MARKET INSIGHTS

Market Bulletin

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The LIBOR spike

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In brief

- One of the most important interest rates in global financial markets, U.S. LIBOR, has spiked causing some investors to fear that there is a fundamental problem with the global interest rate market.
- Rather than rising on fundamental forces, the rise in LIBOR can be attributed to technical factors, including tightening U.S. monetary policy, repatriated overseas corporate profits and increased debt issuance from the U.S. Treasury.
- LIBOR may seem like a small cog in the financial machine, but the recent rise has potentially wide-ranging implications for investors if not addressed.
- Rising LIBOR has three important effects on investor portfolios: shifting cash allocations, potentially rising U.S. rates and increased opportunities in global fixed income.

What is LIBOR and why does it matter?

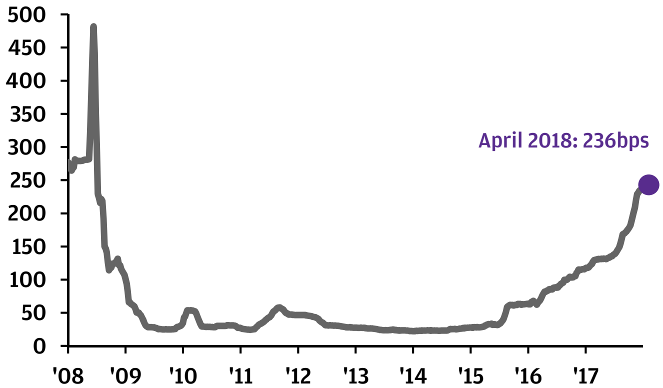
LIBOR stands for "London Inter-bank Offered Rate," and it is defined as the cost of short-term borrowing between banks. Despite its name, the benchmark series is global in nature with LIBOR quoted in five currencies[1] and serves as an important short-term fixed income benchmark with approximately $350 trillion worth of contracts globally trading off it, over 3 times greater than the total market cap of global equities[2]. As such, it is often a closely watched barometer of the financial health of the banking system - if LIBOR rates begin to rise, it can be a sign of financial stress. LIBOR also matters for mortgage repayments in the U.S. with $1.2 trillion of adjustable rate mortgages tied to the benchmark, roughly 11% of outstanding housing debt.

[1] LIBOR is quoted in U.S. dollars, euros, British pounds (GBP), Japanese yen (JPY) and Swiss francs (CHF).
[2] Global LIBOR breakdown: U.S. dollar LIBOR is $150 trillion, Euro LIBOR is $150 trillion, JPY LIBOR is $30 trillion, GBP LIBOR is $30 trillion, CHF LIBOR is $7 trillion

J.P.Morgan Asset Management

EXHIBIT 1: 3-month USD LIBOR

Bps



Source: FactSet, ICE, J.P. Morgan Asset Management. Data are as of April 30, 2018.

What has been happening recently?

Since the end of 2017, U.S. dollar LIBOR has been rising at an accelerated pace (**Exhibit 1**). With so much of the global debt market linked to LIBOR, some investors are worried that it is a sign of deteriorating fundamentals. However, it appears that this year's increase has been driven by technical factors rather than fundamental fears. These factors are as follows:

1. Interest rate hikes

As a short-term lending rate, LIBOR is sensitive to movements in the Federal funds rate. With the Fed underway with its rate hiking cycle, LIBOR has risen to reflect this. However, the Fed funds rate has risen by about 75 basis points over the past 12 months, yet 3-month U.S. LIBOR has risen by 120 basis points, meaning that the spike in LIBOR cannot be entirely explained by rate hikes and other factors must be at play.

2. Treasury issuance

In order to partially fund the new tax act, the U.S. Treasury has increased debt issuance in the first quarter of 2018, with a record $330 billion of net new issuance. This has seen the supply of short-dated bonds increase substantially, driving down prices and forcing yields higher. The yield on a 3-month U.S. Treasury bill has increased by 100 basis points in the last year, while the Fed funds rate has increased by only 75 basis points over the same time period.

3. Repatriation

Under the new tax law, U.S. companies are set to repatriate some of the roughly $2.7 trillion in cash held overseas. Most of that locked-up capital was invested in high-quality liquid investments, many of which are linked to LIBOR. As U.S. firms pull funds back home, the demand for LIBOR-linked products has fallen, resulting in falling prices and higher yields.

