The Demise of Libor is Accelerating – May 2020

Fixed Income Group A Division of RJ O'Brien

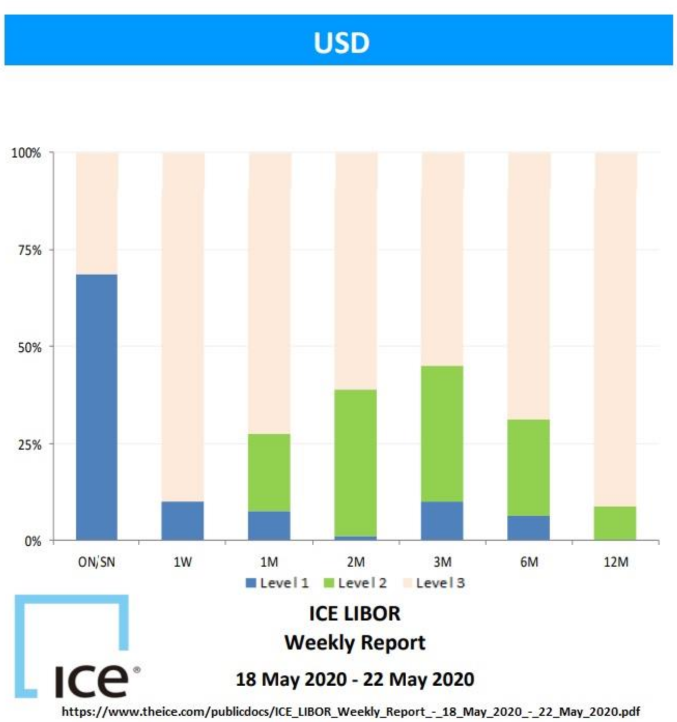
Bank Traders and Risk Managers: LIBOR is history in less than 600 days. Conversion to SOFR discounting and PAI for Cleared LIBOR Swaps and Swap Futures is less than five months from today. The Fed, ARRC, and Agencies are hammering on LIBOR Transition recently—
https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Best_Practices.pdf
https://www.fanniemae.com/portal/funding-the-market/libor/libor-transition.html

As the transition goes for banks (other than the GSIB's), AMERIBOR still makes more sense to me than SOFR. I am well passed arguing one versus the other. The concern is that there is almost nothing left trading in LIBOR. The marks by the survey banks are coming more from FX transactions and dealer 'backside yank-outs' than anything to do with outright, inter-bank, lending via LIBOR.

We, as the hedge folks, need to help our bank-clients find somewhere to use AMERIBOR and/or SOFR futures. Why? Because ***systems*** are a HUGE issue going into the transition. And, it is very difficult to find a system that comprehensively (or minimally!) supports the new benchmarks. The sole exception to systems issues: futures. Virtually all third-party vendors support Eurodollar futures and Fed Funds futures. AMERIBOR and SOFR futures have identical futures contract construction to ED$ and FF.

Most of you know I have been harping on the credit component to the new benchmarks since April 2018. I'm not going there today. Also, as AMERIBOR is about to list their 1-month futures, the objective will be limited to, "How can 3-month futures for the new benchmarks be deployed today?" –responsibly, with sound purpose and expected economic benefit.

Libor, as in interbank rate, is already history. Most of the term LIBOR rates are fabricated from "Level 3—Survey Bank's Best Guess". Less than 10% of LIBOR term rate contributions come from trades of loosely-related products. The rest is wherever a Contributor Bank deems term LIBOR to be:



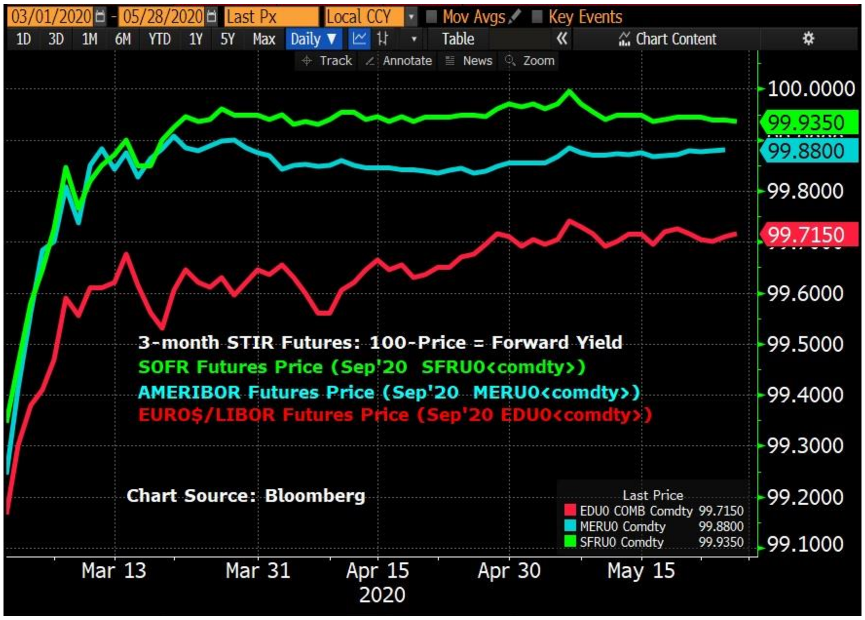
__Level 1__: The LIBOR submission is equal to the volume weighted average price of eligible transactions in unsecured deposits, primary issuances of **commercial paper and certificates of deposit**, with a higher weighting for transactions booked closer to 11:00 a.m. London time.

