is uber-important but risk perception is minimal right now. One measure of this is the rate banks need to pay to entice investors to invest in commercial paper. It's never been lower, helped by risk-on and tight credit spreads. Any Fed taper which elevates risk perception has ramifications well beyond US borders



Fed Chairman, Jerome Powell

The perception of risk is being significantly muted by liquidity excess

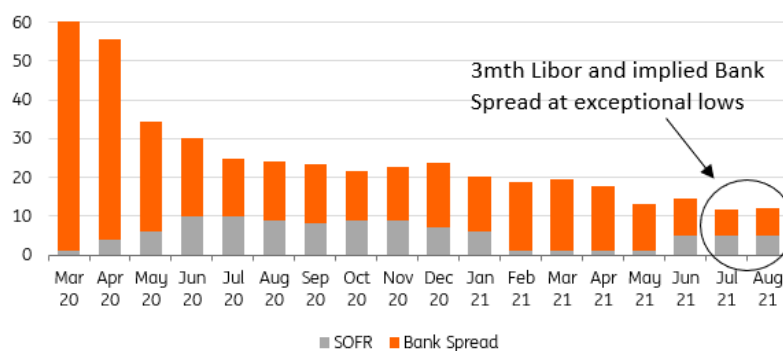
A key driver of global rates, credit and foreign exchange emanates from liquidity conditions in the US. Or to put it better, there's a remarkable excess of liquidity. Since the outbreak of Covid in early 2020 the Federal Reserve has bought a cumulative USD4trn of bonds. It's a massive sum. It equates to almost 20% of US GDP. The size of the Fed's bond-buying has, in a roundabout way, financed much of the crisis in the US. It is also leaving large chunks of liquidity flushing around the system. In fact, in excess of USD1trn is being posted back at the Fed on an overnight basis by

players that are finding it tough to beat the 5bp on offer at the Fed's reverse repo window.

If banks can print virtually for free, then system risk is indeed ultra-low

So why is this important from a global perspective? It is acting to dampen the perception of risk. We see this on a number of fronts. We see it filtering into remarkably tight credit spreads, and seeping into super-buoyant equity markets. This is not all coming from the Fed's bond-buying programme, but at the margin; some of it gets channelled there. Equally important is the effect it's having on the cost of funding for banks, which is on the floor. This is the ultimate measure of risk, in fact, measuring system risk. If banks can print virtually for free (and they can, at just a smidgen above the risk-free rate), then system risk is indeed ultra-low.

USD 3mth Libor = Risk Free Rate + Bank Spread (which is exceptionally low)



Source: Macrobond, ING estimates

This remains a supportive factor for risk assets of all guises

The 3mth USD Libor rate at sub-12bp currently is a measure of this. At just 7bp above SOFR, it's a steal.

The 3mth USD Libor rate at sub-12bp currently is a measure of this. It's a reflection of where banks can fund themselves. At just 7bp above SOFR, it's a steal for banks. More importantly, that gets reflected in funding rates for all types of products linked to USD Libor. It in turn reflects really tight credit spread generally. And for the global system, it means that the global financial system is not worried, at all. This in turn contains the ability for the US dollar to appreciate out of control. It is also a key containment factor, as it allows emerging markets to hang in there too, bolstered by cheap liquidity and low perception of risk.

A taper would begin to unravel a lot of this, raising the perception of risk

There is a means to at least muting this effect, and that would be through a taper of bond buying, and ultimately a stop. Even then that USD4trn of bond-buying remains in place. For that to change the Fed would have to sell bonds back to the marketplace, or let them roll off without reinvesting. These are options for the future, ones that can both take liquidity out of the money market and place upward pressure on longer market rates. When we get to that point, the perception of risk should rise too, affecting credit spreads and pressuring emerging markets.

Chair Powell has much more than a domestic agenda on his mind as he addresses the taper in the weeks ahead. And that's partly a reason for caution. The unravelling of a good thing can have many unintended consequences. Some dither on the taper is understandable.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.