USD: Funding squeeze starts to ease

The Covid-19 shock has sent policy makers into fire-fighting mode. One such fire is the breakdown in short term USD funding, emerging in the middle of last week. The Fed's relaunch of its Commercial Paper facility and now good use of the ECB's USD swap line suggests tensions are starting to ease. This may take some steam out of the dollar.

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Good take-up of ECB USD swap line.

Today's ECB swap auction saw good take-up of the 84 day USD auction - US$76bn was allotted. The EUR cross-currency basis swap, a gauge of dollar funding stress in the FX swap markets, narrowed very quickly back towards zero. Here some demand for USD funding has been satiated via the ECB rather than the wholesale funding markets.

It would be foolish to declare that the worse of the crisis is over, but the Fed deserves credit for quickly papering over the cracks appearing in Dollar money markets. The pricing of the Fed's CP purchase facility (3M OIS +200bp) makes it more of a backstop than a tool that will hoover up most paper. For reference, only A2/P2 non-financial paper was trading above that level, and the Fed has put in place safeguards against issuance from each borrower rising above a certain baseline.

The CP purchase program is useful in providing support for issuers. It should also be noted that we think a facility aimed at supporting money market funds, the natural buyers of CP, would be beneficial. Together the two facilities have the power to bring down Libor fixings.

Ease in USD funding strains to take steam out of dollar?

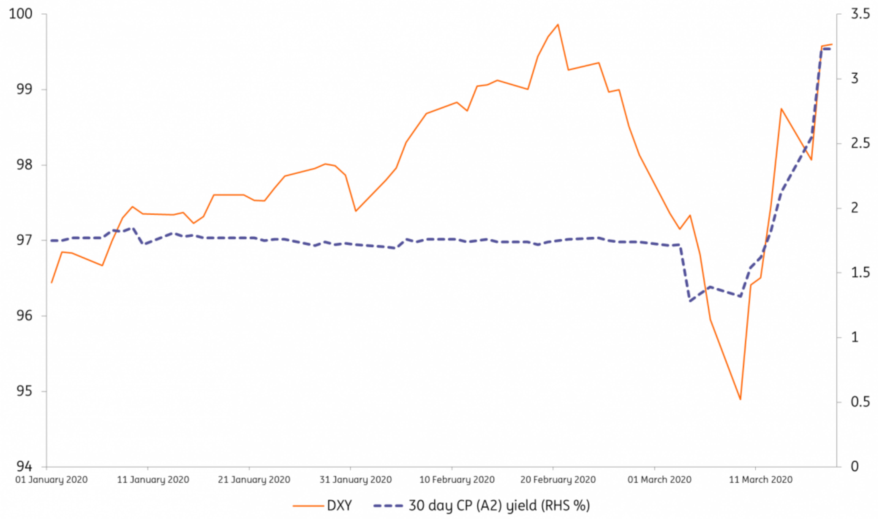
Amongst the huge moves in volatile FX markets, events last Thursday stood out. The dollar started to go bid right across the board. Gone was the view that Fed money printing was bad for the dollar and EUR/$ slumped from 1.15. Driving that move, however, was probably the break-down in the US commercial paper markets. Even though equities had been in sharp decline since late February – it was only last Thursday that confidence in the US Commercial Paper market collapsed.

As we outline below, yields on 30 day CP (A2 rated) surged from 1.6% Wednesday evening to 3.2% yesterday as issuing conditions deteriorate rapidly. The CP market is an important source of corporate USD funding and denied opportunities here, corporates have been forced to draw down on Revolving Credit Facilities at banks. Dollar hoarding is now being widely discussed.

If the Fed action – both by directly buying Commercial Paper and indirectly alleviating pressure in USD wholesale funding markets by providing USD liquidity via the ECB and BoJ etc – can bring calm to the markets – and CP rates drop back, then some of the steam might come out of the dollar's rally.

This could see the DXY hand back some of the gains over the last week. USD/JPY could potentially see the biggest move on this story – given the very fragile equity market through March. EUR/$ may struggle to immediately retrace losses from 1.15 – given a new fire emerging in European sovereign debt markets. Italian 10 year BTP yields trading near 3% clearly is a significant concern for Europe.

Commercial Paper rates spike and drag the dollar with it



Source: Bloomberg, ING

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