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# It Ain't Over 'til the Fat Lady Sings...or Financial Conditions Get Too Tight

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In our work as a global macro-focused team, we have to pay attention to a myriad of variables, some simple, others more complex and esoteric. I suppose the LIBOR-OIS spread might be a variable that meets the latter definition. As its name suggests, it measures the spread between LIBOR (London Interbank Offered Rate) and OIS (Overnight Indexed Swap), two benchmark rates that establish short-term borrowing costs. LIBOR serves as a proxy for credit market conditions and the OIS as a proxy for central bank policy path. The spread provides an indication of relative borrowing costs for banks—so the recent widening of the LIBOR-OIS spread caught our attention, not just because of the level to which it rose but also the speed with which it widened.

## Chart 1: U.S. Libor OIS Spread

As of 3/30/2018



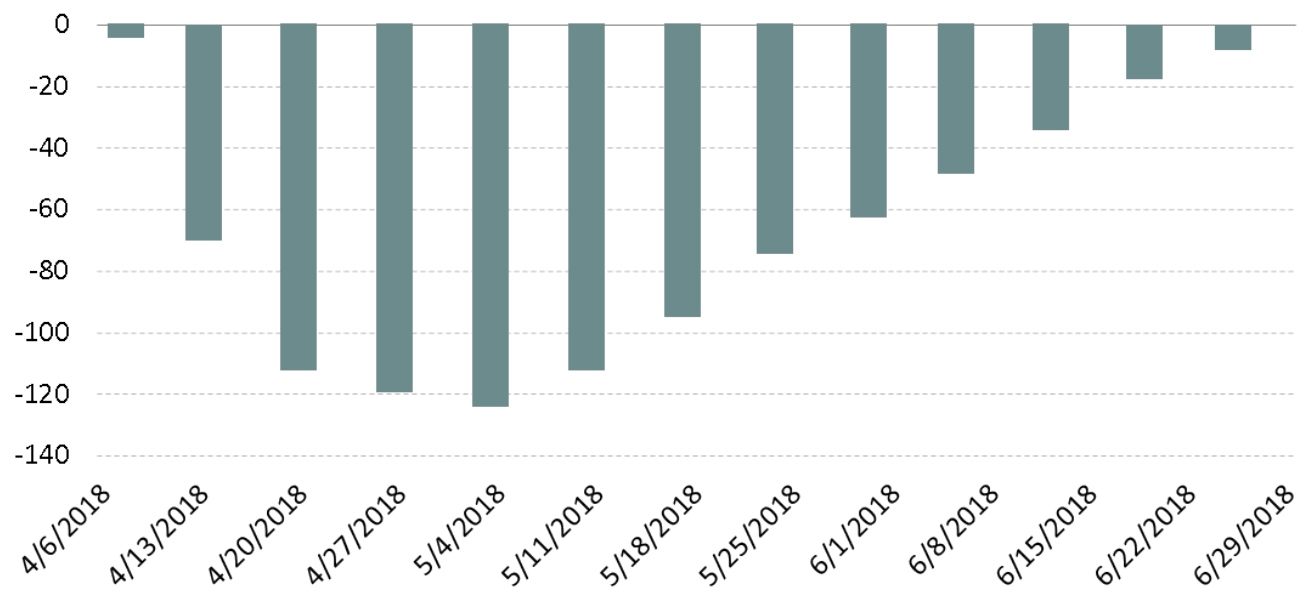
Source: Bloomberg (© 2018, Bloomberg Finance LP)

In the past, the widening of the spread has at times been a signal of financial distress; this was particularly true in 2008. However, this time it turns out that the widening can be explained by technical factors rather than a fundamental deterioration in credit conditions:

1. Treasury bill issuance: the resolution of the impasse over the borrowing limit coupled with the increased borrowing associated with the Tax Cuts and Jobs Act led to a surge in issuance in short-dated Treasuries in 2018, although issuance is expected to peak in May and then decline quickly. The increased supply has required higher rates to be absorbed.

**Chart 2: Q2 T-Bill Issuance Projections**

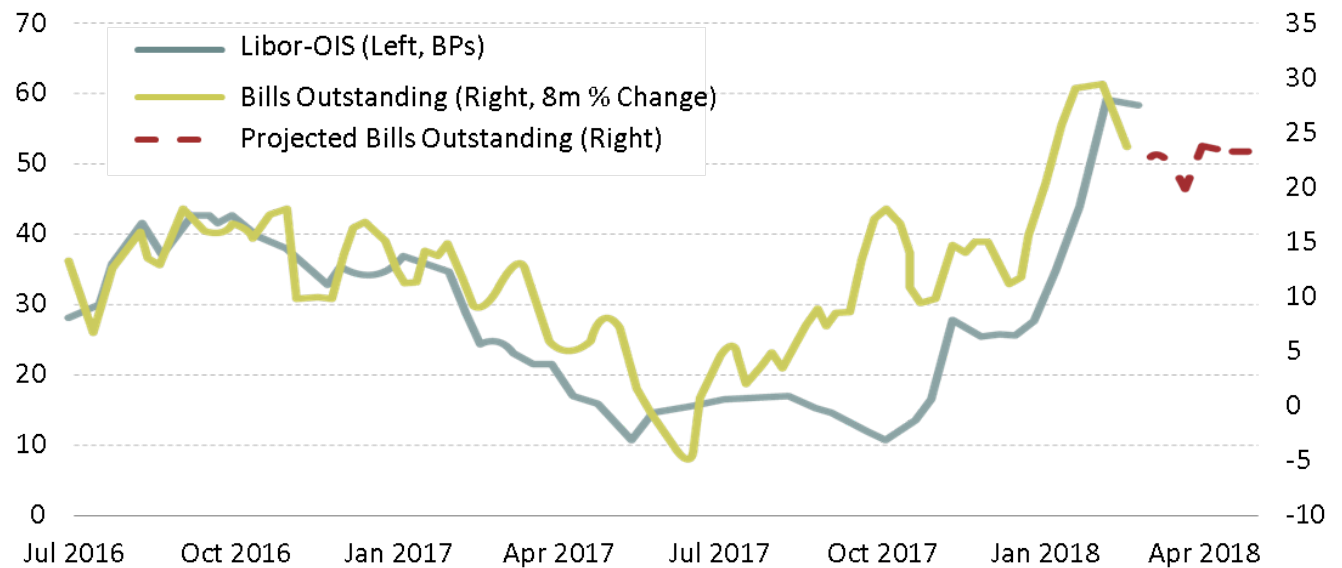
Billions of U.S. Dollars, Published on 04/16/2018



Source: BMO CM

**Chart 3: Bill Supply and LOIS**

Published on 04/16/2018



Source: BMO CM

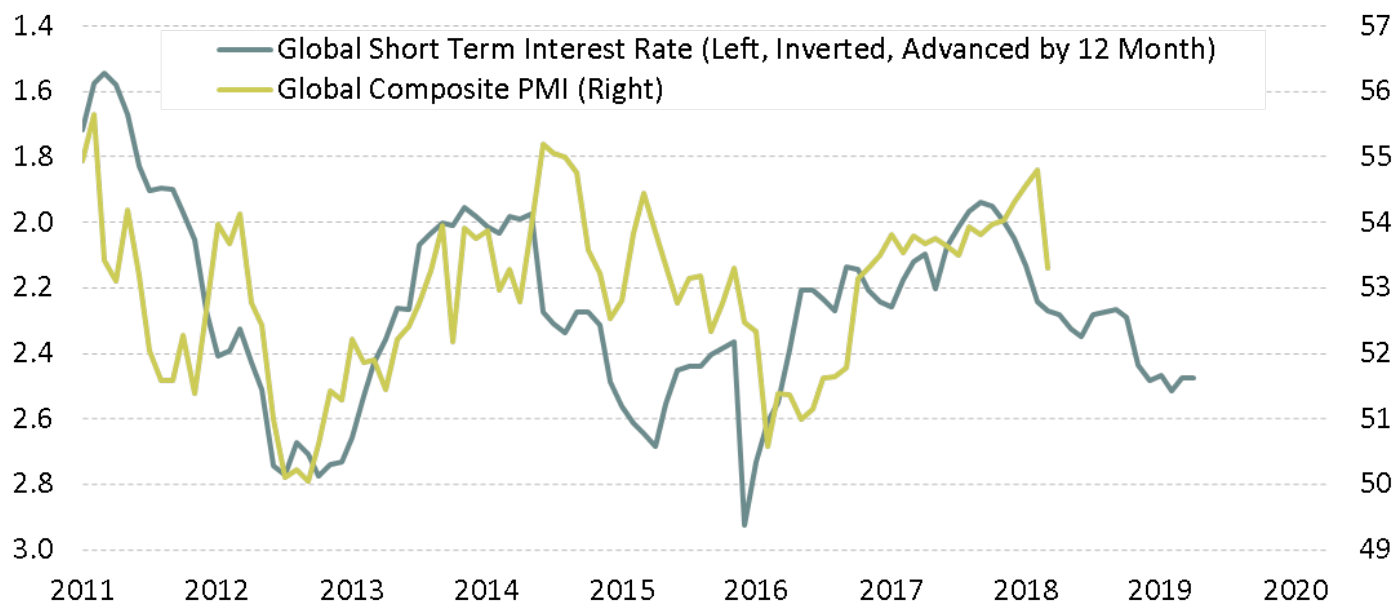
2. **Repatriation:** another side effect of the Tax Cuts and Jobs Act. Companies are reducing their inventory of commercial paper and bank paper to stay in cash now that it can be repatriated at lower tax rates and used domestically; this has reduced demand for these instruments and pushed short-term rates higher.

