Is the Widening LIBOR-OIS Spread Cause for Concern?

By Michael Gladchun, VP, Senior Fixed Income Trader

KEY TAKEAWAYS

- The LOIS spread, traditionally considered a barometer for stress in the financial system, is at its widest point since the financial crisis.
- We don't think the recent widening is a sign of trouble in the financial system. We believe the changes are due to technical factors.
- We do not expect the widening trend to affect FOMC policy in the near term.
- Structural market shifts may keep LOIS wider and more volatile relative to history. We caution against reading into isolated movements.

Traditionally, a widening spread between LIBOR and OIS (LOIS) has been viewed as a sign of emerging stress in the financial system. This spread is now at its widest level since the global financial crisis, exceeding levels seen at the height of the European sovereign debt crisis (2011-2012) and in the midst of US money market reform in late 2016.

Understandably, the sharp widening in LOIS has investors concerned and wondering: 1) Does it indicate increased risk aversion and emerging stress in the financial system? 2) Does this rise in borrowing rates imply an inadvertent further tightening in financial conditions that could limit the pace and magnitude of the current monetary policy tightening cycle?

As we will explain, we believe technical factors have driven LOIS wider; we do not consider it a sign of financial stress or a factor likely to alter near-term monetary policy.

A Closer Look

Analyzing the data, 3-month LIBOR has increased by more than 60 basis points (bps) year to date through April 9, despite the Federal Open Market Committee (FOMC) having made only one 25-bp increase in the federal funds rate during the same period.

ABBREVIATIONS KEY

LIBOR: London Interbank Offered Rate

OIS: Overnight Indexed Swap

LOIS: Spread between LIBOR and OIS

CP: Commercial paper

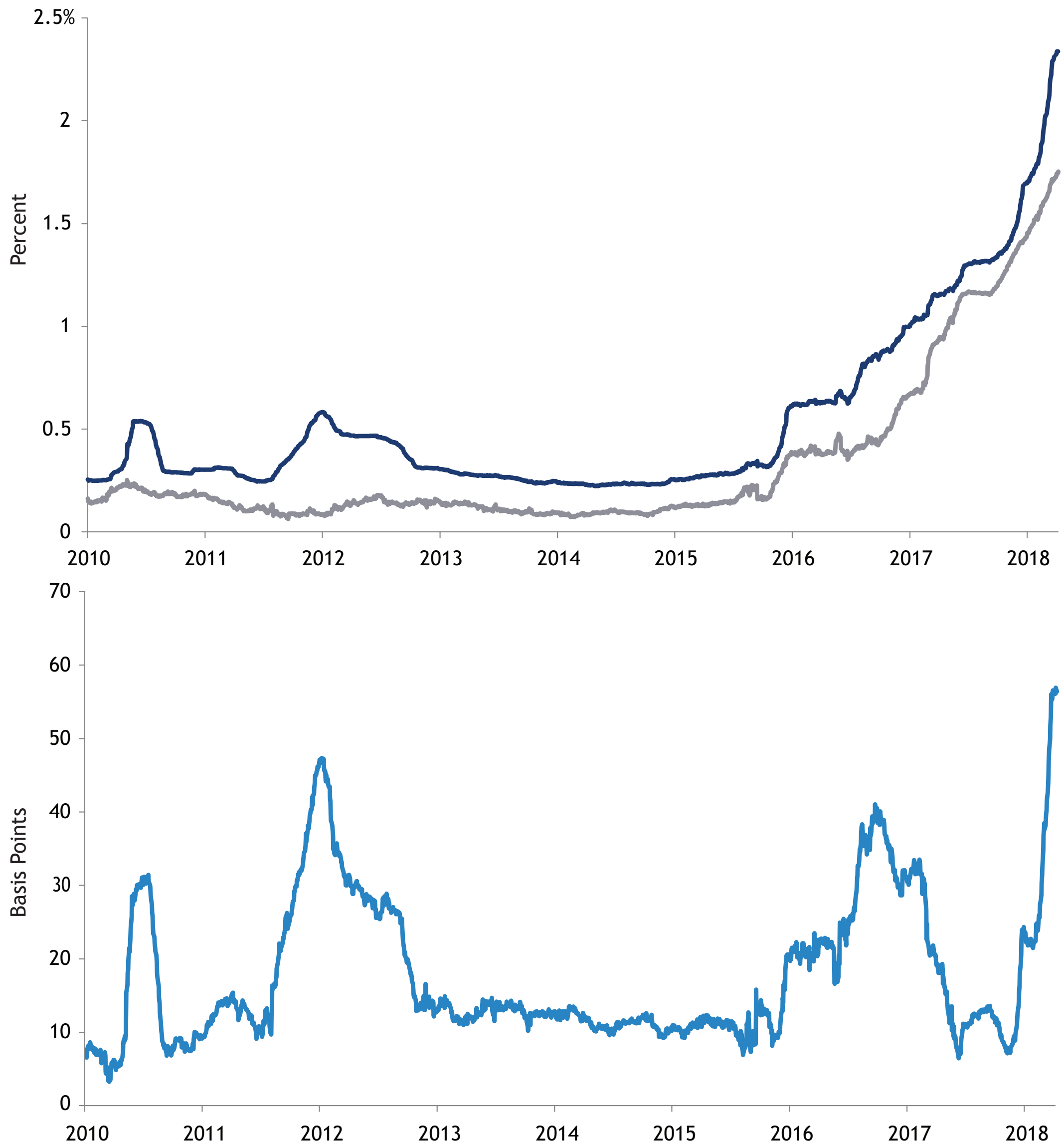
BEAT: Base Erosion and Anti-Abuse Minimum Tax

