RESEARCH TEAM

WHIT DAVIS
STEPHEN HALKOS
HOWELL HOLLIS
STUART HUSTON
HARRY JONES
BRENDAN KEELAN
ELIZABETH MACKIE, CPA
JACOBI PADGETT
DENNIS SABO, CFA®
WILL SKEEAN, CFA®

What is up with Libor?

EDGE RESEARCH INSIGHTS | OCTOBER 2016

Executive Summary:

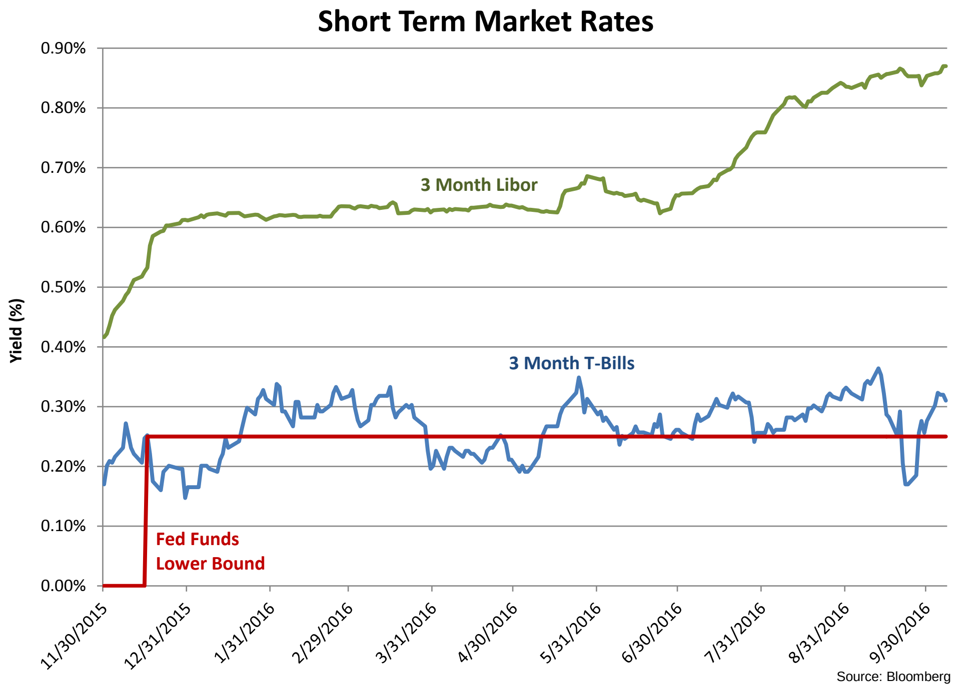
Money market reform has caused a significant shift in buyer demand for short-term capital. As a result, funding costs for banks has increased as reflected by Libor.

What is Libor?

Libor (London Interbank Offering Rate) is a global short-term borrowing benchmark rate used as a reference rate in over $350 trillion of financial products[1]. US Dollar Libor is the rate at which 17 large global banks in London would be willing to lend U.S. dollar deposits to each other.

What Does Rising Libor Mean?

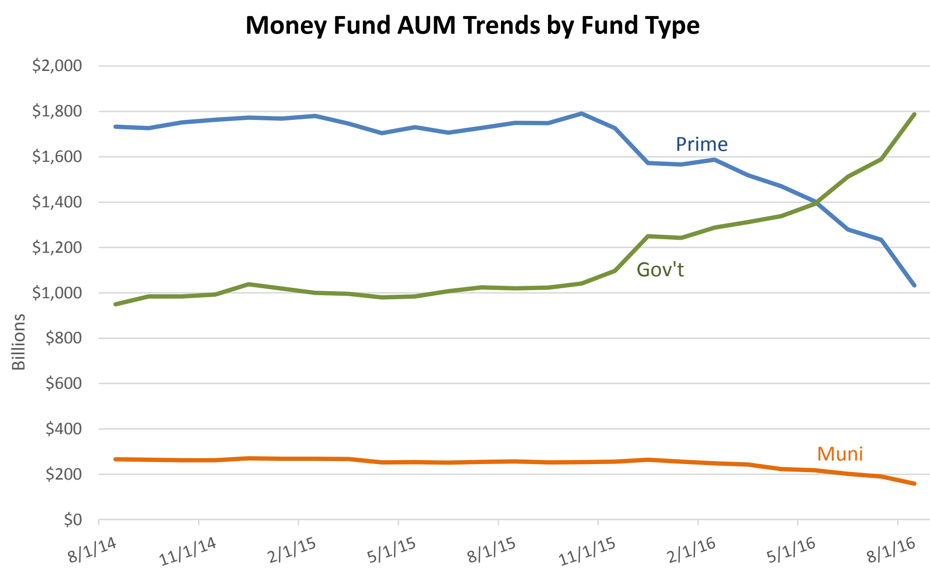
Libor is primarily a benchmark rate for lending, but it can also be viewed as a barometer for stress in the financial system and, more specifically, for stress in the non-US banking system when compared to a risk-free rate. The Ted Spread, which is the difference between 3 month Libor and 3 month Treasury Bill rates, is a popular measure of banking stress and has averaged 40 basis points over the last sixteen years (including the financial crisis when it peaked at 460bps) and 25 basis points post crisis. Currently at 55 basis points, the spread indicator is at the same level as it was during the European Banking crisis of 2011. Should investors be concerned about the current gap between these two closely followed rates? Does this mean that there is the same level of stress in the banking system as there was during the European Banking crisis? While the Brexit vote earlier this year could be the cause of some concern, there are other stress factors that indicate the financial markets are more stable than



