

Coiling The Eurodollar Spring

One of the better ways to spot an amateur in the futures business is any statement implying the market is forecasting something. Contrary to popular opinion, a futures price is not the consensus forecast of where a market will be trading sometime in the future, but rather the reservation price at which the long and short sides of the transaction both can remain in business.

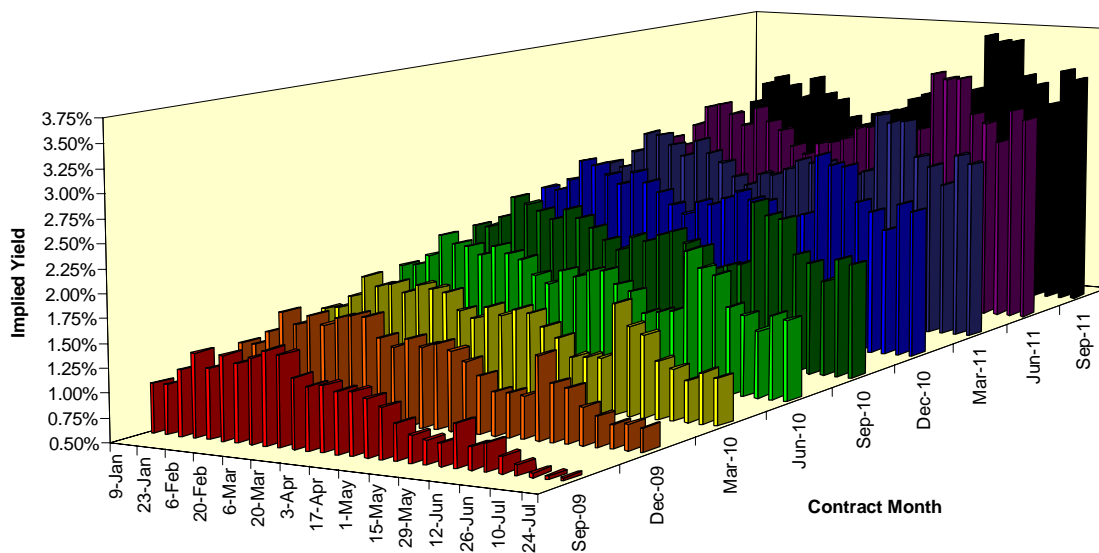
Consider the offsetting positions of a soybean farmer who needs to establish a price floor as part of a loan and a soybean crusher needing to cap the price of beans at a certain level to protect crush margins against fixed-price sales of soymeal and beanoil. The farmer can sell and the crusher can buy futures for some month or combination of months, and both can exit the transaction gritting their teeth at their own stupidity. The farmer may believe the sales price is too low and the crusher may believe the purchase price is too high, but those are opinions. The fact is given by the price, and this transaction may be completely independent of the forecast opinions of both parties involved.

Eurodollar Signals

By late [January](#), the forward-rate structure of the Eurodollar futures market indicated borrowers could live with rising short-term interest rates and lenders were going to be demanding those rates. Such an outlook was consistent with “the low point in credit demand...occurring somewhere in the six months between April and September.” Check and double-check; if we have not bottomed economically, we certainly feel as if we have.

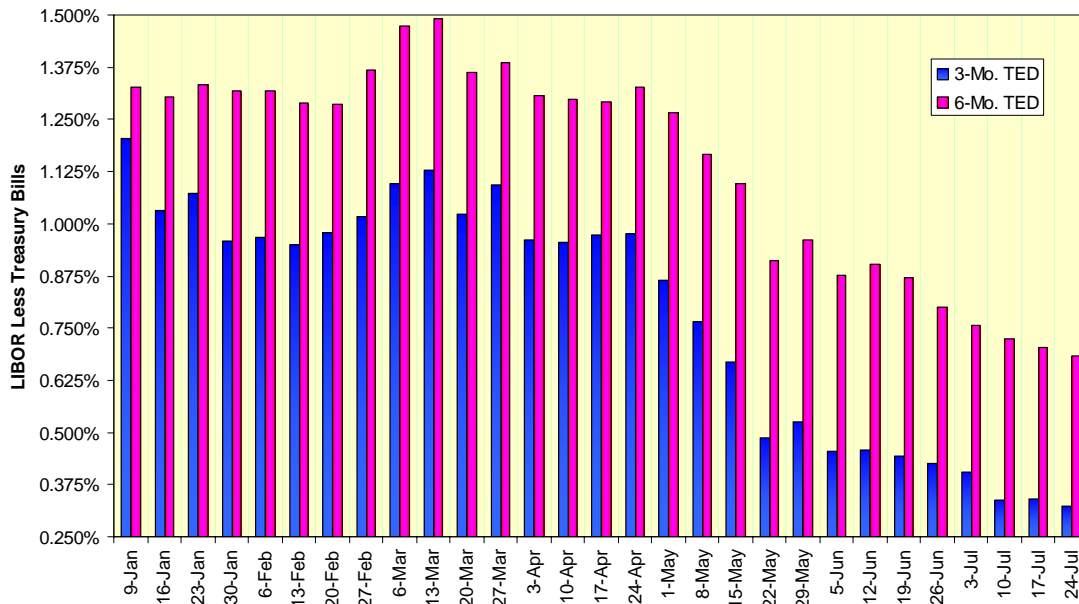
Given that outlook, we have every right to expect the Eurodollar forward curve to have flattened via rising short-term rates. Instead, the Eurodollar forward curve since the early January lows has become steeper, almost dangerously and certainly unstably so. Let’s update the situation from the week ending January 9, 2009, which had been the local minimum for Eurodollar yields.

