Executive Summary
At the time of our last SOFR update in early April, LIBOR rates and SOFR had diverged significantly due to the financial market dislocations that the pandemic imparted to the global economy. However, “normalcy” has more or less returned to money markets due, in large part, to the steps that the Federal Reserve has taken to ease tensions in financial markets. If, as we expect, the Federal Open Market Committee (FOMC) keeps its target range for the fed funds rate unchanged at 0.00% to 0.25% through at least the end of next year, then SOFR should remain at rock bottom for the foreseeable future. Market participants should continue to be prepared to transition from LIBOR to SOFR as soon as the end of 2021.

“Normal” Has Returned to Money Markets
When we wrote our last SOFR update in early April, the global economy was still reeling from the initial shock of the lockdowns that many countries implemented in response to the pandemic. As we noted at that time, 1-month LIBOR and SOFR, which usually are highly correlated, diverged significantly starting in mid-March (Figure 1). Although SOFR followed the FOMC’s target range for the fed funds rate lower, 1-month LIBOR moved higher in late March and early April. This rise in LIBOR, which is an unsecured interest rate, reflected, at least in part, general tensions in credit markets that surfaced in March (Figure 2).

Figure 1
Short Term Funding Rates

Figure 2
Baa Corporate Bonds over U.S. Treasury Securities

SOFR and LIBOR diverged significantly in mid-March.

Get Ready for SOFR: Low Rates for Foreseeable Future

Special Commentary

Fast forward four months, and the situation has returned largely to “normal.” The prompt response of policymakers, especially steps that the Federal Reserve has implemented to support credit markets, has caused corporate bond spreads to compress nearly all the way back to levels that prevailed in late February (Figure 2). Consequently, 1-month LIBOR has receded from roughly

Together we’ll go far

Source: Bloomberg LP and Wells Fargo Securities

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.
1.00% in early April to 0.17% at present. At the same time, SOFR has edged up from its late March low of 0.01% to 0.10% currently. What is going on here?

On the LIBOR front, improved liquidity and tighter spreads in short-term, unsecured lending markets, particularly commercial paper, have helped push 3-month LIBOR down.\(^1\) Diminished concern about bank credit quality has likely also helped, as have the Federal Reserve’s numerous actions to improve access to dollar funding through its various liquidity programs. On the SOFR side, more tranquil financial markets have likely reduced the demand for secured places to park money on a short-term basis. At the peak of the crisis, owning Treasury bills outright or lending overnight in the Treasury repo markets were among the safest places to keep cash.

In addition, the flood of Treasury issuance in recent months has also helped to push up SOFR. Since February, the Treasury Department has issued a net $2.5 trillion of T-bills, and this deluge of supply has pushed down the price of bills (i.e., pushed up their yield). As the rate on the 1-month T-bill has crept up from its low of -0.107% in late March to 0.07% at present, so too has SOFR. That said, SOFR is more or less in the middle of the Fed’s target range for the fed funds rate (currently between 0.00% and 0.25%), which is typical during “normal” times.

**Fed to Keep Rates at Rock Bottom for the Foreseeable Future**

In that regard, our current forecast looks for the FOMC to keep its target range for the fed funds rate unchanged through at least the end of 2021. Moreover, the so-called “dot plot” indicates that most FOMC members believe that rates will be on hold through 2022 (Figure 3). If the target range for the fed funds rate remains near zero for the foreseeable future, then it is likely that SOFR will as well.

