Seeking Alpha

Forget About The Fed, The Hike Has Already Happened!

Sep. 20, 2016 8:18 PM ET12 comments

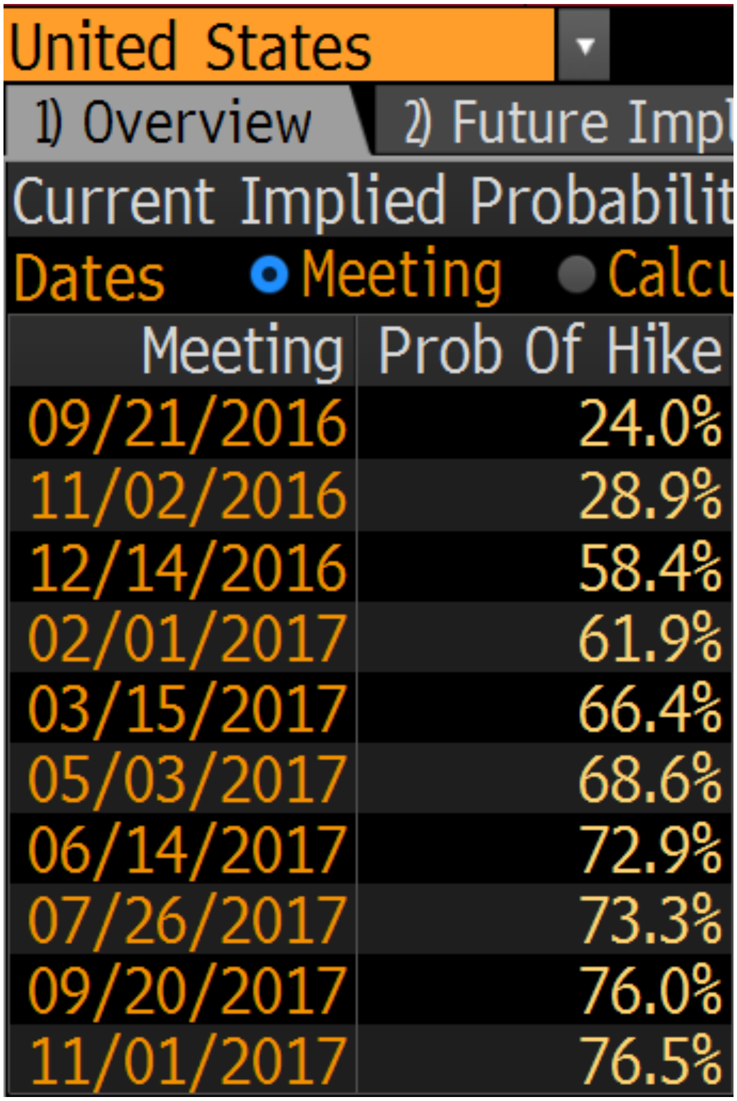
by: Volatility Surfer

Summary

- The markets have been focused on the Fed.
- The LIBOR rate has already made a huge move.
- The policy change from BoJ would impact the markets more.

Are you watching the Fed's actions with your eyes peeled? Sadly, I have been forced to do so. There was a time when fundamentals mattered. There was a time when stock picking was more important than macro musings. There was a time when correlations were lower between stocks and sectors. There was a time when Trump would have never thought of running for El Presidente. It was back when the Fed was a little less transparent, a little less talkative, and the economy hummed along and the markets did their work of valuing securities properly.

Alas those times are gone. The Fed is now all important. But has it gotten so important that nothing else matters? Of course not. But turn on CNBC or any news outlet, or open a publication and you would be unlikely to miss some commentary about the Fed. Heck, I am here commenting on Fed! The probability of a raise heading into the Sept. 21 meeting currently sits at 24%. The probability of a raise by the end of the year seems like a layup if you were to look at the current implied probabilities.



