UNIT Monash: Week Nine Newsletter

Hey <<First Name>>!

We are back on the topic of rates investment this week, with our second instalment covering the London Inter-Bank Offered Rate (LIBOR) and the LIBOR Scandal.

Check out the week nine newsletter below for the details!

Weekly Info Wrap

The London Inter-Bank Offered Rate (LIBOR)

LIBOR is a banking term that not everyone is aware of, but it is essential to have an understanding of it because it has a fundamental impact on the lives of most people. So…. What is LIBOR? LIBOR, short for the London Inter-Bank Offered Rate, is a benchmark rate set by sixteen of the largest banking groups in the world. In its essence, LIBOR is a measure of how much it costs for banks to be able to borrow short-term loans from one another.

The LIBOR determines the pricing of millions of financial transactions around the world, including swaps, floating-rate bonds, and bank loans. Thus, it is critical for the LIBOR rate to be accurate to ensure that the financial transactions derived from LIBOR are priced correctly.

How is LIBOR Calculated

1. Every day, eleven to eighteen banks submit the rate it believes it could borrow from the others at 11:00 am.
2. Each bank submits a rate for five different currencies and seven different borrowing periods, giving a total of 35 separate rate submissions.
3. Out of that, the bottom quarter and top quarter rate submitted are removed from each rate submission.
4. The rest of the submitted rates are averaged, which then becomes the set LIBOR.
5. It is important to note that there is no intervention from any regulatory body in the process of setting the LIBOR.
6. The LIBOR is then published at 11:45 am each day.

LIBOR for Each of the Five Reported Currencies and Seven Borrowing Periods

1. American dollar - USD LIBOR
2. British pound sterling - GBP LIBOR
3. European euro - EUR LIBOR
4. Japanese yen - JPY LIBOR
5. Swiss franc - CHF LIBOR

LIBOR Scandal

In 2012, it was uncovered that the banks responsible for setting LIBOR had formed a cartel to manipulate it fraudulently. During the Global Financial Crisis in 2007-2008, the major banks had colluded with traders and submitted an artificially low LIBOR. Thus, traders who held LIBOR-based financial securities could maximise their profits, and the banks signalled that they were less risky, which was a relevant issue during the GFC.

When the scandal became publicised in the news, it had significant ramifications. The banks involved faced substantial penalties; notably, Barclay's was made to pay $453 million in compensation, and traders faced heavy persecution for the role they played in the scandal.

As a result of the scandal, the administration of LIBOR has shifted from the British Bankers Association (BBA) to the ICE Benchmark Administration (IBA), to provide more stringent regulation on the setting of the LIBOR. Additionally, the IBA increased and diversified the number of participating and submitting banks, to mitigate the risk of collusion. Additionally, the IBA sought to make the process of setting the benchmark rate more transparent, requiring clear information on how LIBOR is calculated. Moreover, there are plans to replace LIBOR as the benchmark rate in 2021; however, due to LIBOR's significant weighting in global financial transactions, phasing out LIBOR would be gradual.

Summary

1. We have learnt about the functioning of LIBOR and its importance in debt and fixed income markets.
2. We have also learnt how some of the leading banks in the world manipulated the LIBOR during the LIBOR scandal and the repercussions which arose.
3. Finally, we now understand the repercussions on the financial system from the scandal; and how regulatory authorities have put in place new measures in the aim of ensuring that such a scandal does not occur again.

Weekly Global Breakdown

Australia

The ASX has given up most of its early gains but still managed to close higher for a 10th day in the past 12 sessions, and the All Ordinaries closed up 13.8 points, or 0.2 per cent. The benchmark S&P/ASX200 index closed Friday up just 13.3 points which represents the fifth straight the index has risen.

Meanwhile, the unemployment rate has risen to a 12-month high in August and traders are betting that the RBA would cut the cash rate further in October. The ASX's Rate Indicator shows that the market is pricing in an 80 per cent chance of a rate cut next month, up from a 25 per cent chance a week ago.

This week, mining stocks showed the most significant gains, up 10 per cent, with gold miners rising after the price of the precious metal climbed to US$1,505 an ounce. In the financial sector, NAB shot up in the final minutes of trading, closing up 1.6%, after the RBS announced that Ross McEwan's last day would be October 31. ANZ and Westpac, meanwhile, both gained 0.3 per cent, respectively.

The AUD is buying 68.07 US cents, up from 67.81 US cents on Thursday.

United States

Equities ended the week moderately lower following a widely expected interest rate cut by the Federal Reserve and increased oil price volatility. The S&P500 closed the week 0.18 per cent lower while the Dow Jones Industrial Average dropped 0.59 per cent.

The US Federal Reserve's move to lower interest rates a second time in the past three months by a quarter of a percentage to 2 per cent seemed to garner an insignificant reaction from investors. This is likely because the move had already been priced in the market as it was highly speculated further cuts were coming.

Despite the September 14 attack on Saudi Arabia's major oil facilities and subsequent volatility in oil prices, the stock market broadly speaking seemed unfazed. However, companies in the transportation industry that are particularly sensitive to commodity price swings did not fare too well in the past week.

Slight progress was made concerning the US-China Trade War as the Trump administration provided temporary relief from tariffs for over 400 imported products from China. This was done following low-level trade talks ahead of the planned negotiation in October. However, hopes that China would begin purchasing US agricultural goods have been clouded as Chinese trade negotiators suddenly cut their Washington trip short, cancelling their visit to US farms.

Asia

At BOJ's policy meeting for this month, it was decided by majority vote that they would leave short-term interest rates at -0.1 per cent and continue targeting a 10-year government bond yield of roughly 10 per cent. The policy statement reiterated forward guidance that interest rates will remain at noticeably low levels and policymakers would not hesitate to implement additional easing measures if there is any concern that their momentum towards achieving a 2 per cent inflation target is in jeopardy.

President Donald Trump said that the U.S. had reached an initial trade accord with Japan, which could be finalised in the coming weeks. The agreement offers U.S. farmers better access to Japan's market in exchange for lower tariffs on various industrial goods and autos. Trump also told Congress that the government would be entering an executive agreement with Tokyo on digital trade.

Chinese stocks retreated for the week as the speculation on the U.S. trade war continues resulting in slowdowns in China's key drivers. Growth in industrial output and retail sales in August missed expectations, with industrial output returning its lowest monthly gain since 2002. Fixed-asset investment slowed to 5.5 per cent in the first eight months of the year, also slightly below expectations. The benchmark Shanghai Composite Index shed 0.8 per cent and the large-cap CSI 300 Index, which tracks blue chips listed on the Shanghai and Shenzhen exchanges, fell 0.9 per cent.

Europe

European stock indices were mixed despite the hopes for a Brexit deal increasing and US-China tensions easing. The STOXX Europe 600 Index gained a modest 0.4 per cent while both the German DAX and UK FTSE 100 declined slightly.

The British pound traded flat despite Brexit deal optimism as the Bank of England signalled potential short-term interest rate cuts.

Despite easing concerns about the US-China dispute and a no-deal Brexit combined with monetary stimulus, the outlook for Germany remains pessimistic due to global economic uncertainties.

Looking ahead, investors will be keeping a close eye on the release of economic data from the eurozone and economic growth numbers from the US.

New to markets? Got Questions?

As we mentioned in previous emails - we started UNIT Monash with the vision of educating the student community in investing and trading to one day strive for financial independence.

We want to create a new concept of peer-to-peer communications about investing and trading. There's a lot of value in sharing experiences, having opinions and shedding light on new ideas. Feel free to get in contact with us via Facebook if you have any enquiries about investment, trading or our upcoming events or if you would like to provide any feedback.

Regards,
UNIT Monash

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