# Points to Ponder

May 22, 2019

## The First Tee...

**SOFR, so good?...the move to replace LIBOR (London Inter Bank Offered Rate) as the benchmark for loans, derivatives and other instruments across various currencies is progressing:**

- LIBOR is targeted to cease in 2021…the index is the pricing basis for $350 trillion in global and domestic financial instruments ($200 trillion of the total is U.S. dollar denominated):
  - Replacing LIBOR has been called the largest financial engineering project the world has ever seen:
    - The Federal Reserve's Alternative Reference Rates Committee (ARRC) has released recommendations for language to enable contracts linked to LIBOR to work if the benchmark ceases to exist (there is still an outside chance LIBOR could persevere):
      - The first release of "fallback" language dealt with floating rate notes and syndicated loans…upcoming recommendations will relate to language aimed at bilateral business loans, securitizations and consumer products *(time to read the fine print!)*.
      - The Committee stated, risks associated with shifting from LIBOR to another index can be mitigated if market participants convert contracts early and if regulators announce the change date well in advance of the actual event *(sounds reassuring)*.
      - A majority of contracts referencing LIBOR do not adequately account for its demise…posing risks to financial stability and participants.
- The Federal Reserve Bank's Secured Overnight Financing Rate (SOFR) is the heir apparent:
  - ARRC is backing SOFR as the new benchmark, but other alternatives are still being considered:
    - The International Exchange Inc. Benchmark Administration division (who oversees LIBOR) has introduced the Bank Yield Index, while Richard Sandor (who helped invent the Chicago Board of Trade interest rate futures) has proposed Ameribor.
  - **SOFR,** which debuted in April 2018, has had some growing pains as it moves into the mainstream:
    - SOFR is a broad measure of the cost of borrowing cash overnight, collateralized by Treasury securities…the U.S. Treasury repurchase agreement market is one of the most liquid and largest in the global financial arena:
      - Futures and other derivatives linked to SOFR are already being traded…volume has steadily increased since introduction:
        - There is about $843 billion per day of trading in the Treasury repurchase agreement market that underpins SOFR…by comparison, the median daily volume of funding transactions that support 3-month LIBOR is less than $1 billion (sharply diminished due to being lame-duck).
    - The Federal Home Loan Bank, who is the largest issuer of short-term LIBOR linked floating rate debt, has issued $32 billion of securities to-date that are SOFR indexed…institutions, banks and municipalities have issued about $79 billion.
  - Some of the key issues that are currently hindering SOFR's acceptance as the new benchmark:
    - The SOFR rate has consistently traded above the level for over-night LIBLOR and the Federal Funds effective rate:
      - Tightness in the repo market has been the major reason for the rate differential…the rate difference has been 3 to 9 basis points.
      - The rate has been erratic at quarter-ends as banks adjust balance-sheets in response to regulatory surcharge calculations:
        - The quarter-end volatility has been discounted to some extent as other benchmark measures are also impacted during these periods.
    - Currently, the New York Federal Reserve is only publishing over-night SOFR rates, benchmark participants are wanting term rates as well…the Fed is working towards introducing longer-term rates using levels inferred from SOFR futures rates.
    - The Bank of International Settlements (the bank for central banks) has indicated a one-size-fits-all alternative may not be feasible or desirable…this raises the possibility that SOFR could exist with another approved benchmark:
      - SOFR does not gauge how stressed global funding markets are, an index with credit risk embedded in it may be needed.
      - Companies outside the financial-services industry have yet to utilize SOFR…corporate bonds tend to price with larger credit premiums.
    - Some market participants have been hesitant to commit to SOFR when there is a chance LIBOR could be extended.
- Eeny, Meeny, Miny, Moe…picking from the other proposed pricing benchmark indexes:
  - **LIBOR:** daily survey of 20 large banks estimating how much it costs to borrow from each other without collateral:
    - The old standby is not totally dead yet but remains plagued by the rate rigging scandals (would save large transition costs).
  - **Bank Yield Index:** gauge designed to measure yields investors are willing to lend U.S. dollars to large, internationally active banks on a wholesale, unsecured basis…the rate is based on real trades, including commercial paper and CD's:
    - Index overseen by the ICE Benchmark Administration, but is not ready yet…targeted to start publishing in 1st quarter 2020:
      - Despite transaction based, unsecured bank funding remains thin…ICE cannot guarantee it will be able to publish the index in the future.
  - **Ameribor:** reflects borrowing costs for transactions between members of the American Financial Exchange:
    - The Exchange is comprised primarily of small and mid-size U.S. banks…commercial banks have started issuing loans tied to Ameribor:
      - Global breadth of the index is unknown…initially, was only an overnight rate, the Exchange is introducing one and three month terms.