Secured Overnight Financing Rate (SOFR)

LIBOR will not be around forever. In April 2018, U.S. authorities introduced a new short-term rate called SOFR. Whereas LIBOR is calculated based on a survey sent to banks, which leaves it open to manipulation, SOFR is based on actual short-term transactions, making it more reliable. With over $150 trillion worth of contracts tied to U.S. LIBOR, it will take some time to transition all contracts over to the new system.

Source: The Federal Reserve Bank of New York, J.P. Morgan Asset Management.

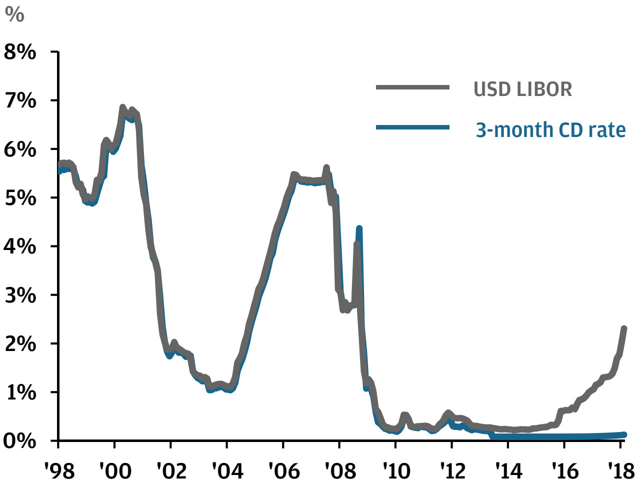
What does a rising LIBOR mean for investors?

LIBOR may seem like just a small cog in the big financial machine, but it plays an important part in investors' portfolios. There are three important ways in which rising U.S. LIBOR could impact investors.

1. Cash is back... sort of

The increase in LIBOR has helped lift offered yields in short-dated liquidity markets. As shown in **Exhibit 2**, a higher LIBOR rate would historically have translated into higher yields on retail Certificates of Deposit (CDs). However, this relationship has broken down recently: banks have been reluctant to pass on higher rates as they seek to maximize profits, potentially helping lift financial earnings in the short-term. Therefore, investors looking to hold cash in their portfolios should consider moving from traditional CDs to more attractively yielding money market products, which are more closely tied to LIBOR.

EXHIBIT 2: USD LIBOR and U.S National 3-month CD rate



Source: ICE, Federal Reserve, FDIC, FactSet, J.P. Morgan Asset Management. Data are as of April 30, 2018. From July 2013 to present, certificate of deposit (CD) rates are calculated from FDIC using a simple average of rates paid on jumbo and non-jumbo deposits by all insured depository institutions and branches. Prior to July 2013, 3-month CD rates are taken from the Federal Reserve Board Secondary Market Rate; a discontinued series found on the H.15 Selected Interest Rates table. Data are as of April 30, 2018.

2. Overseas investors may not anchor U.S. Treasury yields

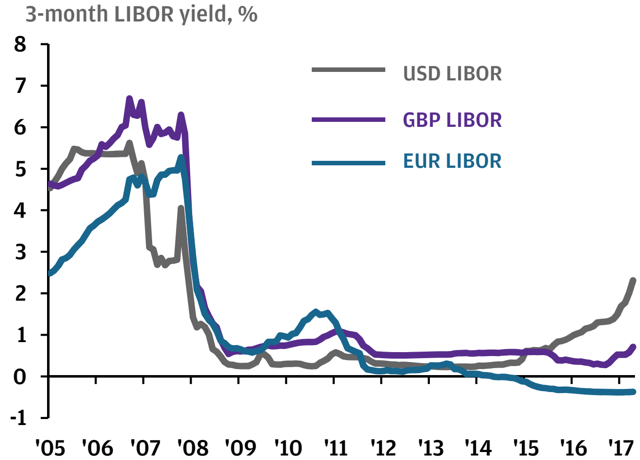
For much of the last decade, the U.S. 10-year Treasury bond has been seen as a relatively high yielding government debt instrument. With a yield of 3.0%, it yields more than 90% of other developed market government bonds. In a world starved of yield, many international investors have come to the U.S. seeking a decent return for their fixed income portfolios with relatively little risk. This international demand has put downward pressure on long-dated U.S. Treasury yields. This is one of the reasons why the yield curve has flattened.

