# Perma-Expectations No More

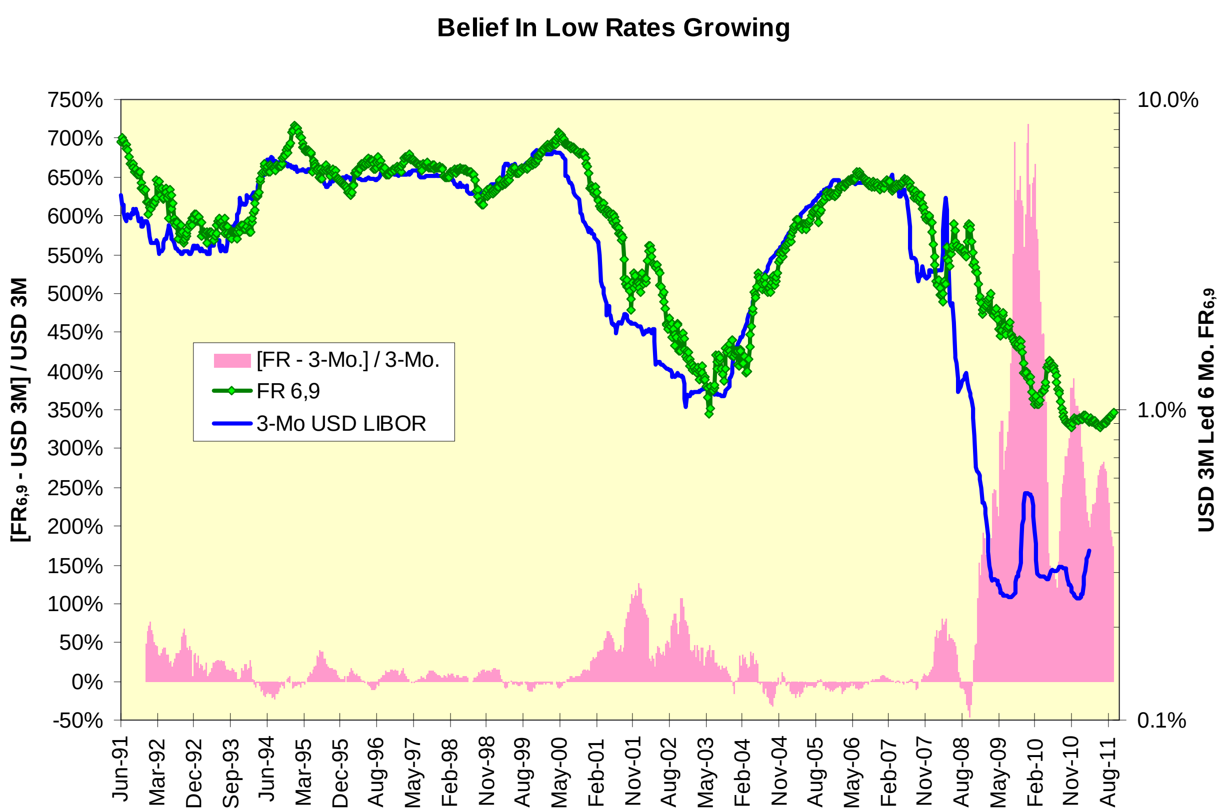
All of the recent news surrounding Steve Jobs' departure from Apple prompted me to remark, "He has a strange opportunity to read his own obituary." For the most part, he would have to be pleased at all of the genuine praise heaped on him.

This prompted me to wonder about what I would want on my tombstone other than, "He should've known better." One candidate could be, "He used the word 'swaption' on a popular Website and got away with it." I did; most recently in a discussion of the Federal Reserve's credibility to keep on doing the incredible, keeping interest rates near zero through 2013.

