Interest Rate Update – RJO FIG

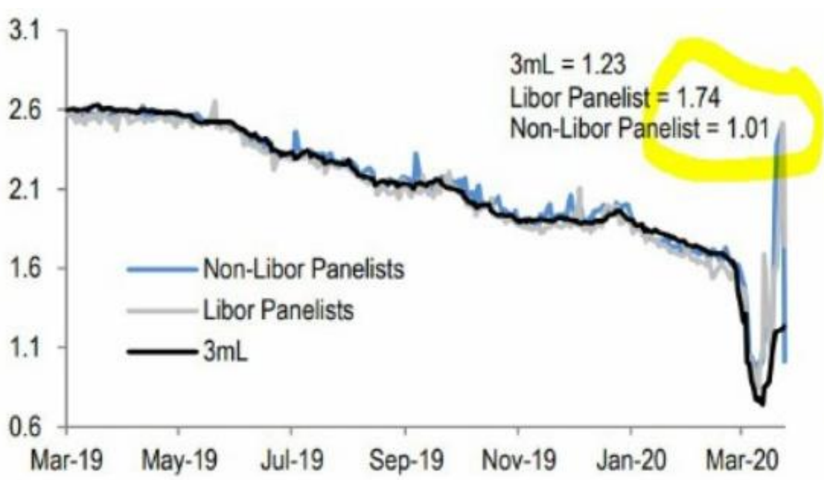
March 30, 2020

Own Swaps vs Treasuries in the belly: 5y-10y. Banks are way too short duration. They don't have room for adding securities and why compete with the Fed to buy non-HQLA? Look for banks to load up LONG on swaps in the belly of the curve given advantage of posting initial margin vs actual balance sheet use. Also, banks are short IRS in the belly to convexity buyers especially. They are going to want those positions more balanced heading into Q4 as swaps change discounting to SOFR.

Own 20y-30y T. Treasury will focus issuance on front end of the curve to NOT undo the Fed's QE buying impact on the longer duration securities, where the primary dealers need help. Mnuchin has said he wants LONG MATURITY issuance. Over time, what Mnuchin wants will happen. In the near term, I don't believe we're going to see a quadrupling of 30yr issuance—because, the primary dealers will get stuck with this paper. While they need duration, they don't need illiquid duration. And owning 30yTs may be all good from an HQLA standpoint, but risk capital requirements at current levels of long-end volatility would be punitive. I bet the Treasury wants a mulligan on Lehman right about now.

Curve will trade directionally. Once some semblance of liquidity is restored, I expect flattening. With USD much more abundant globally and the US with the steepest curve in the G4, our long end must be a buy for global insurers and pensions.

Softening U.S. dollar implies Fed swap lines are working. Begs the question why 3moLI remains so high relative to 1mo and 6mo. But, since short-term LIBOR rates are almost entirely hypothetical, it's tough to trade this one. After quarter end, could be a snap-back to lower levels in 3mo LIBOR (relative to 1mo and 6mo). Another spoonful of the alphabet soup of programs, the CPFF (commercial paper funding facility), should reduce the width to which LIBOR-FedFunds and LIBOR-SOFR blow out. So why don't I just say, "Buy ED$, Sell FF equiv. strip"? If you put a gun to my head, I'd say do it. The problem (and this is deep plumbing) is that the "Panel Banks" (the guys who are surveyed as to rates on o/n, 1mo, 3mo, 6mo, 1y LIBOR and a few more) are marking Commercial Paper ("CP") much higher in rate than the non-panel voters. CP is a "Level 1" influencer on ICE's posting of LIBOR. Here's how much the 'survey banks' (aka the guys squeezing stones on credit lines right now) are goosing LIBOR:



You don't have to be Mr. Plumber to understand what's going on here in the plumbing. Admittedly, I have an axe on this (https://www.linkedin.com/posts/johntcoleman_libor-futures-sofr-activity-6648937865566830592-n3BW). Friday (3/27) morning, we had this:

