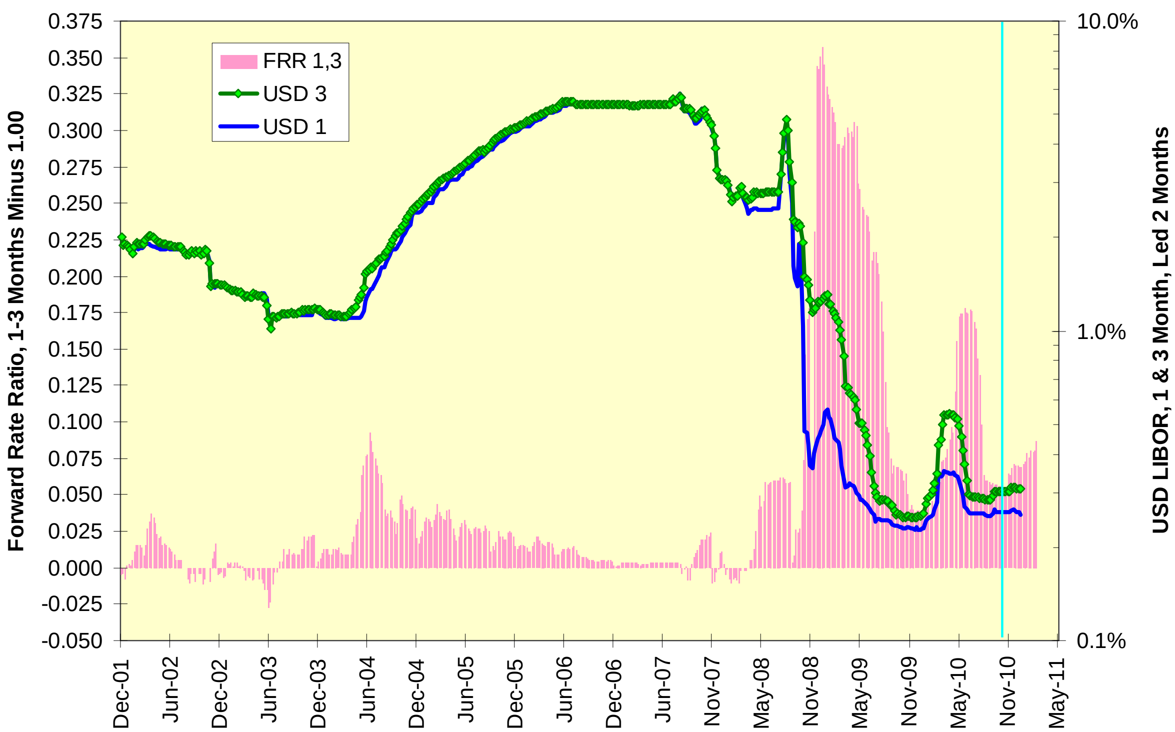
Federal Funds To Walk Down LOIS Lane

The model upon whom the original Lois Lane of Superman fame was based died last month and took with her a piece of Americana. However, the Torch of Lois lives on in the spread between LIBOR and the overnight index swap (OIS) rate. The so-called LOIS spread serves the same general function as the TED spread between Eurodollars and Treasury bills; here the subtrahend of OIS represents not the T-bill rate but rather the rate at which a bank can lock in a strip of federal funds.

