

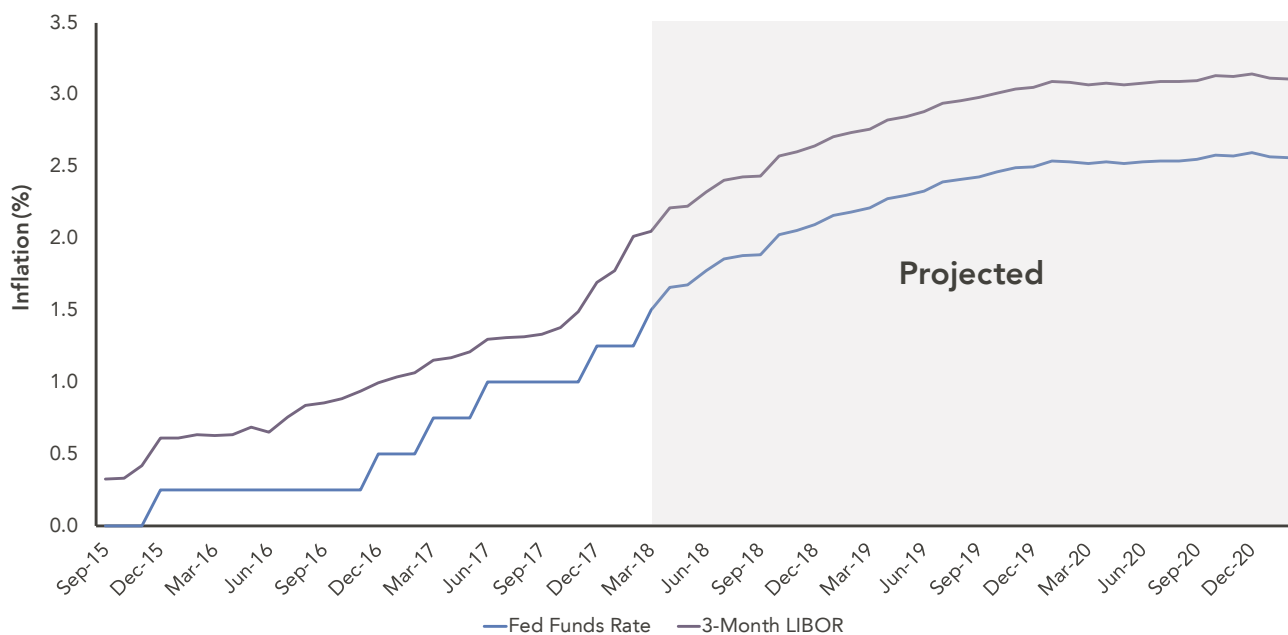
Chart of the Week

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The Sixth Fed Hike and Rising LIBOR

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▾ A strong correlation between LIBOR and the fed funds rate shows both rising in the future



Sources: Bloomberg, Federal Reserve

The Federal Reserve announced its sixth rate hike on Wednesday, with the target fed funds rate now 1.5% – 1.75%. The decision to increase rates was based on low unemployment and low inflation. Our chart this week takes a closer look at LIBOR (more formally known as the London interbank offering rate) and its relationship with the fed funds rate. As a matter of background, LIBOR is primarily used as the base rate upon which the floating rates for bank loans and private credit are set. For example, a bank loan with an L+400 rate means that it yields 400 basis points over LIBOR. As LIBOR rises, the bank loan's yield rises.

As the chart shows, LIBOR demonstrates a strong correlation with the fed funds rate, which is the short-term interest rate controlled by the Federal Reserve. The red line shows the rate hikes over the last three years. The purple line shows the corresponding rise in the three-month LIBOR, which is the most commonly used maturity of LIBOR for bank loans and private credit. On average, the three-month LIBOR is approximately 50 basis points higher than the fed funds rate; thus, LIBOR is currently around 2.0%.

The gray section on the right shows the fed funds rate (blue line) as projected by the fed funds rate futures curve. By applying the 50bp difference to the LIBOR curve, we can project LIBOR to approximately 2.5% for December 2018 and 3.0% for both December 2019 and December 2020. This means that we could expect a bank loan with an L+400 rate to yield about 6.5% in December 2018 and about 7.0% as of December 2019 and December 2020.

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However, we must note that LIBOR is expected to be phased out by the end of 2021. In addition, the London Stock Exchange has been working on a new short-term benchmark interest rate that would replace LIBOR, and plans to launch this replacement rate in April. Marquette will continue to monitor and provide guidance on these LIBOR developments, as they will undoubtedly have an impact on how interest rates and the credit market are measured. ■

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