While this interpretation of the widening spread is a relief, the question still remains, are financial conditions still accommodative enough to sustain this elongated business cycle in the U.S.?

The relationship between monetary and economic conditions is indisputable. Tighter policy will almost always serve as a catalyst to lessened economic performance. The chart below demonstrates this relationship; as you can see higher rates lead to lower Purchasing Manager Indices (PMIs). Lower PMIs invariably imply lower growth ahead.

**Chart 4: Global Short Term Interest Rate and Composite PMI**

*As of 03/31/2018*



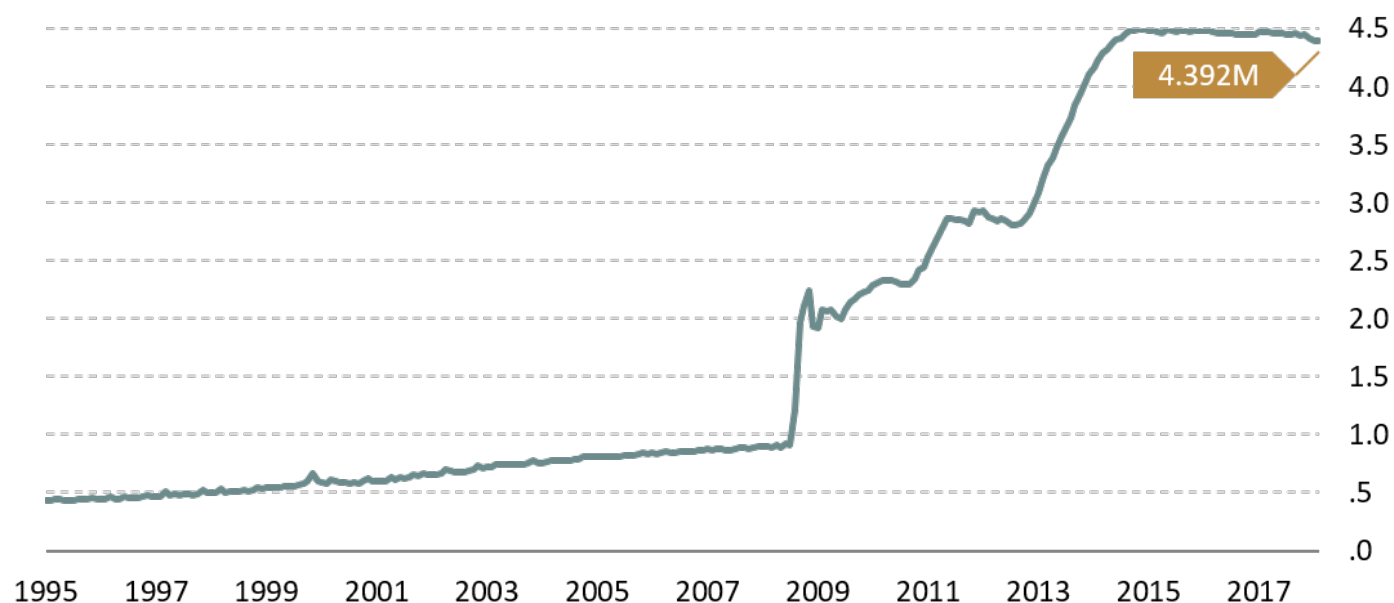
*Source: Macrobond*

In addition to the widening LIBOR-OIS spread, the Federal Reserve (Fed) recently raised rates for the sixth time during this cycle, and is seemingly on track to raise rates again at least twice more this year—maybe even three times. Higher rates, however, are not an exhaustive measure of U.S. financial conditions, particularly in this business cycle, where the Fed is using more than just the fed funds rate as part of its monetary policy toolkit.