**Figure 3**

*June 2020 FOMC Dot Plot*

**Figure 4**

*SOFR and the Fed Funds Target Range*

Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities

Since SOFR started trading in April of 2018, it has ended the day within the FOMC’s target range for the fed funds rate on 92% of the days and 98% of the days since the start of 2020. While these figures suggest there can occasionally be a meaningful gap between SOFR and the effective fed funds rate, any material divergences between the two rates have been driven generally by funding pressures, such as those that materialized in September 2019 (Figure 4). However, the Federal Reserve has shown a willingness and ability to alleviate these pressures. Moreover, in the context of the LIBOR-to-SOFR transition, it is important to note that contracts referencing SOFR have been based on backward-looking moving averages (e.g., the average SOFR rate over the past month). These moving averages tend to smooth out any volatility that could occur in SOFR rates on a daily

---

\(^1\) LIBOR is intended to reflect the rate a submitting bank believes it could borrow from another bank on an unsecured basis. In reality, very few of these transactions take place for terms longer than one month. The Alternative Reference Rates Committee (ARRC) estimates the average daily volume of 3-month LIBOR transactions to be just $500 million. Consequently, banks can, or must, base their LIBOR submissions on rates in other unsecured markets, such as commercial paper.
basis, which would reduce the probability that borrowers experience an unexpected short-term spike in their borrowing costs. With the rate outlook stable and an increasing number of contracts tied to SOFR, we should continue to see a transition towards SOFR as we approach LIBOR’s potential retirement at the end of 2021.

While the establishment of LIBOR’s successor in the United States continues to progress, COVID-19 has brought a new set of challenges to an already complex transition process. Beyond operational adjustments, the pandemic and the resulting economic fallout have focused banks and regulators alike on addressing more immediate problems. For instance, the Federal Reserve chose to base loans in its Main Street Lending Program on LIBOR, rather than SOFR, after potential participants noted “implementing new systems to issue loans based on SOFR would require diverting resources from challenges related to the pandemic.”

Despite the uncertainties that the pandemic has imparted, officials across the world have made it clear that COVID-19 is not expected to change the timeline for the LIBOR transition. For example, the Financial Conduct Authority (FCA), the U.K. regulator that oversees LIBOR, reaffirmed in late March that despite the pandemic firms cannot rely on LIBOR being published after the end of 2021. The steering committee tasked with guiding the transition away from LIBOR in the United States, the Alternative Reference Rates Committee (ARRC), has similarly stuck to its established timeline.

For some policymakers, the events of the past few months have only underscored the need to transition to more reliable reference rates. Speaking at a webinar in July, Bank of England Governor Andrew Bailey and New York Fed President John Williams noted that the already limited lending on which LIBOR is based dried up in March and April, while transactions underpinning SOFR and the sterling overnight index average (SONIA) increased. As a result, these rates were able to provide a more accurate reflection of bank funding costs through the tumult this spring.
Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.  Chief Economist  (704) 410-3274  jay.bryson@wellsfargo.com
Mark Vitner  Senior Economist  (704) 410-3277  mark.vitner@wellsfargo.com
Sam Bullard  Senior Economist  (704) 410-3280  sam.bullard@wellsfargo.com
Nick Bennenbroek  International Economist  (212) 214-5636  nicholas.bennenbroek@wellsfargo.com
Tim Quinlan  Senior Economist  (704) 410-3283  tim.quinlan@wellsfargo.com
Azhar Iqbal  Econometrician  (212) 214-2029  azhar.iqbal@wellsfargo.com
Sarah House  Senior Economist  (704) 410-3282  sarah.house@wellsfargo.com
Charlie Dougherty  Economist  (704) 410-6542  charles.dougherty@wellsfargo.com
Michael Pugliese  Economist  (212) 214-5058  michael.d.pugliese@wellsfargo.com
Brendan McKenna  International Economist  (212) 214-5637  brendan.mckenna@wellsfargo.com
Shannon Seery  Economist  (704) 410-1681  shannon.seery@wellsfargo.com
Jen Licis  Economic Analyst  (704) 410-1309  jennifer.licis@wellsfargo.com
Hop Mathews  Economic Analyst  (704) 383-5312  hop.mathews@wellsfargo.com
Coren Burton  Administrative Assistant  (704) 410-6010  coren.burton@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Canada, Ltd., Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC. and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC’s research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2020 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients
For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 ("the Act"), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE