What's Up with Short-Term Investment Rates?

In a word – everything. An overwhelming combination of Federal Reserve (Fed) tightening, increased U.S. Treasury supply, stronger economic data and U.S. federal tax code changes have conspired to push short deposit and LIBOR rates higher. The widening LIBOR-Overnight-Indexed Swap Rate (OIS) spread, in particular, has gained a lot of media and investor attention. And for good reason – these rates are not academic concepts, but actual market levels impacting the income investors receive on their hard-earned cash. The forces driving the move up in LIBOR and deposit rates are varied, with some transitory and others more permanent. But there is no denying we have seen some fundamental shifts in funding market conditions:

> ***LIBOR is higher, but the incremental return earned from higher deposit rates is due to increased demand for scarcer dollar funding rather than an assumption of increased credit risk.*** For you veterans of the Great Recession, we do not see widening LIBOR spreads as a sign of instability or lack of faith in the global banking system à la 2008. Bank credit default swaps (CDS) – perhaps the best method to gauge banking sector stress – has been well behaved during the recent LIBOR-OIS divergence. Instead, the move higher in absolute and relative yields is almost certainly due to technical factors influencing the supply and demand for U.S. dollar funding, which we outlined in our Q1 commentary (click here to read).
>
> ***Your dollars are a more valuable commodity in today's funding markets.*** We have come a long way from the dreary days of the Fed's Zero Interest Rate Policy and Quantitative Easing (QE). Cash investors are now earning a reasonable return on their funds and are actually being courted by issuers dealing with the realities of today's funding markets. Back in the days of QE, the Fed was generating bank reserves through the purchase of Treasuries and agencies, easing financial conditions and making life simpler for deposit-gathering institutions. Now the Fed is shrinking its securities portfolio and balance sheet, reversing the process and draining reserves from the system. Since the Fed began tapering its asset purchases in the fourth quarter of 2017, securities held outright on the Fed's balance sheet have fallen $75.4 billion from September 28, 2017 through April 26, 2018. $75.4 billion is not a tremendous amount in the context of a $4.3 trillion balance sheet, but if you believe in supply and demand curves – and you should – any reduction in the Fed's balance sheet makes remaining funds more valuable.
>
> ***The U.S. Treasury is going to be a major competitor for your dollars.*** Now that Republicans have dropped any pretense of being the party of fiscal discipline, we can all get on the same page that no one – and I mean no one – in Washington cares about budget deficits. Hardly a shock, really – Congress hasn't cared since the 1990s and New York real estate developers aren't exactly known for their aversion to debt. December's tax cuts and spending increases have kicked deficit and Treasury issuance forecasts into a whole new realm. In the first quarter alone, Total Marketable Public Debt Outstanding has risen $452.1 billion to $14.920 trillion outstanding with T-bills accounting for $328.5 billion of the new

Jim Palmer, CFA
Chief Investment Officer

LIBOR: London interbank offered rate, the basic rate of interest used in lending between banks on the London interbank market and also used as a reference for setting the interest rate on other loans.

OIS: An Overnight Index Swap is an interest rate swap involving the overnight rate being exchanged for a fixed-interest rate, often viewed as a substitute for federal funds rates.

LIBOR-OIS Spread: The LIBOR-OIS spread represents the difference between an interest rate with some credit risk built in and one that is virtually free of such hazards. Therefore, when the gap widens, it can be viewed as a potential sign of stress in the financial sector.

Total Public Debt Outstanding as of 3/31/18 is $21.089 trillion. $5.637 trillion of debt outstanding is in the form of nonmarketable securities held by government trust funds, revolving funds and special funds.

issuance. Which – if my math is correct – is a lot. And it will only get worse. The Congressional Budget Office estimates fiscal deficits will rise from $665 billion in the previous fiscal year to $1.526 trillion by 2028. The upshot of all this new issuance is deposit-gathering institutions will be in a spirited competition with the U.S. Treasury for financing. The long, long, long anticipated government crowding-out effect has finally arrived, probably for good.

Stepped-up Fed policy expectations are playing a role in the LIBOR increase. Three-month LIBOR rates should rise more quickly if the Fed sticks to a once-per-quarter pace for rate hikes. It's simple math. Every time the calendar flips on the rolling 91-day period that makes up three-month LIBOR, one day utilizing today's lower rate rolls off and a new day utilizing a higher future rate rolls on (the higher rate being due to the expectation of a future Fed rate hike). Currently, the Fed's Dot Plot indicates two additional rate hikes for 2018. It seems fairly apparent market expectations are consolidating more around three additional hikes in 2018. And it is this ratcheting up of expectations for a more aggressive Fed that is contributing to the outsized jump in LIBOR rates.

Not that you asked, but I just don't see economic conditions warranting the aggressive Fed action called for by many analysts. After March's PCE Deflator and PCE Core advanced 2.0% and 1.9% year over year, respectively, the Fed can rightly claim success in finally moving inflation measures back to its 2% target. It is this success – as well as the fear low unemployment rates will drive excessive wage growth – pushing the cause for stepped up Fed tightening. I get it to a point, but the structural impediments to inflation remain daunting. Demographics, technology, disruptive retail and distribution models and deregulation all argue for inflation containment. And, of course, the Fed has actually tightened policy and is getting more bang for its buck in the form of juiced-up LIBOR rates. We can toss one more anti-inflation factor into the ring: de-leveraging in non-government sectors. Anecdotal evidence suggests companies may be using repatriated cash or improved after-tax cash flows to pay down outstanding bank lines of credit and debt. Furthering the case, SIFMA data show first quarter U.S. Corporate Investment-Grade and High-Yield issuance is down 21% ($86B) and 32% ($28B), respectively, vs. the first quarter of 2017. While a little de-leveraging in the corporate sector warms my credit-quality loving heart, debt reduction inhibits inflation and can reduce money in the system through a reverse deposit multiplier effect. Ultimately, I think these conditions will stay the Fed's hand from a more aggressive approach. That said, the market clearly wants to push short rates higher in the near term and I see no reason to be quixotic and get in its way. Stay short my friends.

The deposit multiplier, also referred to as the deposit expansion multiplier, is a function used to describe the amount of money a bank creates in additional money supply through the process of lending the available capital it has in excess of the bank's reserve requirement.

Sources:

Bloomberg

Bureau of the Fiscal Service, Monthly Statement of the Public Debt of the United States, March 31, 2018

Congressional Budget Office, Economic Projections, April 2018

Federal Reserve, Statistical Releases, September 28, 2017 and April 26, 2018

JP Morgan, Global Data Watch, March 29, 2018

SIFMA, U.S. Corporate Bond Issuance

SIFMA, U.S. Treasury Securities Outstanding

Definitions:

Credit default swap is a particular type of swap designed to transfer the credit exposure of fixed income products between two or more parties. In a credit default swap, the buyer of the swap makes payments to the swap's seller up until the maturity date of a contract. In return, the seller agrees that, in the event that the debt issuer defaults or experiences another credit event, the seller will pay the buyer the security's premium as well as all interest payments that would have been paid between that time and the security's maturity date.
Federal Reserve (Fed) is the United States central banking system. It is comprised of 12 regional central banks, known as the Federal Reserve Banks, which are owned by private banks. The Fed is governed by a 7-member Board of Governors, who regulates interest rates, availability of bank credit and sets other monetary policies such as legal reserve requirements for banks.
Federal Reserve Dot Plot is issued by the Federal Open Market Committee (FOMC) to pictorially show the participants' collective judgment of expected year-end interest rates.
Inflation is defined as a sustained increase in the general level of prices for goods and services. It is measured as an annual percentage increase. As inflation rises, every dollar you own buys a smaller percentage of a good or service.
Personal Consumption Expenditures Core Index is a measure of price changes in consumer goods and services excluding food and energy.
Personal Consumption Expenditures Deflator Index is a measure of price changes in consumer goods and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.
Quantitative Easing is a government monetary policy in which the total money supply is increased through the Federal Reserve purchasing its own Treasury bonds from banks on the open market. This policy is intended to get money into the banking system so banks have more money to lend to businesses and consumers.
SIFMA is the Securities Industry and Financial Markets Association, a United States based trade group representing banks, brokerages and asset management firms.
Treasury is negotiable debt obligation of the U.S. government, secured by its Full Faith and Credit and issued at various schedules and maturities. The income from Treasury securities is exempt from state and local, but not federal, taxes.
Zero interest rate policy or zirp is a route taken by a central bank to keep the base rate at zero per cent in an attempt to stimulate demand in the economy by making the supply of money cheaper. The term is also used to describe a near zero benchmark rate set by countries such as the UK in the post financial crisis years, which kept interest rates near to zero and accompanied that policy with measures such as quantitative easing.

First American Funds.