

IT'S "FUNDING"MENTAL

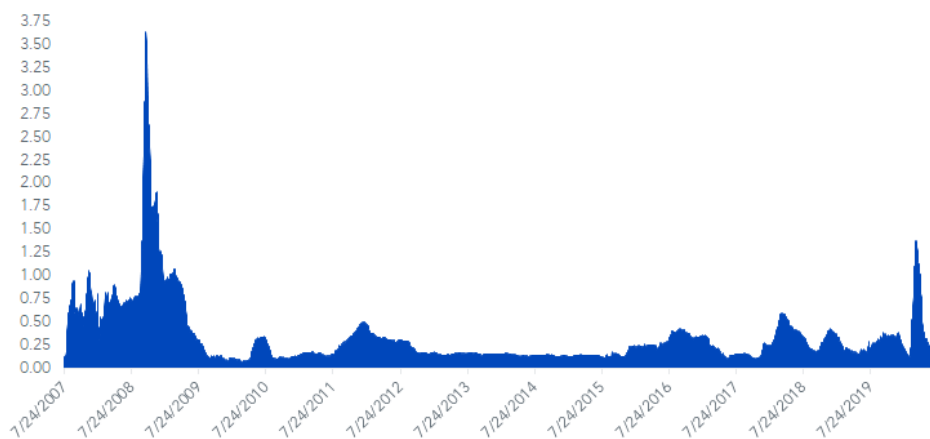
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I haven't had to blog about [LIBOR](#) and any attendant funding issues for a while ... and that was the good news. Unfortunately, the negative market effects from the COVID-19 pandemic created a setting in the funding arena that needed to be addressed posthaste. The [Federal Reserve \(Fed\)](#) has thus far come to the rescue to avoid another financial crisis, realizing how vital it is to prevent another meltdown from a funding perspective.

We can all opine about how the Fed dropped rates to zero and kick-started its [quantitative easing \(QE\)](#) policy, but in my mind, the key was always to make sure that the financial world, companies and others could fund themselves. The concern is not really about debt that matures in later years, but rather the ability for borrowers to meet their short-term debt service costs. As we saw during the financial crisis, once it becomes apparent that these funding needs cannot be met, the adverse setting has the potential to not just snowball but avalanche.

3-Month LIBOR–OIS spread



Source: Bloomberg, as of 7/20/20. Past performance is not indicative of future results.

The focus of the money and bond markets has been on the 3-month LIBOR–OIS spread. We know LIBOR is a key borrowing benchmark rate. [OIS \(overnight indexed swap\)](#) is an interest rate swap that consists of both a fixed and floating rate component. The floating rate part uses an overnight rate index—in the case of the U.S. dollar, the [Federal Funds Rate](#)—while the fixed portion is set at a rate agreed upon by the two parties. Thus, the OIS is considered a proxy for Fed Funds. The LIBOR–OIS spread itself represents the difference between these two instruments and measures one rate that could contain potential credit risk (LIBOR) versus one that essentially does not (Fed Funds).

When this spread widens, it is considered to be a sign of stresses in the short-term bank funding markets. As the graph highlights, this spread widened to 138 [basis points \(bps\)](#) in March, the second highest reading on record. Interestingly, it still pales in comparison to the 364-bps peak during the financial crisis. But that's the important point: the Fed reacted proactively, used its financial crisis playbook, added some new "wrinkles" and prevented a run at the all-time high. The good news doesn't end there, however. The LIBOR–OIS spread has now fallen to roughly 20 bps, back to pre-pandemic levels.

Conclusion

Are we out of the woods? Perhaps being a bond guy, I remain cautious and will continue to monitor developments in the funding markets on a regular basis. Recent Fed commentary suggests that policy makers have a little bond guy in them as well. As a reminder, the [FOMC](#) is scheduled to meet Wednesday, July 29, and we'll be sure to blog about the outcome, which more than likely will underscore the committee's commitment to market normalization and economic

support.

Unless otherwise stated, all data sourced is Bloomberg, as of July 20, 2020.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

London Interbank Offered Rate (LIBOR) : the average rate that major banks offer to lend to each other for short-term unsecured funds in a particular currency for a particular maturity in the wholesale money market in London. It can range from overnight to one year and is utilized as a benchmark for various loans and in the capital markets.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Overnight Index Swap (OIS) : an interest rate swap that consists of both a fixed and a floating rate component. The floating rate part uses an overnight rate index, in the case of the U.S. dollar the Federal Funds Rate, while the fixed portion is set at an agreed-upon rate between the two parties.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Basis point : 1/100th of 1 percent.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.