United States

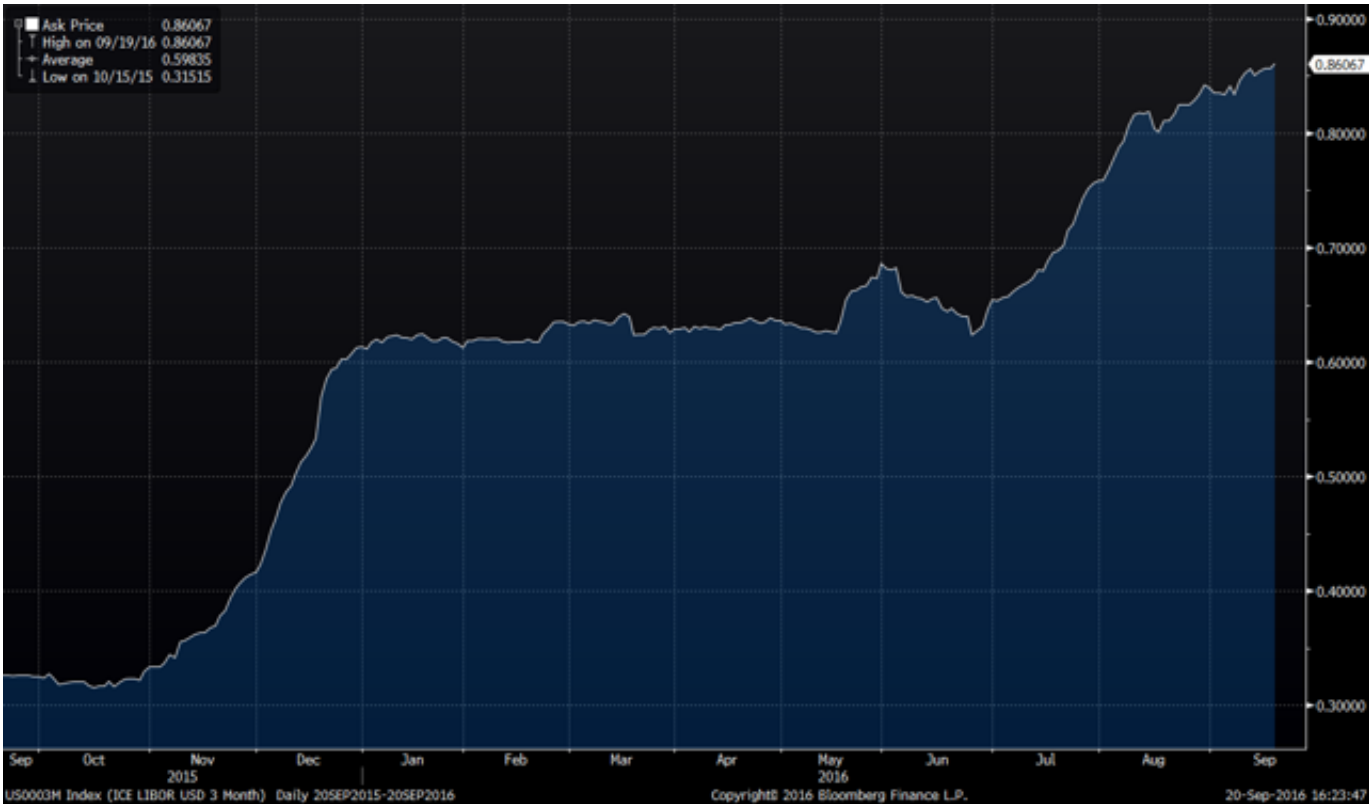
1) Overview 2) Future Impl

Current Implied Probabilit

Dates Meeting Calcu

Meeting	Prob Of Hike
09/21/2016	24.0%
11/02/2016	28.9%
12/14/2016	58.4%
02/01/2017	61.9%
03/15/2017	66.4%
05/03/2017	68.6%
06/14/2017	72.9%
07/26/2017	73.3%
09/20/2017	76.0%
11/01/2017	76.5%

However, I think that the market has become way too fixated on the Fed and has missed the forest by looking too closely at the trees! Why, do you ask? Well, take a look at what LIBOR has done over the past month.



