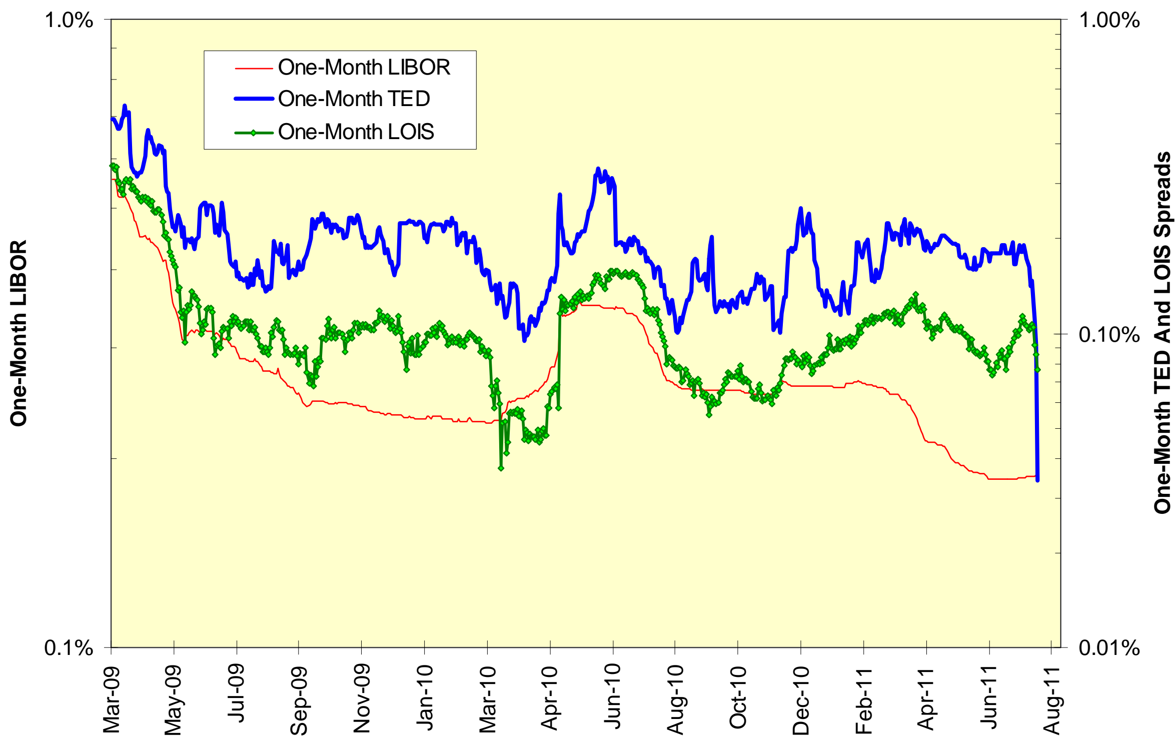
Risk-Free In Name Only

One of the many execrable characterizations of the early Cold War was "un-American." You never heard something described as "un-Canadian," although as not being American is part of Canadians' national self-identities, un-Canadian could, by the transitive property of equality or something like that, be "American." Discuss.

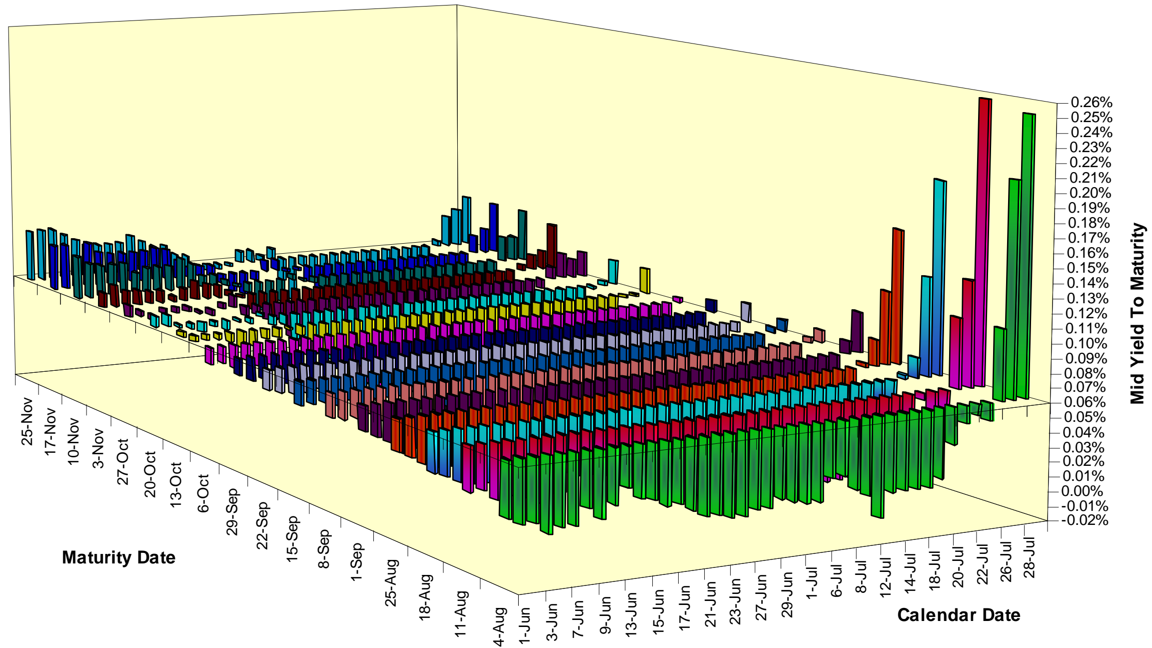
We now have acronyms such as RINO, for Republican In Name Only; the results of these ideological litmus tests have been on display in Washington over the past weeks and the results have not been pretty. What about calling the Treasury bill rate, "risk-free," as is done in just about every finance textbook? They never were free from inflation or currency risk; we now have to recognize we might have to start considering the possibility of default risk.

World Turned Upside Down

The TED spread, or difference between LIBOR and Treasury bills, has been used for years as a measure of stress in the interbank markets. It is now, incredibly, useful as a measure of risk in the Treasury bill market: As the risk of default gets priced into Treasury bills, the TED narrows. We can use the LOIS spread, or difference between LIBOR and the overnight index swap rate based on federal funds, as a check to see whether the TED is being distorted by LIBOR. If the TED is moving and LOIS is standing still and LIBOR is part of both spreads – here is that transitive property again – we know the Treasury bill rate is the one out of line.



The generic one-month Treasury rate used in the chart above is based at present on the bill due August 25th. Let's map the yields of each bill maturing between August 4th and November 25th from June 1, 2011 onwards. The plane is set in the chart below at 6 basis points to accentuate moves over this yield level.



It is apparent the very short bills, those maturing in August, have seen the largest yield spikes in recent days. The decline after one month is in recognition by the market the purported August 2nd drop-dead date is not a hard-and-fast line for government insolvency. What we have done is create an artificial funding crisis that can be solved at any times if cooler heads prevail in the Washington heat.

What we may have created as well is another set of "perma-expectations" similar to those seen in short-term interest rate markets with regard to eventual renormalization. As we move forward in time – just try moving backward – we very well may see each successive Treasury bill rise in yield as it approaches maturity. This will be a truly bizarre situation as it will invite yield hogs to speculate on whether Treasury bills due inside of one month will be paid.

We have created a short-term credibility market for short-term Treasury paper, the stuff we used to call risk-free. This is some accomplishment.