The Fed's balance sheet reduction is now underway, which takes a very large buyer out of the market and should also push borrowing costs higher. At this juncture, while the Fed's balance sheet is indeed declining, it is still notably high—in fact, the decline in the balance sheet is barely perceptible in the chart below. Nevertheless, a smaller balance sheet does represent another form of tightening financial conditions.

### Chart 5: U.S. Condition of All Federal Reserve Banks Total Assets

In Millions, As of 3/30/2018

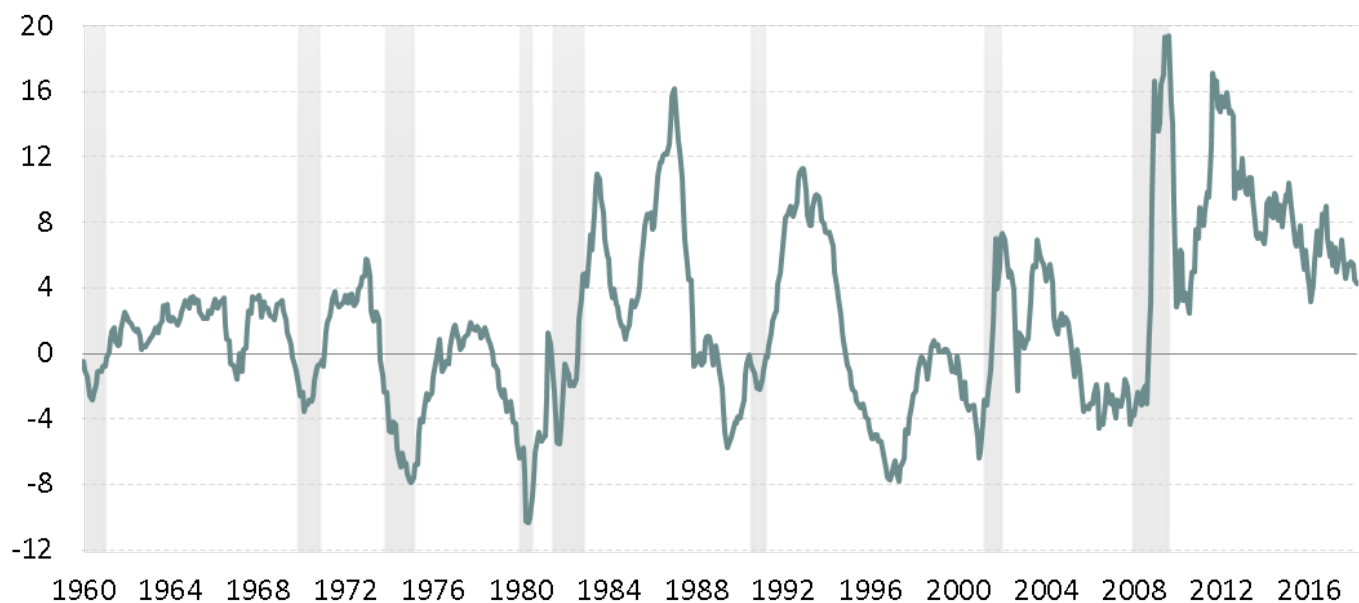


Source: Bloomberg (© 2018, Bloomberg Finance LP)

Looking at money supply, we don't think we are nearly there yet. The historical chart of real M1 growth shows that money supply has always contracted ahead of a recession. While the growth of money supply is currently decelerating, it remains positive, suggesting that financial conditions remain supportive.

