Mitch on the Markets

The Market Risk No One is Talking About

By Mitch Zacks
Portfolio Manager

If your biggest concern as an investor right now is the trade war, or regulation on the technology sector, or even the threat of a new geopolitical conflict, then you might not be digging deep enough into some of the headwinds the U.S. economy currently faces.

To be sure, the risks I just mentioned are legitimate and should be monitored closely going forward. But they are also what I'd refer to as 'headline risks' – widely known, widely discussed risks that are probably already baked into stock prices. In my view, these types of risks generally have less pricing power and are rarely – if ever – strong enough to trigger a bear market.

On the other hand, the risks *that almost no one talks about* are often the more impactful ones we should pay close attention to. And there is a budding risk today that we believe fits the profile: a widening Libor OIS spread that is signaling tightening financial conditions in the U.S. Never heard of it? My point exactly.

What is the LIBOR-OIS Spread, and Why Does It Matter?

You might be hearing the term 'LIBOR-OIS spread' more often going forward, so let me break it apart for you. The LIBOR is the average interest rate that banks charge each other for short-term, unsecured loans. The utility of LIBOR is to give banks around the world a rough idea of how much it costs (interest rate) to borrow money in the short-term. For consumers, the LIBOR is important because it is generally what banks then use as a starting point for determining mortgage rates, student loans, credit cards, etc.

The Overnight Index Swap (OIS) rate represents a specific country's central bank rate, which in the case of the U.S. is our fed funds rate as determined by the Federal Reserve. At the end of the day, the spread between the LIBOR and the OIS should give market participants an idea of credit conditions in a particular country. A higher spread means that banks are demanding more interest for dollars lent, which may also mean they see increasing risk in the credit markets. In short, a widening LIBOR-OIS spread means that banks want extra interest to compensate for extra risk.

You probably know what I'm going to say next: the LIBOR-OIS spread has been widening fairly substantially since the beginning of the year.

Banks have been steadily charging each other more for short-term money, and as a result the LIBOR has been creeping up to levels we saw in the years leading up to the financial crisis in 2008. We're not at 'sound the alarm' levels yet. But the steady ascent has been noteworthy and rather quick in calendar year 2018. In short, financial conditions are tightening here in the U.S., and very few people are talking about it.

3-Month LIBOR Rate (Note the Sharp Uptick in 2018)

Source: Federal Reserve Bank of St. Louis; ICE Benchmark Administration Limited (IBA)[1]

Bottom Line for Investors

The 2008 financial crisis was an extreme case where tightening financial conditions brought the economy to a screeching halt. In our view, we are nowhere near those conditions today.

But, we believe that investors should be on notice that a rising LIBOR-OIS spread – coupled with the Federal Reserve shrinking its balance sheet while raising interest rates – are the types of factors that can quietly slow down an economic expansion and slow the flow of money into risk assets. And, in our opinion, those two effects together can serve as a type of gravity on stock prices.

In the near term, say the next 3-6 months, I think the momentum of corporate earnings growth and the impact of fiscal stimulus will keep this risk at bay. But we will be watching it develop closely, and I'd encourage investors to do the same.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] ICE Benchmark Administration Limited (IBA), 3-Month London Interbank Offered Rate (LIBOR), based on U.S. Dollar [USD3MTD156N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/USD3MTD156N, April 18, 2018.

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings

data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. The information contained herein has been obtained from sources believed to be reliable but we do not guarantee accuracy or completeness. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable.