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Corporate Hedging

Probability of negative 3M USD Libor is small but…

We see little probability of negative 3M USD Libor fixings

The sudden move lower in the 3M USD Libor rate raises uncertainty about whether the Fed could also cut the Fed Funds rate to negative if the coronavirus continues to spread rapidly and paralyses the economy. We hold the view that the probability of 3M USD Libor turning negative is relatively small and we explain why below.

However, we underline that we cannot rule out negative US rates. Hence, if, for example, bank loans in USD floor at zero, it could create complications when paying fixed/receiving 3M USD Libor in the swap. The borrower would effectively 'pay on both legs'.

Today, market participants add only a small probability of US rates going below zero and derivatives that can hedge against negative 3M USD Libor rates are still 'relatively' cheap.

Four reasons we see little probability of negative 3M USD Libor fixings

1. FOMC has been vocal in its dismissal of negative interest rate

The FOMC has been very vocal that it is not in favour of negative interest rates. The FOMC basically dismisses negative interest rates for two reasons: (1) the risk of possible adverse side effects and (2) the financial system in the US is different (see also point 2 below).

However, importantly, the FOMC does not rule out negative interest rates as a policy tool In the FOMC Minutes from 30 October, the FOMC discussed negative interest rates.

> 'All participants judged that negative interest rates currently did not appear to be an attractive monetary policy tool in the United States. Participants commented that there was limited scope to bring the policy rate into negative territory, that the evidence on the beneficial effects of negative interest rates abroad was mixed and that it was unclear what effects negative rates might have on the willingness of financial intermediaries to lend and on the spending plans of households and businesses.
>
> Participants noted that negative interest rates would entail risks of introducing significant complexity or distortions to the financial system. In particular, some participants cautioned that the financial system in the United States is considerably different from those in countries that implemented negative interest rate policies and that negative rates could have more significant adverse effects on market functioning and financial stability here than abroad.' (FOMC Minutes, 30 October 2019).

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Even though the FOMC view is clearly not in favour of negative interest rates, we underline that the minutes also stated, ‘Notwithstanding these considerations, participants did not rule out the possibility that circumstances could arise in which it might be appropriate to reassess the potential role of negative interest rates as a policy tool.’

2. US government money-market funds make negative interest rates difficult

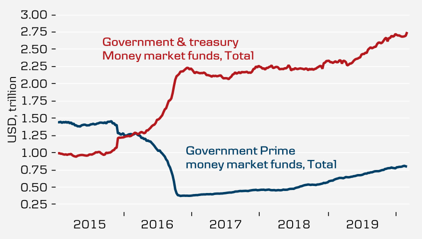
One distinct feature of the US financial system is US money-market funds, which play a pivotal role for financials and corporates as a liquidity instrument and for retail clients as a savings product.

Taking rates below zero could potentially disrupt the money-market system. During the financial crisis, it had severe complications when a major money-market fund ‘broke the buck’, as the net asset value (NAV) fell below the USD1 level. The reason was the default on Lehman Brothers’ debt. It created stress in the system, as money-market funds in general were considered extremely safe. The system was scrutinised in the following years and money-market reform took effect in 2016.

Importantly, the role of government money-market funds became much more prominent, as risk was introduced (floating NAV) in money-market funds backed by corporate debt. However, if the Fed cuts rates below zero, the effective yield on short-dated T-bills would fall below zero and the government money-market funds would no longer secure a USD1 NAV.

We underline that the existence of government funds by itself does not make negative interest impossible but it is a clear feature of the US financial system speaking against negative interest rates.

Government money-market funds to ‘brake the buck’ if Fed goes negative



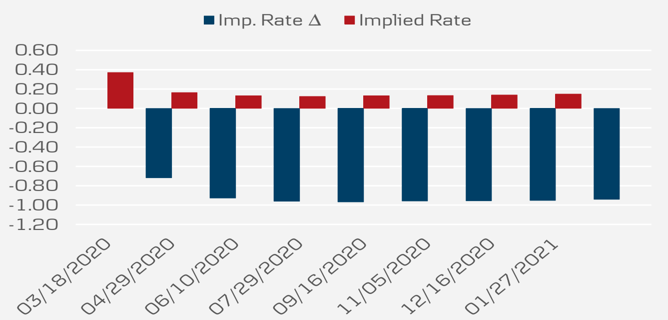
Source: Danske Bank

3. Market prices little probability of Fed Funds or 3M USD Libor going below zero

Another reason we believe there is little probability of the Fed introducing negative interest rates is market pricing. Even over the past few days when market uncertainty has been very high the market has not priced the 3M USD Libor forward curve or Fed Funds below zero.

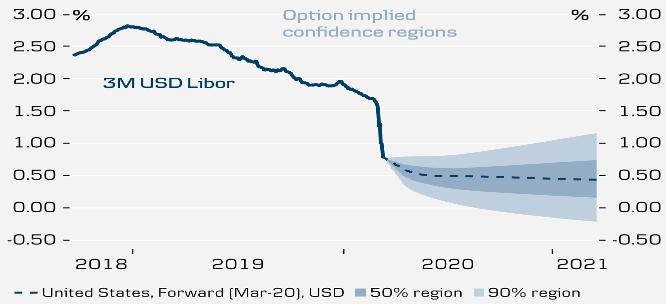
However, if we use the option market, a small probability of 3M USD Libor falling below zero is priced. These calculations are highly uncertain and investors should interpret them carefully. Finally, the effective Fed Funds could be lowered slightly below zero without, for example, the 3M USD Libor fixing going below zero due to the spread between Fed Funds and the money-market rate.

Market pricing of Fed Funds at FOMC dates based on USD OIS curve (%)



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

Confidence regions derived from option market



Note: Past performance is not a reliable guide to future returns
Source: Danske Bank

We note also that to our knowledge no analyst has negative Fed Funds in the US as its main scenario. However, Donald Trump has been vocal that he supports negative rates, although he may not know the finer details of the US financial system. Who knows?

4. Fed has other tools in the toolbox

Finally, we highlight that the Fed has other tools in the toolbox, which we would expect it to utilise before introducing negative interest rates. First, it could restart the QE programme. There are plenty of new government bonds to buy and it could purchase previous programmes' mortgage bonds. Second, the Fed could also opt for corporate bonds like the ECB, or do direct lending to distressed sectors. Some of these tools might be legally difficult to use but still we consider these tools more likely than negative interest rates.

Trump has been in support of negative interest rates

Source: Twitter

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None.

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