It appears that the majority of the recent rise in 3-month LIBOR has more to do with factors that are unrelated to the expected path for the fed funds rate; consider that the spread between 3-month LIBOR and the market's expected path for the fed funds rate over the same 3-month term (the 3-month overnight index swap rate, or OIS) has widened by about 35 bps year to date and nearly 50 bps since November 1, 2017.

INCREASE IN LIBOR OUTSTRIPPING INCREASE IN RATE EXPECTATIONS

Source: Bloomberg data, as of April 10, 2018.

- 3-month USD LIBOR (top chart)
- 3 month USD OIS (top chart)
- 3-month LOIS (bottom chart)



Our View

We believe that the recent widening in LOIS is fully attributable to technical factors that can be easily explained. While we acknowledge that there are structural shifts occurring in the market that are likely to cause LOIS to continue to be more volatile and, on average, probably a bit wider relative to history, we don't think this is consequential at the macro level. We would caution against inferring much, if any, signal from isolated movements in LOIS. We believe the FOMC likely shares this view and, as such, we foresee no material impact from the recent LOIS widening on the path for the fed funds rate or FOMC communications in the very near term.

Analysis

So, what do we believe has contributed to the recent widening of LOIS? In seeking to understand and explain the widening, we find it useful to think of LOIS as a spread consisting of three component spreads.

1. The spread of the 3-month Treasury bill yield over 3-month OIS **(T-bill/OIS)**
2. The spread of 3-month commercial paper (CP) rates over 3-month T-bill yields **(CP/T-bill)**
3. The spread of 3-month LIBOR over commercial paper rates **(LIBOR/CP)**

The table below details how and why these component spreads have risen since the LOIS widening trend began in November 2017.