the Ted Spread might imply. For instance, the premium demanded to compensate for default risk as measured by Credit Default Swap Spreads has not widened for European Financials as it did during the recent crisis. An alternative theory is that the cause for the increase in Libor and the Ted Spread is more a result of recent Money Market Fund reform rather than banking sector stress.

Unintended Consequences of Money Market Reform:

Two years ago the Securities and Exchange Commission (SEC) passed sweeping changes to how money market funds are structured. For institutional money market funds, floating net asset values (NAVs) were instituted for Prime and Municipal funds, along with liquidity gates and redemption fees being allowed at the discretion of the fund complex. These reforms were enacted as a result of funds "breaking the buck" during the financial crisis, but as with anything there are unintended consequences. The two most notable consequences are the consolidation of the money market industry (117 funds have closed in the last 2 years[2]) and the rotation from institutional investors away from Prime and into Government money funds. It is this last point that brings us to the topic of increasing Libor rates. The SEC calculates that over the last two years investors have added $840 billion to Gov't funds while decreasing exposure to Prime and Municipal funds by $700 & $110 billion respectively[2].



Source: SEC Money Market Fund Statistics 8/2016

For a $3 Trillion market place, these movements are substantial and the change in investor behavior has had a significant effect in the bond market. First and foremost, the additional demand for short-term government bonds continues to suppress Treasury yields in shorter maturities and also increase the demand for the Fed's Treasury repo program, there are actually points in time when 3 month T-Bills trade through the Fed Funds lower bound. Secondly, the exodus from Prime funds has created less demand for short-term corporate obligations, namely commercial paper (CP). This last issue is the crux of rising Libor levels. The larger issuers in the money fund space tend to be global financials who are now forced to pay more to get their bonds placed in the CP market or who are seeking alternative means of funding. Those Prime funds that do remain have been significantly reducing risk exposure in their portfolio by decreasing their weighted average maturities, not buying credit securities that mature after Oct 14th, and buying government related investments that are liquid. Ultimately, this dynamic has resulted in Libor trending higher over the past few months and this trend does not seem to be nearing an equilibrium or reversal anytime soon. Should this trend continue, a sustained increase in funding costs can be viewed as a tightening of financial conditions for the $350 trillion of notional securities tied to Libor which can include business, housing, and consumer credit. This is a real concern for the Federal Reserve as they go into December contemplating whether another interest rate hike is prudent.

ABOUT THE AUTHOR

Brendan Keelan
Vice President

Brendan Keelan is a Vice President and member of Edge Capital's Research Team, Brendan's primary role is the management of fixed income portfolios for our clients. He also works on capital markets analysis, helps make investment decisions for client portfolios, and assists with manager selection and due diligence.

ABOUT EDGE CAPITAL

EDGE Capital is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments and macroeconomic trends.

For more research and commentary, visit us online at http://www.edgecappartners.com/.

CONTACT EDGE

1380 West Paces Ferry Road
Suite 1000
Atlanta, GA 30327
Phone: 404-890-7707
Email: info@edgecappartners.com

1: Intercontinental Exchange Roadmap for ICE Libor March 18, 2016
2: U.S. Securities and Exchange Commission Money Market Fund Statistics August 31, 2016