## At the turn...

## The Back Nine…

**Survival of the Fittest…retailing is in a transitional period, it is becoming increasingly evident firms need to evolve or die (the ongoing process of keeping a step ahead of consumer behavior changes):**

- With the glow of the holidays well behind us, debt reality is plaguing many retailers:
  - Retailers comprise about a fifth of the universe of distressed borrowers…default rates on the retail sectors junk bonds have risen to over 10%, more than double 2017 levels (debt loads have eclipsed recession levels):
    - The prolonged restructuring in the retail industry and cost of developing online commerce is pressuring solvency:
      - Bankruptcies are becoming more common for many iconic brands (Sears, Toys-R-Us, Payless Shoes), with more in the wings:
        - Some highly leveraged names that are drawing analyst scrutiny include J.C. Penny, Neiman Marcus, PetSmart and Petco.
      - Regional mall vacancy rates are running at 9.3% in the U.S…the amount of empty retail space available is at an all-time high.
  - There are some brighter spots in the environment as retailers remarket and resurrect themselves:
    - Moody's Investors Service has increased its outlook for retailers to "positive" from "stable" (the first increase since 2015):
      - Stores improvement of their web capabilities is helping operating income expand by an additional 5% to 6% per year.
      - Only about 4.9% of retail mortgages are overdue (down from over 6% at the start of 2018)…partially due to many large retailers already failing.
- **New Kids on the Block**…it seems Generation Z (young adults between the age of 7 and 22) are embracing malls:
  - According to a study by the International Council of Shopping Centers, 95% of the Gen Z populous visited a mall in a 3-month period in 2018…this compares to 75% of millennials and 58% of Gen X shoppers:
    - Three-quarters of Gen Z's interviewed stated going to a physical store was a better experience than shopping online:
      - i-Phone burnout…in a Bloomberg survey, six out of ten Gen Zer's self-diagnosed themselves with smartphone overuse.
      - The Z labeled generation is projected to currently have $143 billion in spending power in the U.S. alone *(nice allowances!)*.
  - Here are some Gen Z buying patterns that have emerged, causing some retailers to revamp strategy:
    - **Cell phone sales tool**: despite phone fatigue, young shoppers *(and older ones as-well)* are searching their phones for deals while in store…firms are leveraging on premise phone use by offering e-mailed promotions/discounts/coupons that can be instantly used.
    - **Let me entertain you:** over a third of Gen Z consumers say shopping should be entertaining…as retailers try to differentiate themselves and widen their appeal, the entertainment factor has become a key marketing tool *(as Topgolf has reinvented the driving range*
    - **Customizing customization:** nearly half of Gen Z shoppers want products tailor-made to their tastes and interests:
      - Gains in technology are allowing retailers to personalize goods in-store at point of purchase (especially fashion and jewelry).
    - **Are you experienced?:** looking for deals, Gen Z'ers do not object to buying secondhand goods…according to Thredup's 2019 Resale Report, one in three Gen Z shoppers are expected to buy used goods this year (fashion and some luxury items are main secondhand buys
- **Welcome to the Jungle**…competition for the consumer's dollar continues to intensify, only the smartest, strongest, fleetest and most agile will be successful and avoid the pitfall of extinction.

## 19th Hole...

***First things first, but not necessarily in that order*.**

Dr. Who

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