1-Month Libor Set	0.98938	+.04850	(99.01062)
3-Month Libor Set	**1.45013**	**+.07550**	(98.54987)
6-Month Libor Set	1.07200	+.01437	(99.02800)
1-Year Libor Set	0.96850	-.00425	(99.03250)

You can have steep curves and inverted curves. BUT, when I see a curve where a 1mo rate and 6mo rate are BELOW a 3mo rate (by 85bps on the butterfly), well, I get a little angry. Then, when you add that almost NOTHING trades in any of these LIBOR terms—a few survey banks just say, "Survey says…!!! Hahaha", my blood boils. Yes, we can hedge this stuff with Eurodollars coupled with term repo resetting on the IMM date. But we cannot hedge the '+X' component of financing lines that are billed as 3mo LIBOR+X, and "X" suddenly becomes X^2 and the line size gets reduced. How 'off' is 3mo LIBOR spot right now?

1) Spot 3mLI:3mFedFunds is 112bps as of Friday
2) Forward/Futures anticipate this spread at 81bps in a month
3) Out to June IMM date, 46bps.

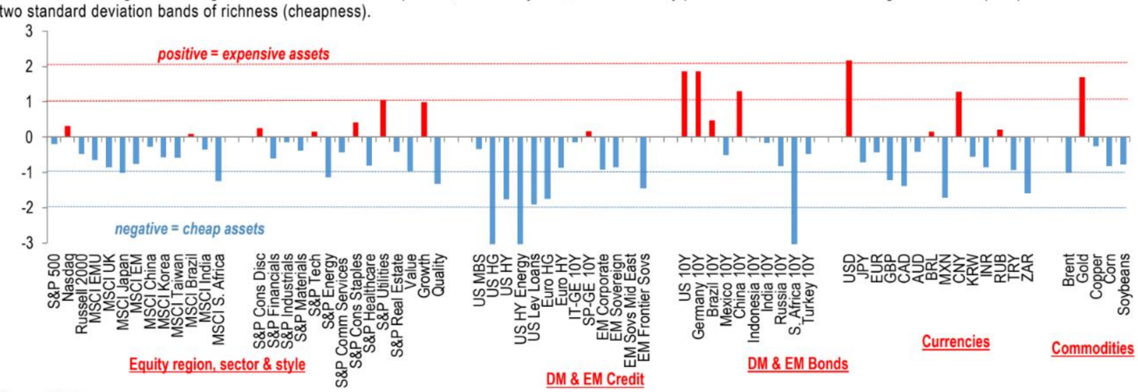
Every crisis in my life that blows up multiple financial concerns can ALWAYS be traced back to the front-end of the curve: repo and financing. And for this crisis, the game is on again.

As an aside, now that those international swap lines are working, if I were a currency guy, I'd be selling USD on all substantial upticks. Dollar dropping further from here will stir inflation talks. 10yr TIPS have rallied sharply in the last 2 weeks—like crazy last week (Fed buying them doesn't hurt either).

IG is cheap:

Chart 6: Many assets trade cheap to their long-run average, but DM Credit is the stand-out for value

Deviation from long-term average for forward P/Es, credit spreads, real bond yields, real commodity prices & real effective exchange rates. Red (blue) lines show one and two standard deviation bands of richness (cheapness).



Source: J.P. Morgan

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Cross Currency Switches

In this scenario, we think this presents an attractive opportunity to switch into dollars from euros with (i) the Federal Reserve's asset purchase program announcement providing further support for corporates, (ii) a reopened primary market in Europe tempering favorable supply-demand balance, and (iii) slowing fund outflows helping close the gap.

In the tables below, we present our cross currency screen for the top ten financial and non-financial switches from euros to dollars. With the extreme price action and large swings currently seen in the front end of the market, particularly in $ credit, we restrict the tables below to bonds with at least 5y to maturity and with TRACE data on traded prices available from yesterday.

