

DEBATING STRESS IN THE FUNDING MARKETS

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03/17/2020

Our latest “Behind the Markets” podcast had a great panel: Wharton Professor Jeremy Siegel; Jim Bianco of Bianco Research; Kevin Flanagan, Head of Fixed Income Strategy for WisdomTree; and Liqian Ren, Director of Modern Alpha at WisdomTree.

We discussed the outlook for stocks amid the coronavirus pandemic. Professor Siegel recently detailed why he finds equity [valuations](#) quite attractive at today’s levels.

Bianco has tracked the coronavirus spread carefully, and he is worried about confirmed cases doubling every three days in the U.S. and what measures we are taking to prevent infections from spreading further.

But the most interesting segment of the podcast debated stress levels in the funding markets.

Bianco is perplexed that the [Federal Reserve \(Fed\)](#) offered to provide \$1.5 trillion of [liquidity](#) in the funding markets—an amount so large it is hard to comprehend—while only \$42 billion was absorbed by banks. Note that \$1 trillion would have added more to the Fed’s balance sheet than all of [quantitative easing \(QE\)](#) provided during the first QE phase of the financial crisis.

Bianco believes that regulations and newly added capital restrictions prevented banks from taking more of this funding at quite attractive financing rates. Bianco is monitoring the FRA-OIS spread¹ as his key gauge for the level of stress in the bank funding market, and this spread rose significantly from 11 to 66 [basis points \(bps\)](#).

3-Month FRA-OIS Spread



Sources: Bianco Research, Bloomberg, as of March 12, 2020.

Professor Siegel countered that the [LIBOR](#) disconnected from the [Fed Funds Rate](#) by 400 bps at the peak of the Lehman Brothers crisis. Most loans at the time were based on the LIBOR, a real issue the Fed had to address, because lowering their Fed Funds Rate didn’t translate to lowering funding costs, as fears spread that banks were going bankrupt.

Siegel does not see this same issue today. We are transitioning away from LIBOR pricing of loans to a new [SOFR](#) rate, and the SOFR on Friday was 120 bps versus 110 bps for the Fed Funds Rate, which he views as a spread that is a result of markets functioning normally.

Siegel further commented that the [TED spread](#) (the difference between the interest rate on short-term U.S. government debt and the interest rate on interbank loans) was only 41 bps, while its average over the last four years was close to 35 bps, signaling a level is not extreme.

Flanagan is less focused on the 100 bps of additional rate cuts that the Fed announced Sunday night, and more on additional funding facilities that could allow banks to expand the collateral they can place with the Fed beyond [Treasuries](#) and [agencies](#) in exchange for short-term liquidity and cash.

In addition, the Fed introduced QE4, which has the Fed buying \$500 billion of Treasury securities and \$200 billion of [mortgage-backed securities](#). It also lowered the "[discount window](#)" primary credit rate 150 bps to 25 bps, one step that may ease the funding stress Bianco referenced.

It was great to have a lively debate on these important issues, and I am sure we will keep coming back to this funding market question in future podcasts.

Please listen to the full conversation below.

For more investing insights, check out our [Economic & Market Outlook](#)

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DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

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

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

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.

Basis point : 1/100th of 1 percent.

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 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.

U.S. Secured Overnight Financing Rate (SOFR) : An influential interest rate that banks use to price U.S. dollar-denominated derivatives and loans. The daily SOFR is based on transactions in the Treasury repurchase market, where investors offer banks overnight loans backed by their bond assets.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Agency : a debt security issued by a U.S. government-sponsored entity such as FNMA, FHLB, and SLMA.

Commercial mortgage-backed securities : a fixed income security that is composed of multiple underlying commercial mortgages.

Discount : When the price of an ETF is lower than its NAV.