Article | 6 March 2020

That sinking feeling as Libor spikes

When Libor spikes, we need to sit up and pay attention. Why? It's telling us that the financial system is feeling real stress. Stress that goes beyond a vanilla fall in equity markets, but more of the type that could become as infectious as the coronavirus is for the financial system

Source: Shutterstock

A financial crisis reminder?

Few spend time looking at Libor. We don't blame you.

It's old-school, and it will be replaced by new risk-free rates after 2021. Also, Libor is more about where banks can print commercial paper these days than a measure of risk attached to interbank lending (as there is virtually no volume there). But when it spikes, as it has been doing in the past couple of days, we need to sit up and take attention. This is, in fact, reminiscent of the beginnings of the extremes we saw during the financial crisis.

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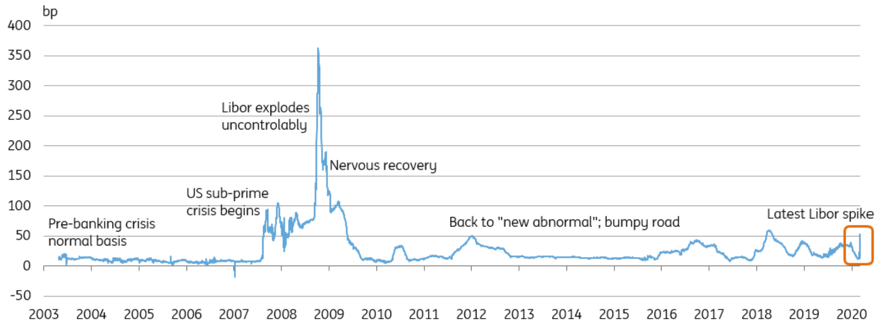

This is a measure of credit risk, the spread of Libor above the risk free rate as set by the Federal Reserve

Why we shouldn't necessarily panic, but then again ...

We are not necessarily expecting to see those extremes ahead; we view the financial system as better capitalised with access to exceptional liquidity provision. The Federal Reserve has been rebuilding its balance sheet through T-bill purchases and has also been making liquidity available to the street through repo operations.

Providing liquidity is one thing, but getting access to it is another. One of the risks we are running is a scenario where some e.g. high yield players flip from running in the black to the red, requiring then a stop-gap, but finding that access to credit is not easy. Access to the bond market for stressed players would prove tricky as the primary market stalls. And as default risks rise, discussions with banks for lines of credit could prove difficult, especially as rating agencies are already making noises on heightened credit risk.

"This is part of a scenario that could result in a credit crunch should conditions continue to deteriorate"

Flight to safety: 2-year eyeing zero

This is part of a scenario that could result in a credit crunch if conditions continue to deteriorate. A de-rating in credit conditions generally is a backdrop that requires help from the Fed. The first step was an emergency 50bp cut earlier this week. Those that doubted the wisdom of that move should factor in the high-risk scenario that we are encountering.

The spike in Libor is a credit event and will see echoes in more traditional credit spreads right out the yield curve, with high yield under particular pressure. At the same time, core rates continue to gap lower (amplifying the wider credit spreads story). The bond market is leading the process here. The 2-year is now below 50bp and will see zero as an extreme but natural target. The 10-year is now below 75bp and will be dragged ever lower by the flight into the front end.

> *"Pressure for another 50bp Fed rate cut is now extreme"*

The Fed needs to deliver more than just a cut

Pressure for another 50bp rate cut from the Federal Reserve is now extreme. It needs to come with a more rounded policy response though. Ideally, measures that provide a comfort blanket for credit providers so that lending can continue.

Resumed quantitative easing is also on this list of remedies, as the Fed risks running out of rate cut bullets. And don't forget that in the extreme QE, does not have to be all about bonds, any risk asset could be on that list (even equities!).

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