It has conveniently moved up from ~60 bps to ~86 bps. Now many readers here may not be truly aware of the powerful nature of LIBOR. Let me quickly explain what you are looking at. LIBOR is the rate at which banks lend to each other. It tends to track very closely with the short-term rate that the Fed controls plus a few basis points because everyone has to make a little extra coin after all. As you may have noted already, it is not the Fed that ultimately decides who gets to borrow money, it is the banks. The banks originate the loans and the mortgages and all sorts of paper wonderful and toxic alike. They also lend to each other in order to facilitate business. The LIBOR is what forms the interest which the banks pay each other in order to facilitate transactions.

It is very important to the functioning of the overall market, of course, because all the companies on the S&P 500 (NYSEARCA:SPY), the Nasdaq (NASDAQ:QQQ) and the Russell 200 (NYSEARCA:IWM), all the way down to the tiny little Mom and Pop shop, have a bank. If there are ever issues which come up in form of a liquidity challenging event, banks stop lending to each other, and what we would get would be the second coming of 2008-2009 type crisis.

However, it appears that liquidity at this point in time is fine. What is highly apparent is that LIBOR has moved in front of the Fed. Now the natural question is "Why?"

As you may recall, there were several new regulations which came into effect as a result of the huge crisis we faced in 2008-2009. The regulators definitely don't want to have this re-occur again. Money market funds, which are the closest thing to a prime, high liquidity, safe and sound investment had actually come under pressure during the crisis. The new measures will require these funds to temporarily bar redemptions (bad) and also allow the value of the funds to float (it has usually been fixed at $1/unit). There is almost $2.8 trillion invested in these short-term funds and the investors have decided to pull their money from these funds as a result. The anticipated withdrawals are expected to range from $200-400 billion. These withdrawals have resulted in a spike in LIBOR, but because of the changes, the spike in LIBOR will likely not resolve to its previous levels of 60bps. What this all means is the market participants have already increased the funding rate for each other without the Fed needing to.

Changes in LIBOR rate will affect virtually all companies that do business internationally in some way, shape, or form. Companies which will be impacted more than others include Valeant (NYSE:VRX), whose pile of debt is largely pegged to LIBOR.

Now switching gears, I am very lucky to know some very smart people. And some of the smartest people I know are not even looking at the Fed, because whether or not they decide to raise doesn't have a huge impact on the way business is conducted because as I just laid out above, business is largely conducted using the LIBOR rate, which has already moved higher. The really smart people are paying attention to the BoJ and their policy making. It is not about whether or not the BoJ moves the front end of the rate up or down, but how it is going to change the long end of the yield curve. The Japanese have been buying the long end of the yield curve, which has flattened the rates and made business very very difficult for the banks. The BoJ gets this (I think), and as a result, will likely try to stimulate the long end of the yield curve higher. This impact could have some major reverberations through the currency, bond and equity markets all across the world. In fact, some of the changes are already getting priced in as the USD-JPY basis swaps and USD-EUR basis swaps have moved mightily recently and those moves have been attributed to the change in the bond curves both in the US, Europe and Japan. It is for this reason the smartest minds I know are closely watching Kuroda over Yellen. As for myself, I can't wait for things to go back to normal to a place where Econ 101 still applies.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Comments (12)

clemmo
The regulations did it.

20 Sep 2016, 08:20 PM

Bob Cirillo
No, sending half of our factories to China did it.

20 Sep 2016, 08:46 PM

marquse1
So, what? This article is missing a conclusion. Ok, businesses will be affected. And?

20 Sep 2016, 08:35 PM

Volatility Surfer , Contributor

Author’s reply » Aah, perhaps the article wasn't clear. What I was trying to speak of here was that while everyone is focused on the policy makers, the rate that the business world largely operates on, which is the LIBOR has already shifted higher. Therefore regardless of what the Fed does tomorrow, the effect of increased rates is already being felt by businesses making a 25 bp raise a non-event to the real world. In essence, nothing to see here as far as the Fed goes.

20 Sep 2016, 10:29 PM

Mark_A
"...LIBOR has already shifted higher. Therefore regardless of what the Fed does tomorrow, the effect of increased rates is already being felt by businesses making a 25 bp raise a non-event to the real world."

That is a very rational and logical conclusion. But since when are equity markets rational and logical?

