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Economics Group

Special Commentary

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Get Ready for SOFR: Low Rates for Foreseeable Future

Executive Summary

At the time of our last SOFR update in early April, LIBOR rates and SOFR had diverged significantly due to the financial market dislocations that the pandemic imparted to the global economy. However, "normalcy" has more or less returned to money markets due, in large part, to the steps that the Federal Reserve has taken to ease tensions in financial markets. If, as we expect, the Federal Open Market Committee (FOMC) keeps its target range for the fed funds rate unchanged at 0.00% to 0.25% through at least the end of next year, then SOFR should remain at rock bottom for the foreseeable future. Market participants should continue to be prepared to transition from LIBOR to SOFR as soon as the end of 2021.

"Normal" Has Returned to Money Markets

SOFR and LIBOR diverged significantly in mid-March.

When we wrote our last SOFR update in early April, the global economy was still reeling from the initial shock of the lockdowns that many countries implemented in response to the pandemic. As we noted at that time, 1-month LIBOR and SOFR, which usually are highly correlated, diverged significantly starting in mid-March (Figure 1). Although SOFR followed the FOMC's target range for the fed funds rate lower, 1-month LIBOR moved higher in late March and early April. This rise in LIBOR, which is an unsecured interest rate, reflected, at least in part, general tensions in credit markets that surfaced in March (Figure 2).

Figure 1

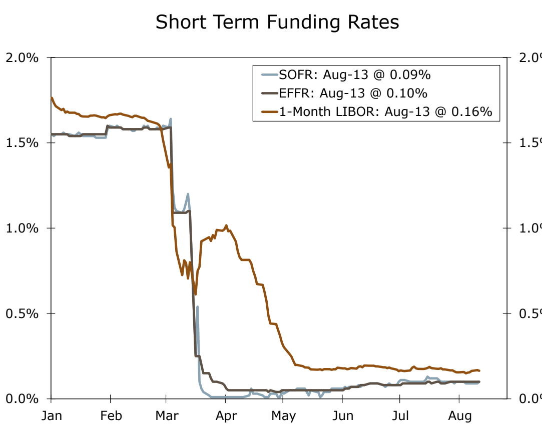

Figure 2

Source: Bloomberg LP and Wells Fargo Securities

The situation has largely returned to "normal."

Fast forward four months, and the situation has returned largely to "normal." The prompt response of policymakers, especially steps that the Federal Reserve has implemented to support credit markets, has caused corporate bond spreads to compress nearly all the way back to levels that prevailed in late February (Figure 2). Consequently, 1-month LIBOR has receded from roughly

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1.00% in early April to 0.17% at present. At the same time, SOFR has edged up from its late March low of 0.01% to 0.10% currently. What is going on here?

On the LIBOR front, improved liquidity and tighter spreads in short-term, unsecured lending markets, particularly commercial paper, have helped push 3-month LIBOR down.[1] Diminished concern about bank credit quality has likely also helped, as have the Federal Reserve's numerous actions to improve access to dollar funding through its various liquidity programs. On the SOFR side, more tranquil financial markets have likely reduced the demand for secured places to park money on a short-term basis. At the peak of the crisis, owning Treasury bills outright or lending overnight in the Treasury repo markets were among the safest places to keep cash.

In addition, the flood of Treasury issuance in recent months has also helped to push up SOFR. Since February, the Treasury Department has issued a net $2.5 trillion of T-bills, and this deluge of supply has pushed down the price of bills (*i.e.*, pushed up their yield). As the rate on the 1-month T-bill has crept up from its low of -0.107% in late March to 0.07% at present, so too has SOFR. That said, SOFR is more or less in the middle of the Fed's target range for the fed funds rate (currently between 0.00% and 0.25%), which is typical during "normal" times.

Fed to Keep Rates at Rock Bottom for the Foreseeable Future

We look for the FOMC to keep rates unchanged through at least the end of 2021.

In that regard, our current forecast looks for the FOMC to keep its target range for the fed funds rate unchanged through at least the end of 2021. Moreover, the so-called "dot plot" indicates that most FOMC members believe that rates will be on hold through 2022 (Figure 3). If the target range for the fed funds rate remains near zero for the foreseeable future, then it is likely that SOFR will as well.