### Chart 6: U.S. Real M1 Growth

Annual % Change, As of 03/31/2018



Source: Macrobond

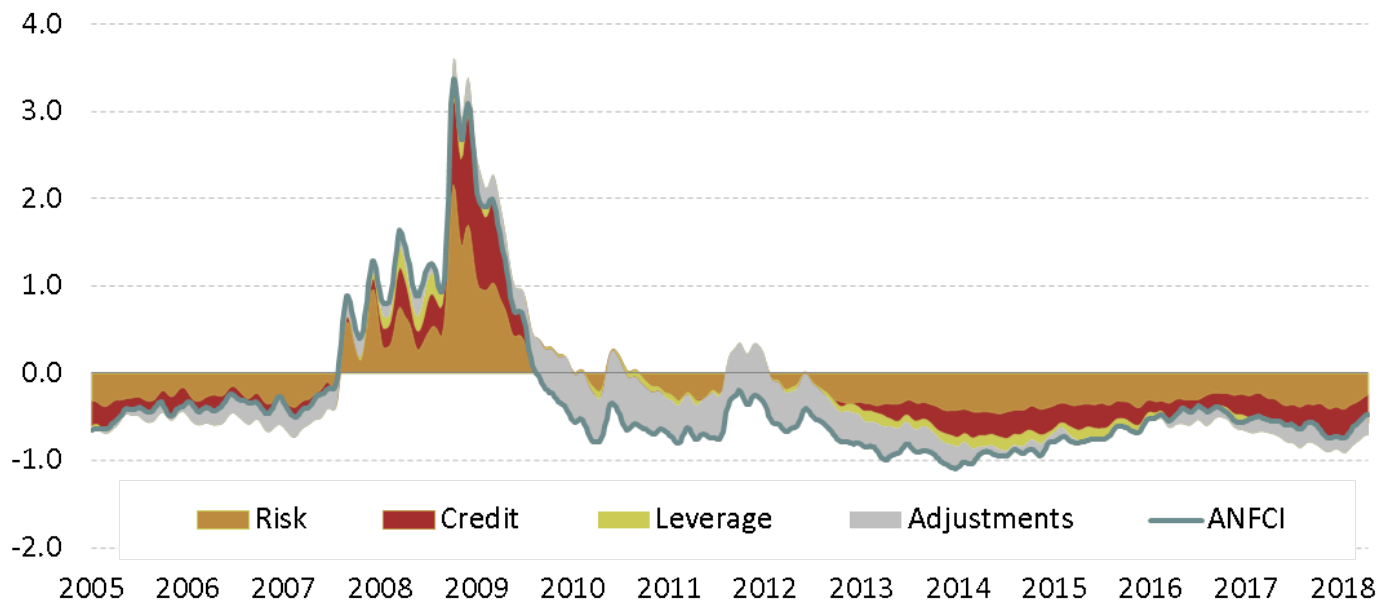
Some of the regional Fed banks maintain interesting broad indicators to help us monitor monetary and financial conditions.

The Chicago Fed publishes an Adjusted National Financial Conditions Index (ANFCI) which is a composite index comprised of a weighted average of 105 indicators of risk, credit, and leverage in the financial system. This indicator has been climbing recently but currently sits below zero, suggesting that financial conditions remain relatively accommodative.

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### Chart 7: Adjusted National Financial Conditions Index (ANFCI)

*As of 04/13/2018*



*Source: Federal Reserve Bank of Chicago*

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Similarly, the St. Louis Fed publishes a Financial Stress Index (STLFSI) which is a composite index of 18 variables focused on interest rates and yield spreads. It exhibits a similar pattern to the ANFCI, rising but still far from levels associated with financial stress.

## Chart 8: St. Louis Fed Financial Stress Index

Weekly, Not Seasonally Adjusted, As of 4/06/2018



Source: Federal Reserve Bank of St. Louis

In summary, the days of truly easy money in the U.S. are clearly behind us. While the fat lady has yet to sing, she is warming up her vocal chords. Several factors are slowly conspiring to tighten financial conditions in the economy, but the broad indicators that we watch are telling us that conditions still remain supportive enough to suggest that the cycle can persist for at least a few more quarters.

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