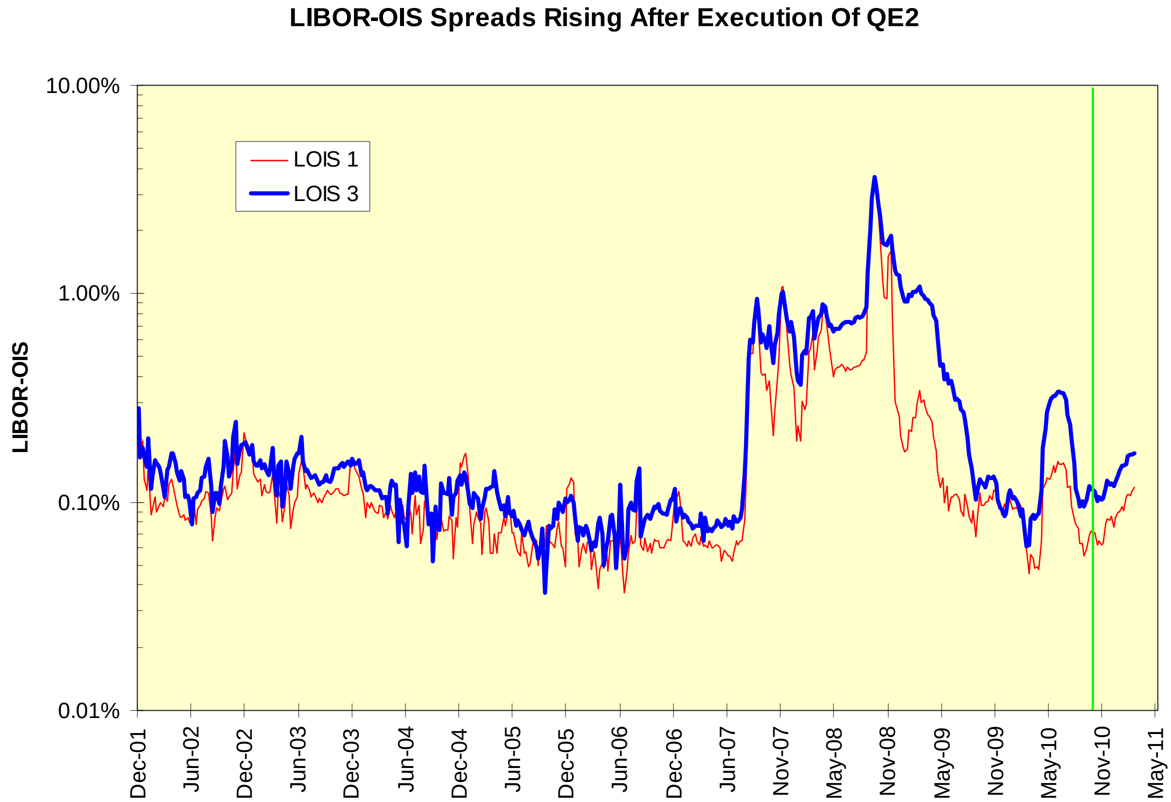
A funny thing has happened since the execution of QE2 began in November 2010, marked with vertical lines in both charts. All of the money created by the Federal Reserve has driven OIS rates down toward levels last seen in February 2010 and has led to an inversion of the term structure of OIS. If you simply looked at these yield levels and term structure, you might think we were still in a financial crisis.

The exact opposite has been occurring in the LIBOR market. As these are funds held outside of the U.S., they are not affected immediately by money-printing. Not only have these rates not fallen, the three-month rate has increased relative to the one-month rate and thus steepened the yield curve as measured by the forward rate ratio between one and three months. This is the rate at which we can lock in borrowing for two months starting one month from now, divided by the three-month rate itself.

USD LIBOR Forward Rate Structure Steepening



If we haul out our forever-useful transitive property of equality, we can deduce the LOIS spread has been widening since QE2 began, and this indeed has been the case. Federal funds have been suppressed artificially by the Federal Reserve's actions and are trading at an artificially wide spread below LIBOR.



The most immediate consequence of the LOIS spread will be an upward convergence of OIS to LIBOR once the money-printing stops; we might learn more about this later this afternoon when the FOMC emerges from the clouds of smoke around Mt. Sinai, clears its collective throat and tells us to take two tablets and call them if further miracles are needed.

The rise in OIS after QE2 ends will force a deleveraging in the fixed-income markets are leveraged positions financed therewith will become more expensive to carry. Whether any of this affects credit spreads or earnings prospects is less clear, however, and no one should make an immediate connection between a narrowing of the LOIS spread and any directional move in the stock market.

However, given markets' propensities to shoot first and think later, if ever, you might see a short-term selloff before cooler heads prevail. Whatever happens, it will not be boring and it will not leap tall buildings in a single bound.