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Libor on the rise

September 2016

WHY IS LIBOR RISING? In this report, we discuss the main causes of the recent and quite dramatic rise in USD Libor and consider its implications for short-term fixed income investors.

What is Libor?

Libor (the London interbank offered rate) is one of the most widely-used benchmarks in the short-term fixed income markets. It is used to set interest rates on corporate bonds, mortgages, deposits, loans and derivatives. Libor is quoted in five currencies (CHF, EUR, GBP, JPY and USD)[1] and across seven maturities, ranging from overnight to 12 months. Each quote is an indication of the average interest rate at which banks can obtain unsecured funding in the London interbank market for a given period, in a given currency.[2]

What has been notable about Libor recently?

Libor rates have been steadily rising for the last several months. Since late June, three-month Libor rates rose by over 20bps (to 0.83%[3])—a striking increase over a fairly short period of time that has caught the attention of market participants (**Exhibit 1**). While historically such a rapid rise would signal credit stress, today's higher rates reflect a much less concerning supply/demand dynamic. As we discuss below, upcoming money market reform is propelling a change in investing behavior by money market fund (MMF) portfolio managers. It is the main driver behind the change in market rates.

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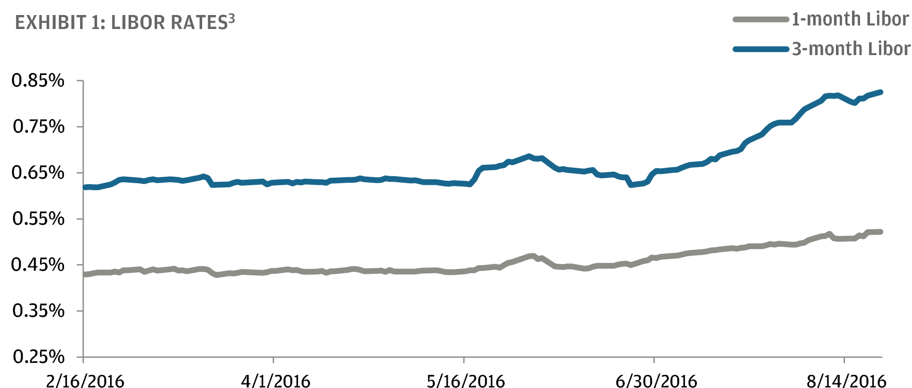
EXHIBIT 1: LIBOR RATES[3]



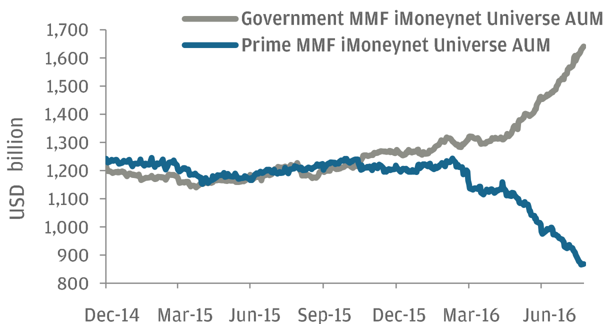
[1]CHF= Swiss Franc; EUR= Euro; GBP= Sterling; JPY= Japanese Yen; USD= US Dollar
[2]Source: www.theice.com/iba/libor
[3]Source: Bloomberg; data as of August 22, 2016

What does money market reform have to do with Libor? What is so special about three-month maturities?

Over the last several years, Securities and Exchange Commission (SEC) regulatory reforms have made the money market fund industry stronger and more transparent. The last and most significant of these regulatory changes must be implemented by October 14, 2016. From that date, institutional prime and municipal MMFs must float their net asset value (NAV) by executing sales and redemptions based on the current market value of the securities in their portfolios. In addition, the SEC reforms stipulate that the board of trustees of an MMF may impose a liquidity fee on redemptions or temporarily suspend redemptions (impose a gate) if the fund's weekly liquidity assets fall below 30% of total assets—and the board determines that such a fee or gate is in the fund’s best interests. By contrast, government MMFs are not required to be subject to the fee and gate provisions and they continue to operate with a stable dollar NAV.

The new requirements, both a floating NAV and gating/fees provisions for prime institutional funds, are spurring an unprecedented migration of assets (in the hundreds of billions), from prime money market funds to government money market funds, whose operations will remain largely unchanged (**Exhibit 2**).

EXHIBIT 2: TOTAL UNIVERSE MONEY MARKET FUND ASSETS



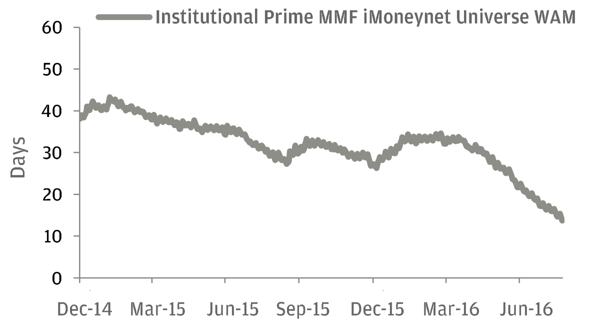
Source: iMoneyNet Fund Analyzer; data as of August 22, 2016.

To manage this significant drawdown in assets, prime fund managers have curtailed almost all term purchases to ensure they have the liquidity they need. Because prime MMFs have traditionally been one of the largest buyers of three-month funding products, mostly in the form of commercial paper (CP) and institutional certificates of deposit (CDs), the largest front end buyer is now largely out of the market. As a result, banks hungry for dollar funding are bidding up higher yields in order to find demand. It is no coincidence that we continue to see increased pressure on three-month Libor.

How long will Libor remain elevated?

Year-to-date, domestic prime money market balances have fallen from USD 1.21 trillion to USD 868.2 billion.[4] We expect prime funds to continue to lose balances right up until the October implementation date. We would not be surprised to see institutional prime assets level off at between USD 250 billion and USD 300 billion. Because it is still unclear what the remaining balances will be in the institutional prime space, fund managers are primarily targeting very short dated paper (30 days and shorter) in order to have the necessary liquidity to fund redemptions. In fact, the weighted average maturity (WAM) of the prime money market sector has dropped from approximately 40 days to 12 days today (**Exhibit 3**).

EXHIBIT 3: FIRST TIER INSTITUTIONAL MONEY MARKET FUND WEIGHTED AVERAGE MATURITY



Source: iMoneyNet Fund Analyzer; data as of August 22, 2016.

[4] Source: iMoneyNet Domestic Marketshare; data as of August 22, 2016.

Even after October, we expect it may take several months before the market determines what the new post-reform level of prime money market assets might be. Therefore, we believe the term structure of Libor will remain steep at least through the end of 2016, and perhaps into the first quarter 2017, as post-reform prime money market funds determine the new optimal amount of three-month paper to hold.

Is there any way to take advantage of this as a front end investor?

Yes. We believe that the steepness in the curve for front end bank paper is very attractive. Strategies that can buy three-, six- or even 12-month bank commercial paper or institutional certificates of deposit are at an advantage. Additionally, for investors in non-financial paper, corporate floating rate notes from higher-quality industrial issuers also offer value: their coupons are influenced by Libor dynamics yet their corporate fundamentals are those of a high- quality company.

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