LPL RESEARCH

BOND MARKET PERSPECTIVES

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LIBOR-OIS SPREAD WIDENING: WHAT LIES BENEATH?

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

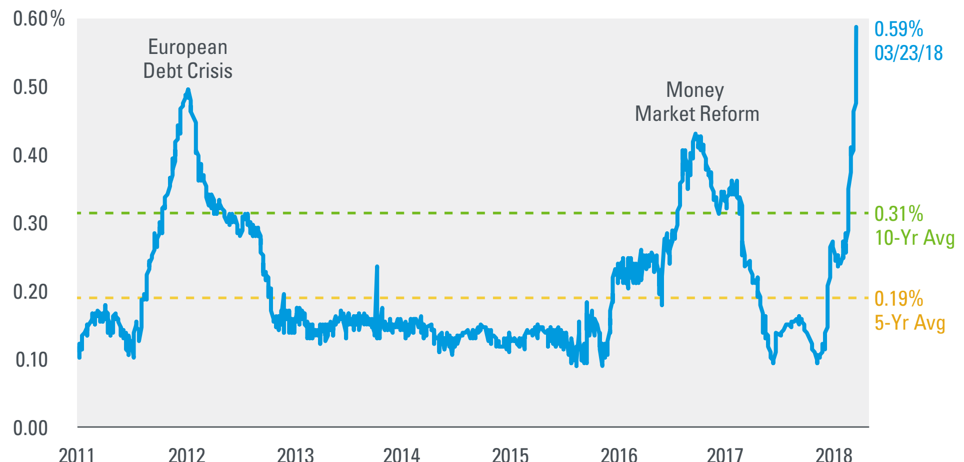
The spread between the three-month LIBOR and OIS rates has widened considerably.

Technical factors appear to be driving the rise in rates, though it warrants ongoing monitoring to ensure it does not become a fundamental concern.

We believe the spread may see reprieve in the second quarter, as Treasury issuance slows down and tax receipts start to come in.

The spread between the three-month London Interbank Offering Rate (LIBOR) and the Overnight Indexed Swap (OIS) has widened to its highest level since 2008. This increase may be grabbing headlines, but in our view it is not portending anything ominous at this point. The three-month LIBOR is a good proxy for interbank lending, as it tracks the rate at which banks are willing to lend money to each other. It stands at 2.29% (as of March 23, 2018). OIS uses an overnight index rate, such as the overnight fed funds rate, making it a good proxy for central bank rates. It currently stands at 1.70%. Thus the spread between the two can be seen as an indicator of credit concerns within the banking system as an increase in the spread may indicate that banks are requiring higher interest rates on peer loans, suggesting deterioration in banks' credit quality. Its recent sharp increase [Figure 1] has investors understandably concerned. The current level of 0.59% is well above the 0.19% 5-year average and the 0.31% 10-year average (which includes the very elevated levels during the financial crisis, when it peaked at 3.64% on October 10, 2008, over 3% higher than today's level). The overall level, but also the consistency and pace of the rise, have been worrisome phenomena as well.

1 LIBOR–OIS SPREAD HAS SURPASSED RECENT ELEVATED LEVELS



Source: LPL Research, Bloomberg 03/22/18

Performance is historical and no guarantee of future results.

The London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The three-month Overnight Indexed Swap (OIS) rate tracks the overnight effective fed funds rate. While the fed funds contracts track to the average effective fed funds rate over the course of a calendar month, the three-month OIS contracts track the compounded fed funds rate over a three-month period.

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WHAT'S THE CAUSE?

