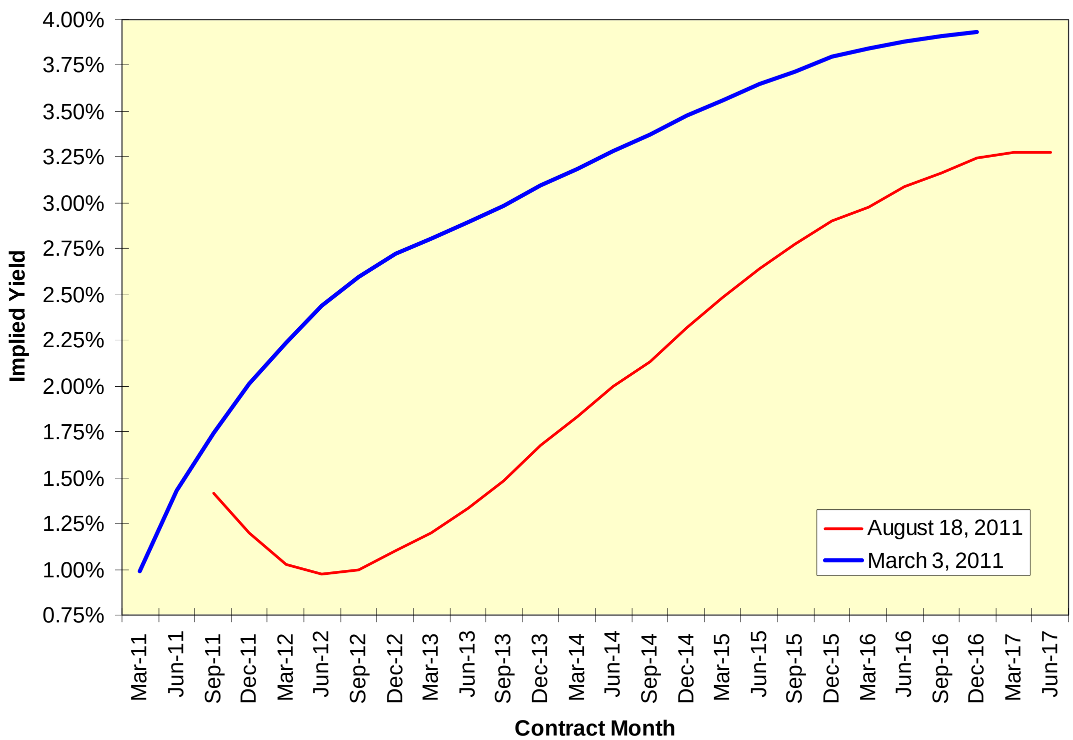
What Is The Greek Word For Hubris?

Every economist should learn the Iron Law of Forecasting sooner or later: Give them a number or give them a date, but never give them both. A corollary to this should be markets never should exhibit a path dependency in their forward rate structure. Please note how I said, “forward rate structure” and not “forecast” as markets do not forecast, they measure the marginal reservation prices for both buyers and sellers. The rest of this discussion can and will be left for a future day.

Much of the recent global financial distress has been linked to the problems of European commercial banks, which in turn are linked to the dismal credit quality of the sovereign issuers on whose bonds they gorged; I could make some reference to a Strasbourg goose, but that would be wrong. These sovereign debt problems do not appear to have an actual solution, although they have produced enough European summits replete with pictures of Nicolas Sarkozy and Angele Merkel posing together to last me for a few years.

But do not tell this to the Euribor market and its forward rate structure. As of last Thursday, the Euribor market had a definite path-dependency implying things are going to remain hot into the second quarter of 2012 and then they will, as if by magic, start moving back to normal. We can see this in the shape and shift of the forward curve since March 2011.

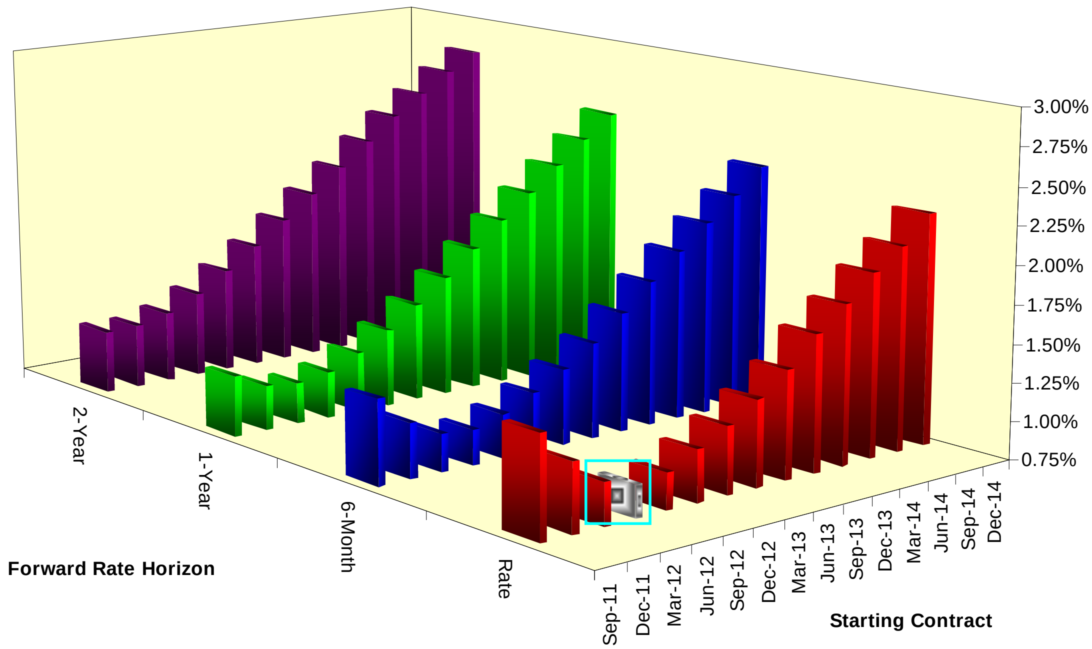
Euribor Curve Has Shifted Bullishly Since March



Yields shifted lower as the outlook darkened and investment horizons shortened, but that is not the significant part. Please note how the August forward curve is inverted for a few quarters, bottoms for the June 2012 contract covering fixed-rate Euribor for the July-September 2012 period, and then turns back to a normal, positively sloped yield curve.

If we extract the synthetic forward rates out of this yield curve, we see much the same pattern. The current rates are marked in red columns, forward rates for a six-month period following those contract months are marked in blue and the one- and two-year rates are marked in green and purple, respectively. We see the “kink” lower for all forward rates though one-year.

Euribor Synthetic Forward Rates: August 18, 2011



Now all of this path dependency may prove to be correct in hindsight some day, but it would be nice to know in advance why you, I or anyone else has reason to believe events will unfold in this manner. The Sarkozy-Merkel meeting concluded with a message not to expect Eurobonds issued by a multinational authority anytime soon, which leaves the European Central Bank without the ability to ramp up the printing presses the way the Federal Reserve, Bank of Japan or Swiss National Bank have, but considering the results of rampant money-printing, why should this be a source of regret? It also means the Eurozone's periphery will not be able to leverage off the core's balance sheet, for which Germans in particular must be grateful.

If countries where greater extraordinary measures have been tried have failed to end the nonstop banking crisis, why will it exceed in the more constrained Eurozone? The Greeks gave us a word for this: Hubris.