Figure 3

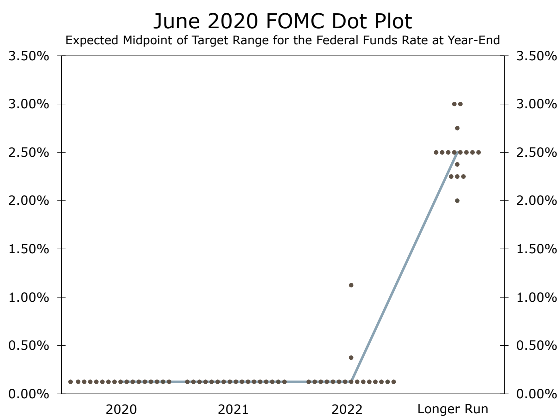
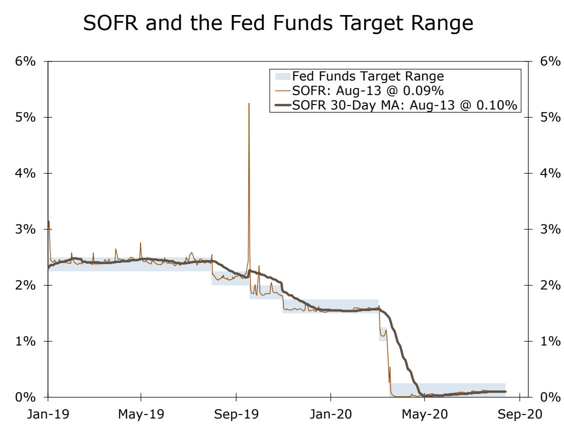


Figure 4



Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities

Since SOFR started trading in April of 2018, it has ended the day within the FOMC's target range for the fed funds rate on 92% of the days and 98% of the days since the start of 2020. While these figures suggest there can occasionally be a meaningful gap between SOFR and the effective fed funds rate, any material divergences between the two rates have been driven generally by funding pressures, such as those that materialized in September 2019 (Figure 4). However, the Federal Reserve has shown a willingness and ability to alleviate these pressures. Moreover, in the context of the LIBOR-to-SOFR transition, it is important to note that contracts referencing SOFR have been based on backward-looking moving averages (*e.g.*, the average SOFR rate over the past month). These moving averages tend to smooth out any volatility that could occur in SOFR rates on a daily

[1] LIBOR is intended to reflect the rate a submitting bank believes it could borrow from another bank on an unsecured basis. In reality, very few of these transactions take place for terms longer than one month. The Alternative Reference Rates Committee (ARRC) estimates the average daily volume of 3-month LIBOR transactions to be just $500 million. Consequently, banks can, or must, base their LIBOR submissions on rates in other unsecured markets, such as commercial paper.

basis, which would reduce the probability that borrowers experience an unexpected short-term spike in their borrowing costs. With the rate outlook stable and an increasing number of contracts tied to SOFR, we should continue to see a transition towards SOFR as we approach LIBOR's potential retirement at the end of 2021.

While the establishment of LIBOR's successor in the United States continues to progress, COVID-19 has brought a new set of challenges to an already complex transition process. Beyond operational adjustments, the pandemic and the resulting economic fallout have focused banks and regulators alike on addressing more immediate problems. For instance, the Federal Reserve chose to base loans in its Main Street Lending Program on LIBOR, rather than SOFR, after potential participants noted "implementing new systems to issue loans based on SOFR would require diverting resources from challenges related to the pandemic."

Despite the uncertainties that the pandemic has imparted, officials across the world have made it clear that COVID-19 is not expected to change the timeline for the LIBOR transition. For example, the Financial Conduct Authority (FCA), the U.K. regulator that oversees LIBOR, reaffirmed in late March that despite the pandemic firms cannot rely on LIBOR being published after the end of 2021. The steering committee tasked with guiding the transition away from LIBOR in the United States, the Alternative Reference Rates Committee (ARRC), has similarly stuck to its established timeline.

For some policymakers, the events of the past few months have only underscored the need to transition to more reliable reference rates. Speaking at a webinar in July, Bank of England Governor Andrew Bailey and New York Fed President John Williams noted that the already limited lending on which LIBOR is based dried up in March and April, while transactions underpinning SOFR and the sterling overnight index average (SONIA) increased. As a result, these rates were able to provide a more accurate reflection of bank funding costs through the tumult this spring.

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