Several technical factors have been conspiring to press this spread higher over the last four months. However, in our opinion, they are not indicative of any material deterioration in credit conditions, nor are they foreshadowing any major negative event on the horizon. Some of the factors include:

- **A surge of Treasury issuance** is pushing up borrowing rates for the U.S. Treasury and thus other borrowers, whose rates are generally tied to Treasury rates and include a premium (spread) for credit risk. Treasury issuance, especially of short-term T-bills, has been heavy in recent months to make up for the initial shortfall in tax receipts due to the tax plan.
- **Repatriation is taking a buyer out of the market.** Part of the Tax Cuts and Jobs Act allows companies to bring foreign profits back to the United States at advantageous tax rates. Because of this, companies are keeping the money in cash or in one-month debt to use it more opportunistically for wages, buybacks, or other corporate uses. This is corroborated by the modest widening in the one-month LIBOR-OIS spread relative to the three-month spread. These corporate buyers had been a good source of demand for short-term debt markets and affected the supply/demand dynamic when removed, which pressed rates higher.
- **The Federal Reserve's (Fed) balance sheet unwind** is also taking another source of liquidity out of the market. The Fed's balance sheet roll off is proceeding as planned, and with one less buyer and a huge liquidity source withdrawn, it can be seen as adding further upward pressure on borrowing rates.

LIBOR-OIS may tighten in April and May as the market receives clarification on the use of repatriated cash, and as the Japanese fiscal year-end passes, which could bring another big buyer back into the market. Additionally, as the Treasury pays down some of its T-bills in the second quarter, funding pressure—and thus funding rates—could see some reprieve.

Despite the concerning nature of the indicator, the following measures suggest that this shift is not indicative of fundamental concerns:

- **Most other measures of financial conditions are still accommodative.** Credit spreads remain tight, long-term Treasury rates have been moving sideways at low levels from a historical perspective, and equity markets are still trading less than 8% from their all-time highs.
- **High-yield pricing is restrained.** Spreads (the differential between yields on high-yield bonds and comparable maturity Treasuries) remain tight by historical standards, despite modest widening amid equity volatility. High-yield dispersion, the difference between yields on lower-rated and (relatively) higher-rated high-yield bonds, is actually improving. This is a distinct counterpoint to the narrative of increasing credit concerns.
- **Financial sector stocks have been beating the broad market.** Since the widening in the LIBOR-OIS spread initiated in early November 2017, the S&P 500 Financial Index has beaten the S&P 500 Index overall (November 11, 2017 to March 26, 2018), which would likely not be the case if the widening spread were truly indicative of stress within the banking system. In contrast, the financial sector underperformed the S&P 500 by over 30% during 2007 and 2008 combined, another period of rising LIBOR-OIS spread. During 2007, when the initial widening began, financials underperformed the broad market all 12 months of the year.

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NEGATIVE FEEDBACK LOOP

The market may not be out of the woods yet, as the feedback loop could be trouble. Liquidity, the availability of capital within the economy or markets, cannot prevent all crises from happening. However, a lack of liquidity can certainly cause a credit crunch. Rising funding costs, even if they are not originally driven by fundamental reasons, can become fundamental problems if borrowing costs rise high enough. This is one of the reasons we track bank lending standards as a leading indicator of defaults within lower-quality fixed income. Tightening lending conditions, whether done explicitly by banks or more implicitly via higher market interest rates, can be a headwind for more highly leveraged firms or those more reliant on funding markets for ongoing operations. We are already seeing some minor evidence of this. We previously discussed that rising T-bill supply has pressed Treasury borrowing costs higher, partly explaining the rise in LIBOR over OIS. However, the spread between the LIBOR and T-bill rates has been rising as well, indicating that other factors are at play.

CONCLUSION

We do not believe the widening LIBOR-OIS spread has been driven by major fundamental concerns. In fact, it may see some reprieve during the second quarter of 2018 because Treasury bill issuance during April could actually turn negative, as the Treasury begins to get receipts from tax payments. This would be a reversal from the heavy issuance that helped pressure this spread higher. That said, there are other factors that could be driving the rise at the margins, including slightly increasing the perceived credit risk of some borrowers. While we don't believe this to be the main driver, it remains an important phenomenon we will continue to monitor. ■

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Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

High-yield/junk bonds (grade BB or below) are not investment-grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

DEFINITIONS

The London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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