**Forward Rates When The Future Is Now**

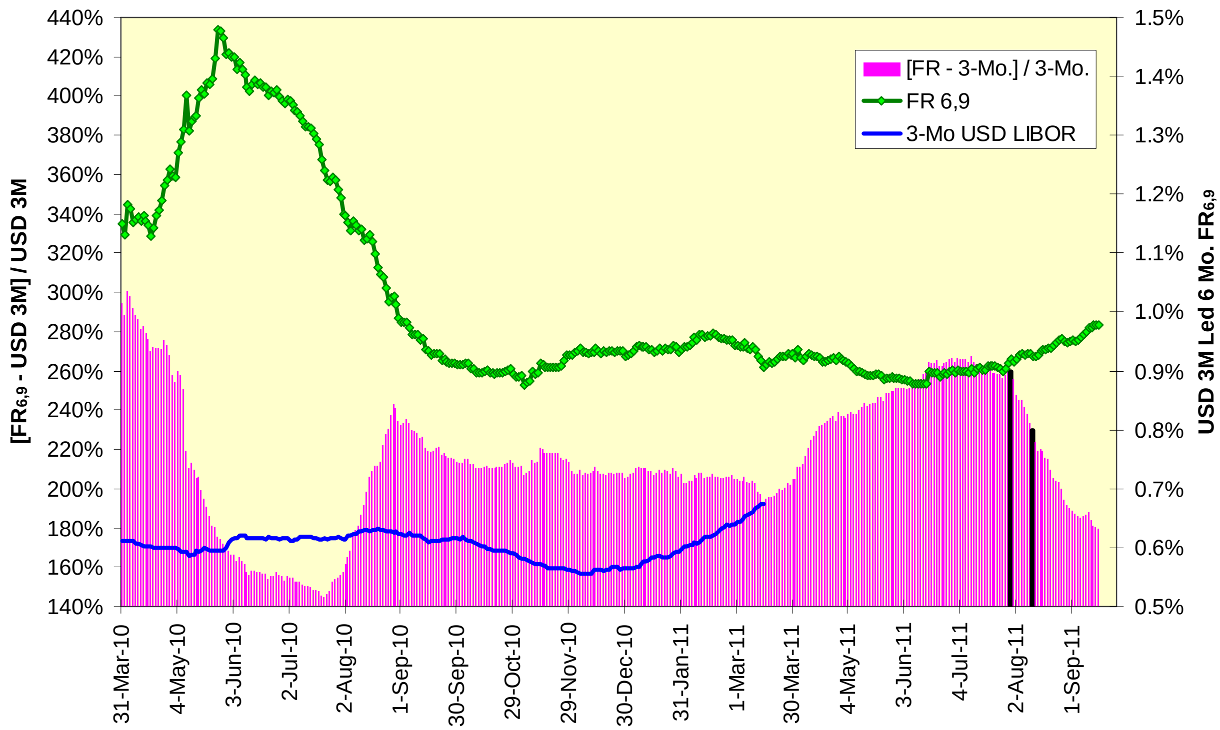
Can the swaption conclusion be confirmed by another indicator? Yes; let's return to a thread last updated in December 2010, on the relationship between the forward rates between six and nine months and the actual three-month rate as it arrives six months later. If the gap between expectation and reality is high, it means the market has been fooled again in its expectations low short-term interest rates must be headed in one direction, higher. The opposite has been observed in practice, too; markets can incorrectly price in expectations for low short-term rates and get whacked upside the head by reality.

Where are we today? The expectations gap, marked with roseate columns, is shrinking, although it is still at levels unprecedented until the adoption of zero interest rate policies (ZIRP) in December 2008. This is the same thing as saying forward rates are in the process of declining to levels that will be matched by actual three-month rates six months from now. If you are keeping track of these months by counting on your fingers, we see you.




The chart above uses weekly data. Let's go down to daily data for the period following the end of QE1. Two dates are marked, one when the debt ceiling debate in July was taking the ominous course toward default and one just after the August FOMC meeting. Both developments put the market on course toward accepting low rates were going to be here for awhile; the intractable federal debt can be serviced only at low levels without doing something really, really stupid like cutting out-of-control spending.

**Expectations For Low Rates Grew After Debt Ceiling Debate**




**Where To Now?**

Japan has had a much longer experience with these low rates and one attempt, between November 2005 and July 2006 to start moving away from them. One major difference between the U.S. and Japan here is their perma-expectations started to disappear in a rising short-term rate environment; our rates have yet to rise. Still, the Japanese attempt failed as the hint of higher interest rates caused yen carry trades to start unwinding around the world. Once low interest rates become embedded in an economy, they are very hard to increase without stress.

Despite the failures of QE1 and QE2 and the impending failure of whatever they announce next, the Federal Reserve has convinced itself they are doing something right. How would "They never learned from their mistakes" look on their tombstone?