Table 1: Top EUR -> USD Switches – Financials, >5y to maturity

EUR ISIN	Description	EUR Z Spread	USD ISIN	Description	USD Z Spread	Pick-up after FX
XS1619568303	ULFP 1.5% '29	187	US92928QAF54	ULFP 3.5% '29	364	**154**
DE000DL19US6	DB 2.625% '26	464	US251526BZ10	DB 4.1% '26	613	**123**
XS1933820372	INTNED 2.125% '26	229	US45685NAA46	INTNED 4.625% '26	360	**106**
XS2063495811	DLR 1.125% '28	318	US25389JAT34	DLR 4.45% '28	428	**85**
XS1117298163	MCO 1.75% '27	136	US615369AM79	MCO 3.25% '28	242	**82**
FR0013448859	SOCGEN 0.875% '29	259	US83368RAW25	SOCGEN 3% '30	356	**74**
FR0013422011	BNP 1.375% '29	234	US09659W2H65	BNP 5.198% '29	319	**61**
XS1327028459	MA 2.1% '27	83	US57636QAJ31	MA 3.5% '28	167	**59**
XS2049583789	PLD 1.5% '49	276	US74340XBJ90	PLD 4.375% '48	338	**51**
XS2022424993	ISPIM 1.75% '29	338	US46115HBL06	ISPIM 4% '29	413	**51**

Source: J.P.Morgan. TRACE, Bloomberg. USD Bond Z Spreads based on internal pricing where available / last traded price on TRACE. Spreads as on 26th March

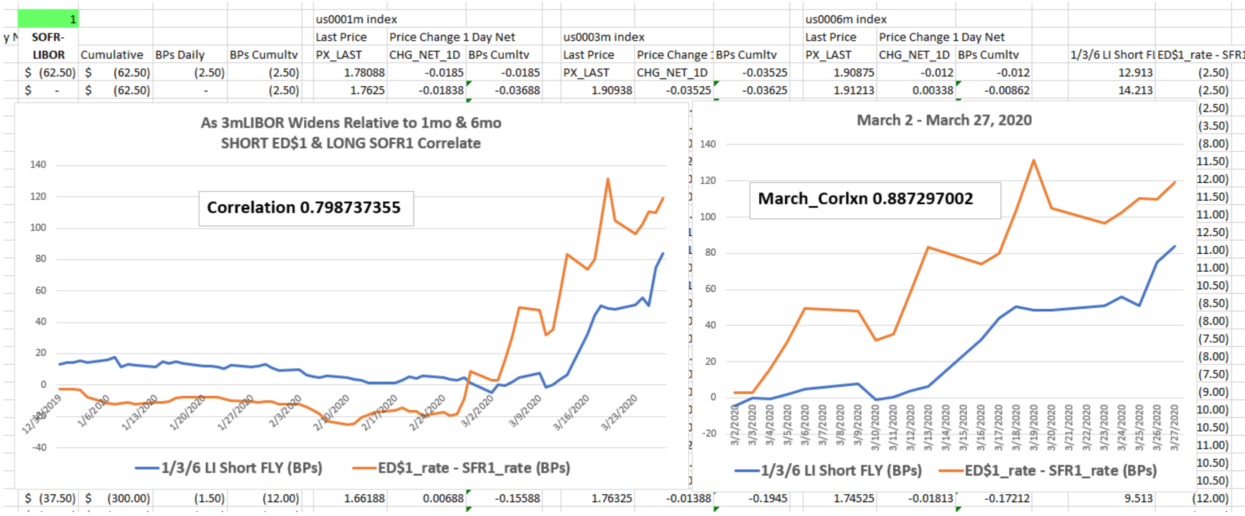
Table 2: Top EUR -> USD Switches – Non-financials, >5y to maturity

EUR ISIN	Description	EUR Z Spread	USD ISIN	Description	USD Z Spread	Pick-up after FX
XS2010039381	ZFFNGR 2% '26	536	US98877DAC92	ZFFNGR 4.75% '25	851	**290**
XS1493328477	ENIIM 1.125% '28	168	US26874RAE80	ENIIM 4.75% '28	422	**230**
XS1843459436	APH 2% '28	130	US032095AH42	APH 4.35% '29	368	**214**
XS1190624038	EQNR 1.25% '27	140	US656531AM27	EQNR 7.25% '27	357	**193**
XS1828033834	DT 2% '29	165	US25156PAC77	DT 8.75% '30	352	**164**
XS1652855815	VOD 1.5% '27	156	US92857WBK53	VOD 4.375% '28	324	**144**
XS0993148856	T 3.5% '25	148	US00206RHT23	T 3.875% '26	312	**139**
FR0010961540	EDF 4% '25	114	US268317AS33	EDF 3.625% '25	277	**137**
BE6285457519	ABIBB 2.75% '36	244	US035242AM81	ABIBB 4.7% '36	393	**132**
XS1203860934	BATSLN 2% '45	322	US761713BB19	BATSLN 5.85% '45	457	**124**