Implied Eurodollar Yields Since January Low



The implied yields for the September and December 2009 contracts are lower now than they were in January, while the implied yields for contracts expiring in December 2010 and later are higher. Part of the reason for this change is the collapse of the spread between LIBOR, on which the Eurodollar futures are based, and the Treasury bill rates. This TED spread has moved sharply lower for the three-month horizon, and while the six-month TED has declined, it is not low by historic standards.

Progression Of Three- And Six-Month TED Spreads

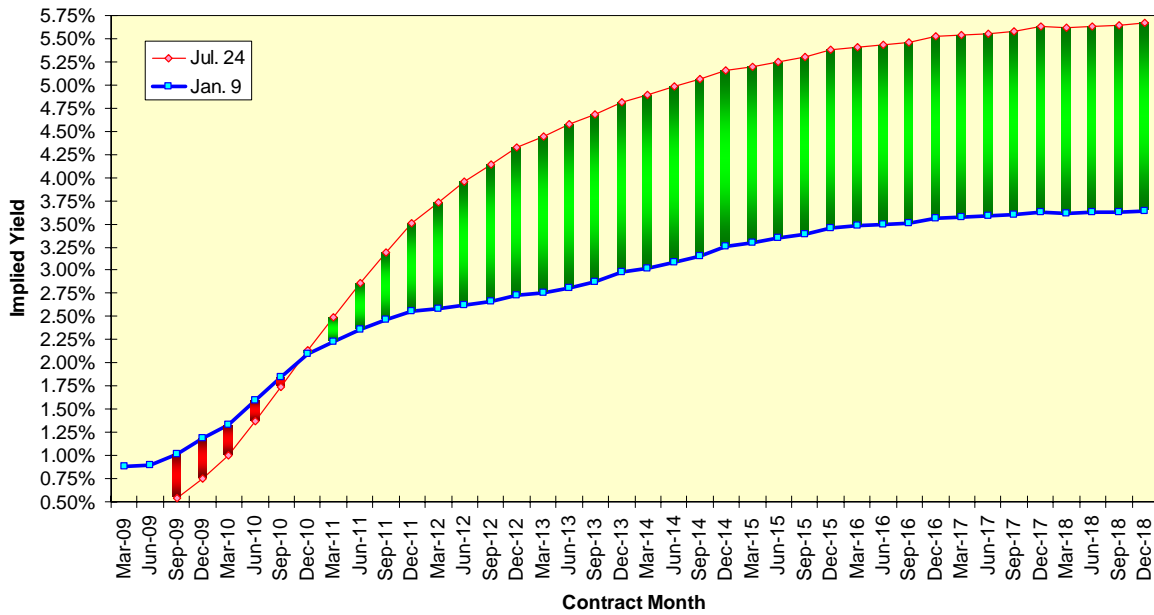


The LIBOR markets have been in and out of various levels of dysfunction for nearly two years; the European Central Bank first intervened on behalf of BNP on August 9, 2007. Then came the stories about banks cooking their quotes and the wide separation between LIBOR and overnight index swaps, covered here in [June 2008](#). As LIBOR is used as the basis for most interest rate swaps, corporate borrowings and adjustable-rate mortgages, central banks have been moving heaven and earth to force it lower.

The Bearish Steepening

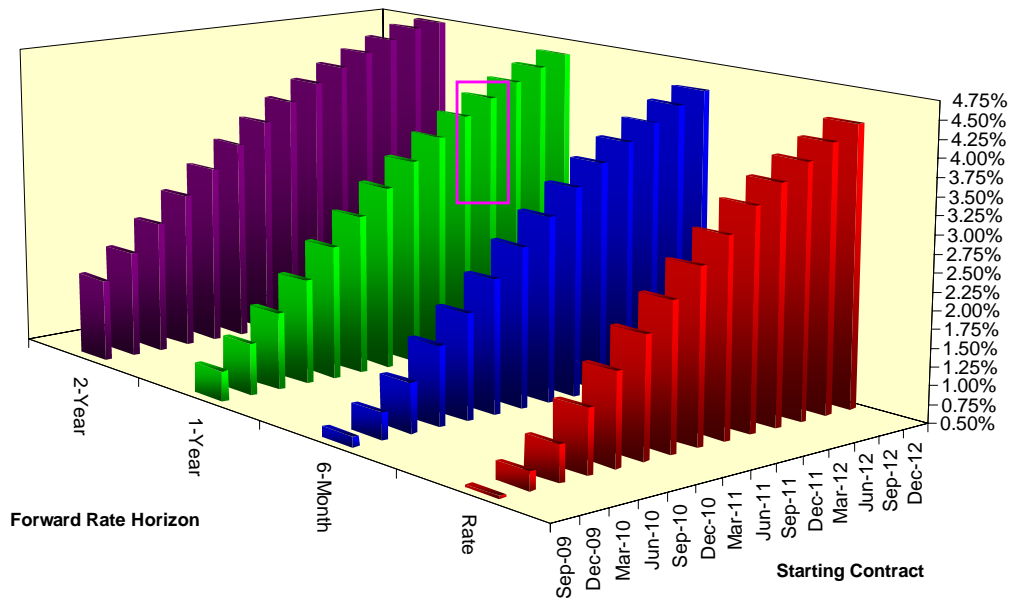
They have succeeded, perhaps too well, in forcing the front-end of the Eurodollar curve lower. If we compare the forward curves from January to today, we see lower short-term rates and much higher long-term rates. Yes, three-month LIBOR starting in September 2009 is 48.5 basis points cheaper, but unless you are Munchkin Industries doing everything short-term, this is not a critical rate. Look at the height of those green bars; by March 2012, the increase has been over 100 basis points, by December 2012 150 basis points, by June 2013 175 basis points and by December 2017 200 basis points. If you are doing an interest rate swap or locking in forward rates for any purpose, you are facing much higher, not lower, prospective short-term interest rates.

Eurodollar Curve In A Bearish Steepening After January 2009



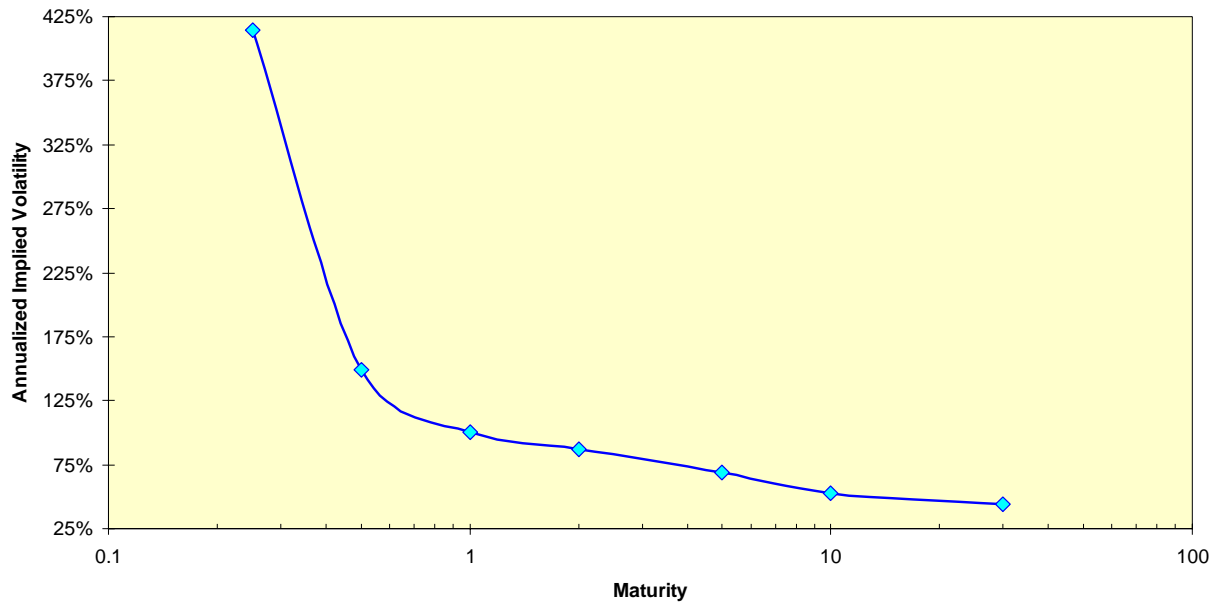
In tribute to the late Billy Mays, but wait, there's more! Let's take a look at a synthetic forward rate map. Each colored row depicts the costs of locking in borrowing for 6 months or either one or two years starting from the expiration of any of the futures contracts listed. If we zero in on the one-year forward rate agreement starting with the expiration of the June 2012 Eurodollar futures contract, highlighted with the magenta rectangle, we can see it is over 4.00%.

Eurodollar Synthetic Forward Rates



An additional risk posed by this preternaturally steep yield curve comes in the form of extremely high and inverted implied volatility for interest-rate instruments. Let's take a look at the snapshot along the zero-coupon Treasury curve.

Short-Term Volatility Is Extreme



Short-term interest rate traders have bought insurance against a renormalization of this yield curve, “renormalization” being another term for a sudden flattening of the yield curve via higher short-term rates. That is the “what.” The “when” is quite another matter; even this past week Chairman Bernanke was indicating he is willing to keep short-term rates unusually low for an extended period.

Each day that goes by stores more energy in this spring. If February 1994 and April 2004 are any examples, once the market gets the hint rates are going to rise, they will do so in abrupt fashion.