However, any international investor buying a U.S. Treasury bond for access to stable, dependable yield will likely hedge their currency exposure in order to dampen the day-to-day currency volatility that could damage risk-adjusted returns. Hedging costs are calculated as the difference between the U.S. LIBOR rate and the LIBOR rate in a different region. As shown in **Exhibit 3**, the gap between U.S. LIBOR and its international equivalents is widening, driving up the cost of hedging for international investors. As of April 2018, for a European investor to hedge their currency exposure they would have to deposit euro at a Euro LIBOR rate of -0.4% and then borrow at the U.S. dollar rate of 2.4%. The difference between these two rates is 2.7%, which is the investor's currency hedging costs for the year.

Rising hedging costs are a tough obstacle for international investors to overcome, and they reduce the attractiveness of the U.S. Treasury market. The flow of capital from overseas may therefore begin to reverse. This should result in falling bond prices and higher yields, particularly towards the back end of the curve.

EXHIBIT 3: Short-term borrowing rates, LIBOR

3-month LIBOR yield, %



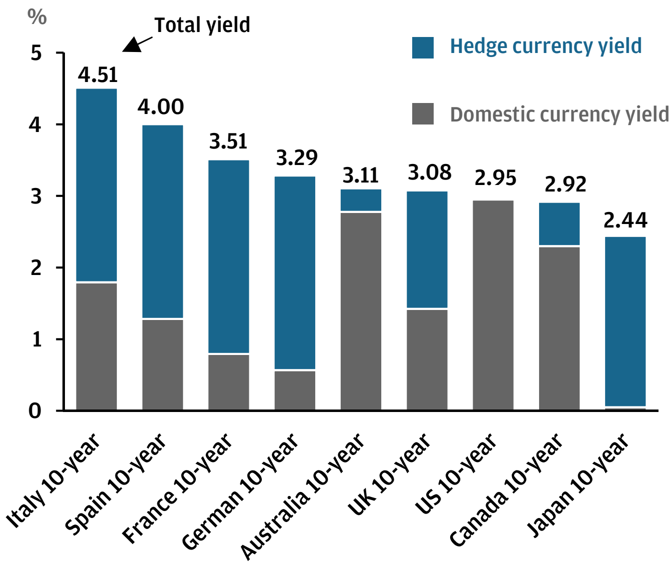
Source: Bloomberg, FactSet, ICE, Tullet Prebon, J.P. Morgan Asset Management. Data are as of April 30, 2018.

3. Global bonds look more attractive

While a widening hedging cost spread may be an obstacle for international investors accessing U.S. fixed income, it can help U.S. investor portfolios. Any U.S. investor looking to hedge their global fixed income currency exposure will benefit from that currency hedge.

As shown in **Exhibit 4**, for example, the German 10-year Bund has a yield of just 0.6% when held in euros. If a U.S. investor were to buy the bond and hedge their currency exposure, however, they would receive 2.7% from the hedge alone, resulting in an effective yield of 3.3%. This is higher than the U.S. 10-year treasury yield, making international fixed income markets much more attractive for U.S. dollar-based investors.

EXHIBIT 4: GLOBAL BOND YIELDS & HEDGING RETURN FOR A U.S. INVESTOR



Source: AFMA, Bloomberg, FactSet, ICE, Tullet Prebon, J.P. Morgan Asset Management. Hedge calculation for Canada uses the Canadian Dealer Offered Rate (CDOR). Hedge calculation for Australia uses the 3-month bank bill swap rate (BBSW). Data are as of April 30, 2018.

Investment Implications

The rise in LIBOR has been driven by technical factors, including Fed rate hikes, repatriation of overseas profits and increased debt issuance. This rise has implications for investor portfolios:

- CDs are no longer an optimal strategy for holding cash. Instead, investors should look to the money markets for products more closely tied to LIBOR for any short-term cash holdings.
- Long-dated U.S. yields could rise as international investors are pushed to return home due to rising hedging costs driven by rising U.S. LIBOR.
- Global bonds now look more attractive for U.S. investors, as rising hedging costs help boost hedged international yields.

The rise in U.S. LIBOR does not likely point to an unwillingness among banks to lend to each other. Still, the rise should be monitored, as it calls for an adjustment in how investors should utilize cash vehicles and creates opportunity in global fixed income markets.

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