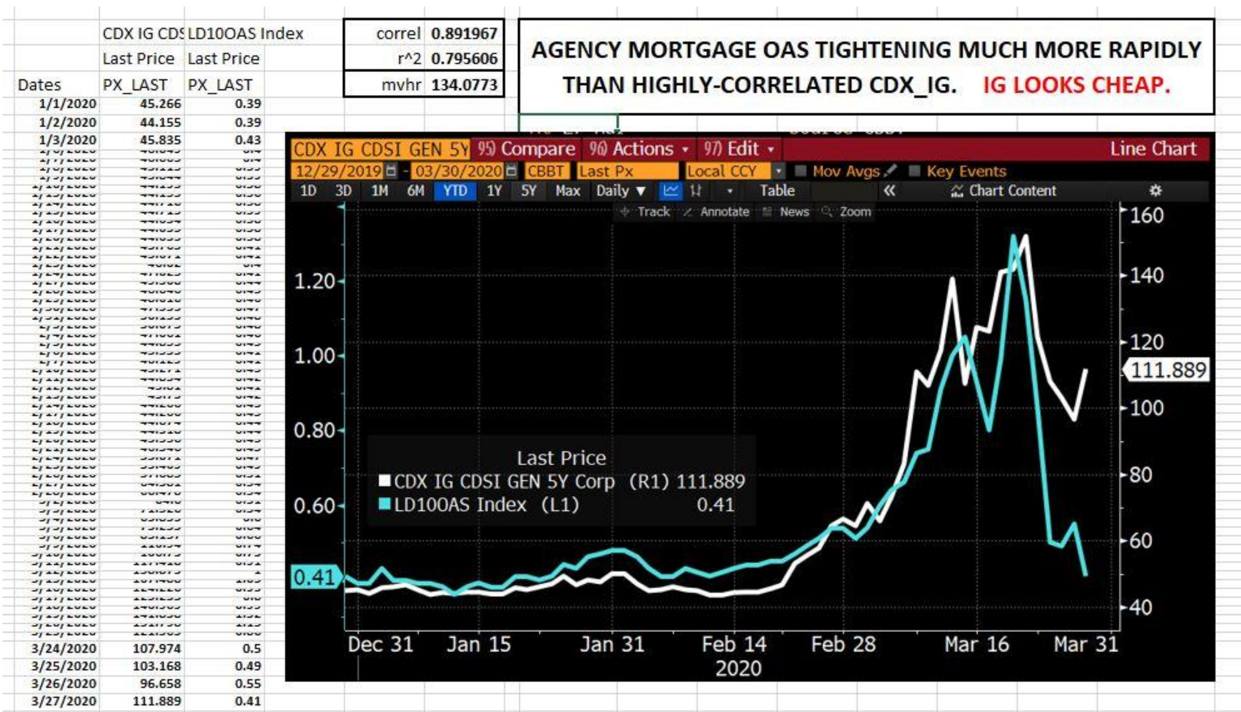
Source: J.P.Morgan. TRACE, Bloomberg. USD Bond Z Spreads based on internal pricing where available / last traded price on TRACE. Spreads as on 26th March

Correlations and Risk Layoffs

Traders getting hammered by 3mLI blowout? Correlated protection using Short EDM0/Long SFRM0



Agency Mortgage OAS has TIGHTENED much more rapidly than CDX_IG. IG Looks CHEAP after Fri 3/27



Look for a post early this week on LIBOR, SOFR and IG.

JC- for the Fixed Income Group at R.J. O'Brien

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