TECHNICAL FACTORS PUSHING LOIS COMPONENT SPREADS WIDER

	TECHNICAL FACTOR	CHANGE IN COMPONENT SPREAD SINCE NOV 2017	PERCENT OF LOIS WIDENING
T-BILL/OIS	**T-bill supply**: Debt ceiling dynamics and the Treasury's seasonal financing needs have led to a surge in T-bill supply. ***Result: The market has demanded higher T-bill yields; and the yield on 3-month T-bills has exceeded the 3-month OIS rate for the first time since 2009.***	+11 bps	22%
CP/T-BILL	**Repatriation:** US dollars held offshore by US corporations had largely been invested in higher-quality shorter-duration US-dollar-denominated assets. Repatriation is reducing this stockpile of dollars available to invest in such assets. ***Result: The supply of funds in CP markets has decreased.*** **Tax reform:** The Tax Cuts and Jobs Act of 2017 added a new BEAT minimum tax, which penalizes inter-affiliate bank funding. New York branches of foreign banks are not currently able to efficiently obtain US dollars from their global headquarters. Many are now turning to local unsecured markets, like CP, for dollar funding. ***Result: The demand for funds in CP markets has increased.***	+27 bps	57%
LIBOR/CP	**LIBOR** is an average of estimated borrowing rates. Given the dearth of actual unsecured term borrowing occurring in the interbank market, the bulk of these estimates rely on "market-data based" observations, including transactions in instruments whose values are derived from expectations about future LIBOR fixings. ***Result: Expectations about future LIBOR fixings impact the spot rate that is reported today. This feedback loop makes the LIBOR/CP spread highly pro-cyclical, likely exacerbating any trend.***	+ 10 bps	21%

Source: Bloomberg; data from November 1, 2017, to April 5, 2018.

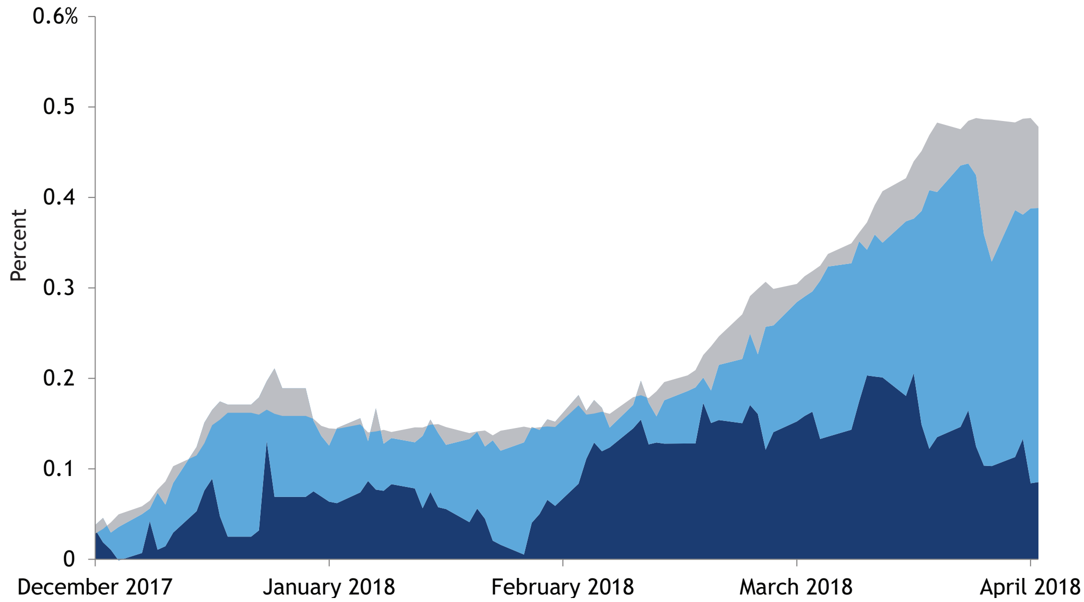
Influence of Component Spreads

In an effort to further clarify the influence of the components, the chart below shows data normalized to begin at zero on November 1, 2017.

LIBOR-OIS: CHANGE IN COMPONENTS SINCE NOVEMBER 2017

Source: *Bloomberg data, as of April 5, 2018.*

- T-Bill/OIS
- LIBOR/CP
- CP/T-Bill



Conclusion

In summary, we think the recent widening in LOIS is about a supply and demand imbalance triggered by a surge in demand for US dollars by money markets (increased T-bill supply, BEAT-related CP issuance) amid a reduction in the supply of funds available (due to US dollar repatriation). The move has likely been exacerbated by the pro-cyclical feedback loop embedded in the LIBOR reporting methodology. We believe these factors represent either short-term technical pressures or an ongoing adjustment in market structure, neither of which we view as a cause for concern regarding the health of the financial system or the general state of broad financial conditions.

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