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Weekly Commentary

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Overnight lending market in sound shape

Preparation is paying off for the Federal Reserve and the liquidity markets.

While the big news last week was the Fed's aggressive, 50-basis-point cut of the federal funds rate range because of expected economic slowdown due to the coronavirus, its carefully considered framework for buttressing the finances of banks and the repo markets has helped the short-liquidity market to run smoothly. For the latter, policymaker's painstaking work in recent years to calibrate the overnight lending set the foundation, and their involvement in daily operations since the repo spike in September has allowed them to fine tune it.

Like in September, the Fed's continuing injection of funds into the overnight market is not due to a credit event. Banks and corporations likely will be affected economically by the virus, but that is a long-term consideration. In the short end, high-quality banks and corporations are having no trouble getting funding, and both fixed- and floating-rate paper are able to be placed. That speaks further to the fact that this is not a credit event but one pushed by fear and a rush to the safest vehicles out there. The plumbing of the short-end of the market is in sound shape.

Investors are, of course, searching for havens now, as is the case in any time of concern. With bond yields plummeting, money market funds can fill that role. Historically, they serve as places of stability, with attractive returns relative to other cash options, while allowing for same-day withdrawals to facilitate opportunistic trading.

The London interbank offered rate (Libor) fell last week amid the market rout: 1-month Libor fell from 1.52% to 0.86%, 3-month decreased from 1.46% to 0.90% and 6-month dropped from 1.40% to 0.88%.

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