

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

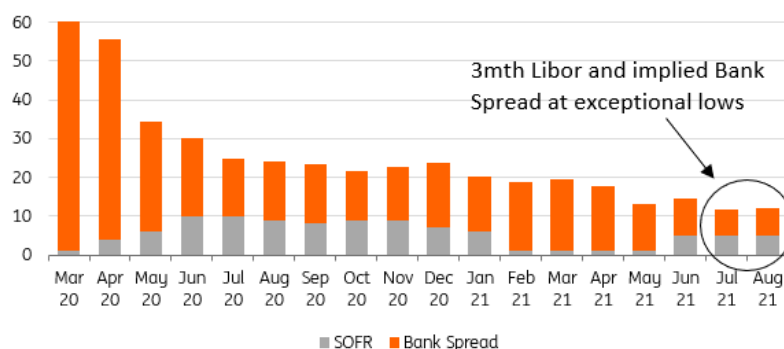
A key driver of global rates, credit and foreign exchange emanates from liquidity conditions in the US. Or to put it better, there's a remarkable excess of liquidity. Since the outbreak of Covid in early 2020 the Federal Reserve has bought a cumulative USD4trn of bonds. It's a massive sum. It equates 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

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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.

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