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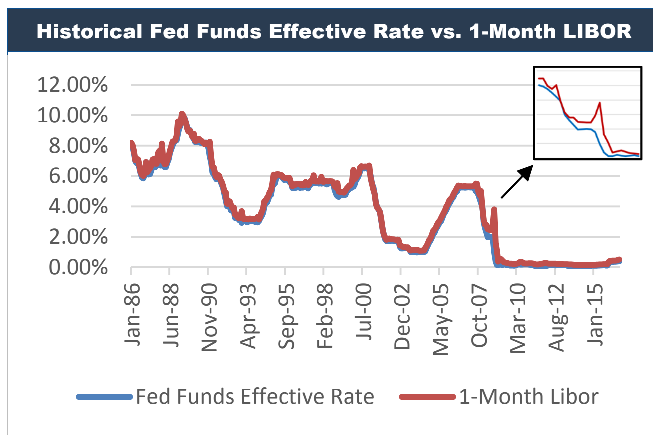
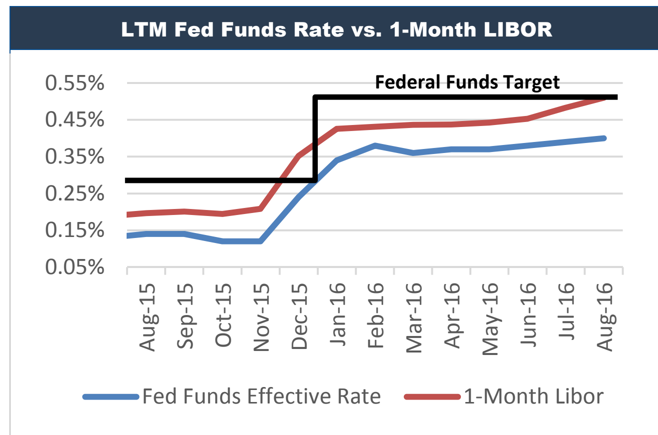
PCCP Market Commentary
The Rate Hike That Already Happened
Fourth Quarter 2016

We usually publish our newsletter at the end of the quarter, but we're rushing this one to press to beat Janet Yellen. With all eyes on the Fed and where rates will go, folks in the fixed income world already know that index rates have moved substantially. No, the target federal funds rate hasn't changed (yet). Seemingly overlooked in 2016 is that reference rates, including 1-month LIBOR, have more than doubled over the last 12 months. Let's refresh ourselves on why LIBOR is so vital and try to explain what has caused this increase.

LIBOR is crucial to the transitional real estate business. Old-timers know that prior to the GFC, LIBOR generally hovered around 5%. Post-GFC, LIBOR has been trivial – averaging about 20 basis points.



Sources: Moody's, Federal Reserve Bank, ICE Benchmark Administration



Sources: Moody's, Federal Reserve Bank, ICE Benchmark Administration

LIBOR – The London Interbank Offered Rate – is arguably the most important reference rate for borrowing and lending around the world. LIBOR is the benchmark interest rate that banks charge each other for overnight, one-month, three-month, six-month and one-year loans. Typically, LIBOR is a few tenths of a point above the federal funds rate. In volatile times, LIBOR can gap out from the Federal Funds Rate, as shown in the inset above.

LIBOR doesn't just set rates for interbank loans, it guides rates for adjustable rate loans including business loans, home-equity loans, adjustable mortgages, private student loans and even car loans. LIBOR is also the rate used to base the price for interest rate swaps and credit default swaps. It's hard to quantify the total impact of LIBOR, but it certainly reaches into the trillions on corporate debt alone. Let's use $10 trillion for illustrative purposes (which we consider a very conservative estimate). Based on $10 trillion of corporate debt tied to LIBOR, each single-basis-point rise translates into $1 billion in additional annual interest cost on the collective debt. WOW!

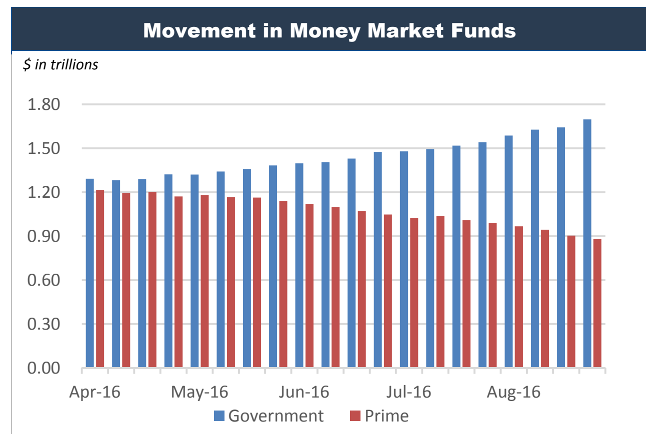
So, while the Fed hems and haws about the fed funds rate, LIBOR has been moving and as a percentage of where it was just last year, moving dramatically. But why?

It seems that the current moves are all about pending regulatory changes in the money market world. Following the GFC, regulators expressed concerns that money market funds had contributed to financial instability. The SEC adopted rules, which finally go into effect in October 2016, that separate money market funds into two categories: those that can represent that shares will always be worth $1.00, and those that must float in value.

The prime money markets are the primary buyers of short term (less than one year) commercial paper issued by corporations and banks; this is the favored way to access short-term capital. Money market funds have historically been viewed as a safe investment – they keep their net asset value (NAV) fixed at $1 per share, guarantying that investors will get back what they put into the fund. However, in the fall of 2008, after Lehman Brothers filed for bankruptcy protection, the Reserve Primary Fund, the oldest U.S. money market fund, "broke the buck" and lowered its NAV to $0.97. This was unheard of. Investors fled from the Reserve Fund causing it to collapse. This prompted a run on other money funds, threatening liquidity across the whole financial system.

The new rules adopted by the SEC that go into effect in October require institutional money market funds investing in corporate debt (as opposed to government debt) to float their NAVs, and also require liquidity fees and redemption gates in tough times. Theoretically, this should make the market safer – a floating NAV should give investors a better idea of the risk profile and the redemption rules should prevent runs on the market that destroy liquidity. However, the changes ultimately make these funds less attractive to investors.

So what does all this have to do with LIBOR? As the chart to the right demonstrates, investors are fleeing from prime money market funds (which buy LIBOR-indexed corporate debt and cannot offer the $1 per share guaranty anymore) and into government money market funds, which are still permitted to ensure the sacred $1 per share. Market observers generally agree that this phenomenon is driving down demand for LIBOR-indexed debt, and thus driving up rates.



Source: Investment Company Institute

But wait, what about the Fed? Markets are telling us that rates will go up. The forward LIBOR curve is predicting a 37 basis point increase in 1-month LIBOR over the next 12 months and a 61 basis point increase over the next 36 months. Treasury futures are also predicting higher rates. (The forward markets have been predicting higher rates for years, and have been generally wrong, until now.) If the Fed raises the federal funds rate, we may see an unusual and unprecedented spike in LIBOR as a result of the twin effects of regulatory reform and correlation with a government set index. An increase in LIBOR will be cheered by floating rate lenders, and if indicative of a strong economy, perhaps borrowers too. Your move, Fed!

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