21 Sep 2016, 03:52 AM

10966361
The conclusion is this..
Sell Bank stocks
Because that Libor rate is about to implode to 10 in the next 5 months or so
The yield is about to drop to .25 basis point
The market will reverse
There is no way for banks to make money
Now add in the bad loans they have on their books or possible defaults
BAC goes back to $2
Ouch !!

20 Sep 2016, 08:59 PM

David de los Angeles
Hello Volatility Surfer,

Yes, the LIBOR is indeed up but is that the entire credit market?

1) Consider this, since the Federal Reserve Bank raised the Federal Funds Rate in December last, the average 30 year mortgage rate [1] and the Moody's Seasoned Aaa Corporate Bond Yield[2], those interest rates have actually fallen. At the beginning of December they were 3.86 and 3.79 respectively but are now 3.50 and 3.51%, a *decline* of 36 and 35 basis points. In between the 10 year UST Bond was paying 2.15% on December 1, 2015 and is now paying 1.70%, a 35 basis point decline[3].

2) Are higher interest rates an I duplication of how tight the credit market is?

[1] http://tinyurl.com/z3r...
[2] http://tinyurl.com/jm8...
[3] http://tinyurl.com/j6r...

20 Sep 2016, 09:23 PM

David de los Angeles
Addendum

During the Crash of 2008 the volume of money was quite high and interest rates were quite low, a situation that most would consider a loose monetary conditions. Nonetheless the credit market was extremely tight. As the Federal Reserve Bank (FRB) itself notes, through the Quantitative Easing Policy (QEP) the credit market is awash in liquidity [1] but not very much of it was used because of low demand for credit.

A better measure is the bid-ask spread (BAS). The BAS for United States Treasury securities (USTS) are much lower than the spreads on stocks or corporate bonds. The former might only be 0.1%. Safe / higher rated bonds are more liquid than riskier / lower rated bonds so the BAS is larger the less liquid an instrument is. The BAS has been narrow and stable for USTS[2] at least in last August and more recent data might suggest some deterioration [3]. The corporate bond market does not appear to be too much different [4].

Dr. Milton Friedman once noted: "I thought the fallacy of identifying tight money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die."[5]

[1] http://tinyurl.com/jq6...?

[2] http://tinyurl.com/zgs...

[3] http://tinyurl.com/gwj...

[4] http://tinyurl.com/z7o...

[5] http://hvr.co/1IiPBCw

20 Sep 2016, 09:27 PM

Volatility Surfer , Contributor
Author’s reply » Hi David - you raise some excellent points! I have written a couple of pieces on the credit market, and in particular the high yield market. You can find the articles at:
http://seekingalpha.co...

http://seekingalpha.co...

Key point being, credit spreads are so tight that the risk reward is not favorable especially to HY investors.

20 Sep 2016, 10:32 PM

Volatility Surfer , Contributor
Author's reply » This article isn't painting a picture of tighter credits but a natural shift in rates. The financial conditions index I track points to slightly tight conditions which are largely a function of banks not lending. Interbank lending appears OK, if you are excluding some problem actors in Europe.

20 Sep 2016, 10:34 PM

Baidewei
Is this the result of the BoJ today? It seems they did almost nothing. Although - not increasing the negative rate might be a something as the market was pricing in an increase to the negative side. This means that you might be wrong.

If this is true - and the markets are already (starting) to price in the rate hike, that would still make sense because even if the Fed does nothing, we all know that they will in December. Since that isn't priced into equities (or the dollar) yet, we should expect it to gradually be inserted. What does this mean for everybody? A stagnant stock market until December, a stronger US dollar = lower oil (depending on the Headline chatter about "freezes") and a weaker Yen. This is because the major houses chasing yields will want US treasuries instead of Japanese bonds. More treasury demand = more demand for US$ = stronger US $.

HOWEVER, if we assume the Japanese increase to negative rates was priced in, and today they announced no increase into negative rate territory, we should see some flow into Japanese bonds, out of US $, and a weakness in the US $ = the opposite of what would happen given a Fed rate hike.

In the end - it's probably an agreed upon move by both central banks for the purposes of stability - ending up in a wash this week.

21 Sep 2016, 05:49 AM

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batistuta009
Sorry, after which its position in SPY, after the Fed?

21 Sep 2016, 06:18 AM