__Level 2__: Where a Contributor Bank has insufficient eligible transactions to make a Level 1 submission, the LIBOR submission is based on transaction-derived data, including **time-weighted historical eligible transactions adjusted for market movements** and linear interpolation.

__Level 3__: Where a Contributor Bank has insufficient eligible transactions or transaction-derived data to make a Level 1 or Level 2 submission, the LIBOR submission is the rate at which it considers it could fund itself at 11:00 a.m. London time with reference to the unsecured wholesale funding market. In order to determine this rate, the **Contributor Bank must follow its internally-approved procedure** agreed with IBA, basing its rate on transactional data, related market instruments, **broker quotes and other market observations.**

Copyright © 2020 The Fixed Income Group at RJO | All Rights Reserved

Let’s take a look at the 3-month FUTURES Benchmark Complex: Eurodollars/LIBOR, SOFR, AMERIBOR



SOFR, calculated from Treasury Repo, trades the lowest rate (highest futures price- green). The AMERIBOR (blue) rate is above the SOFR rate and trades at or above IOER. Then, the highest rate is LIBOR (red) which is tied most closely to the Submission banks slowly un-screwing their clients.

With all of the Fed financing programs (most specifically, the foreign USD swap lines), LIBOR continues to drift lower. The major Wall Street banks anticipate 3-month LIBOR continuing to trend in to a rate of 0.15%-0.25% As the U.S. dollar remains globally abundant and cheapening (via Fed swap lines, the impact of our money printing, and rapidly accelerating ‘risk-on’ environment), foreign banks borrow dollars from the swap lines, buy up GSIB commercial paper, and drive the only visible component of LIBOR (CP) downward in rates. This is largely responsible for LIBOR continuing to creep lower in rate and tighter in spread to both SOFR and AMERIBOR. And, herein, lies the opportunity on the very front end of the yield curve.

There is a better chance of me running back to back marathons in Cairo, yesterday, than the Fed raising rates before year end. We have also explored and discussed negative short rates—which the Fed will also not be considering in the immediate future. The front end of the yield curve is largely dormant—except for LIBOR that should continue to decline, at least a handful of basis points at 3-month term.

So, whether 3mo AMERIBOR or SOFR futures, both seem a better bet from the SHORT side than Sep’20 Eurodollar futures. The “test the plumbing” trade for the new benchmarks is easy:

Where you have a short EDU0 future, move the position (or a piece of it) to SHORT MERU0 or SFRU0.

This could be on a loan or securities hedge position or part of short position in the 6mo key-rate bucket for MSR hedges. If you want to dip your toe into a new benchmark, with little risk and a good possibility of saving a few basis points, try it with Sep’20 3mo Futures.

For the Fixed Income Group,
JC

800.367.3349
fig@rjobrien.com
www.fixedincomegroup.com

Copyright © 2020 The Fixed Income Group at RJO | All Rights Reserved

DISCLAIMER

This material has been prepared by a sales or trading employee or agent of R.J. O'Brien and is, or is in the nature of, a solicitation. This material is not a research report prepared by R.J. O'Brien's Research Department. By accepting this communication, you agree that you are an experienced user of the futures markets, capable of making independent trading decisions, and agree that you are not, and will not, rely solely on this communication in making trading decisions.

DISTRIBUTION IN SOME JURISDICTIONS MAY BE PROHIBITED OR RESTRICTED BY LAW. PERSONS IN POSSESSION OF THIS COMMUNICATION INDIRECTLY SHOULD INFORM THEMSELVES ABOUT AND OBSERVE ANY SUCH PROHIBITION OR RESTRICTIONS. TO THE EXTENT THAT YOU HAVE RECEIVED THIS COMMUNICATION INDIRECTLY AND SOLICITATIONS ARE PROHIBITED IN YOUR JURISDICTION WITHOUT REGISTRATION, THE MARKET COMMENTARY IN THIS COMMUNICATION SHOULD NOT BE CONSIDERED A SOLICITATION.

The risk of loss in trading futures and/or options is substantial and each investor and/or trader must consider whether this is a suitable investment. Past performance, whether actual or indicated by simulated historical tests of strategies, is not indicative of future results. Trading advice is based on information taken from trades and statistical services and other sources that R.J. O'Brien believes are reliable. We do not guarantee that such information is accurate or complete and it should not be relied upon as such. Trading advice reflects our good faith judgment at a specific time and is subject to change without notice. There is no guarantee that the advice we give will result in profitable trades.

Fixed Income Group at RJO

800.367.3349
fig@rjobrien.com
www.fixedincomegroup.com

Copyright © 2020 The Fixed Income Group at RJO | All Rights Reserved