Pay Attention To Rising Interbank Stress Levels

Nothing Ever Starts Out As A Big Loss, Does It?

Here is a true story out of a business where so many un-truths pass for the truth, the whole truth and nothing but the truth. I had to teach a special class on foreign exchange options to a group of equity option traders back in 1999. I scribbled the notation 'ln(Price/Strike) up on the board in a manner of passing whereupon one rather large fellow started to squirm. Always quick to read students, I asked him if he had a question. He asked what the 'ln' stood for, to which I replied, "The logarithm." He said, looking around the room for support, he had not encountered a logarithm since high school, did not remember exactly what it was and why was it important, anyway?

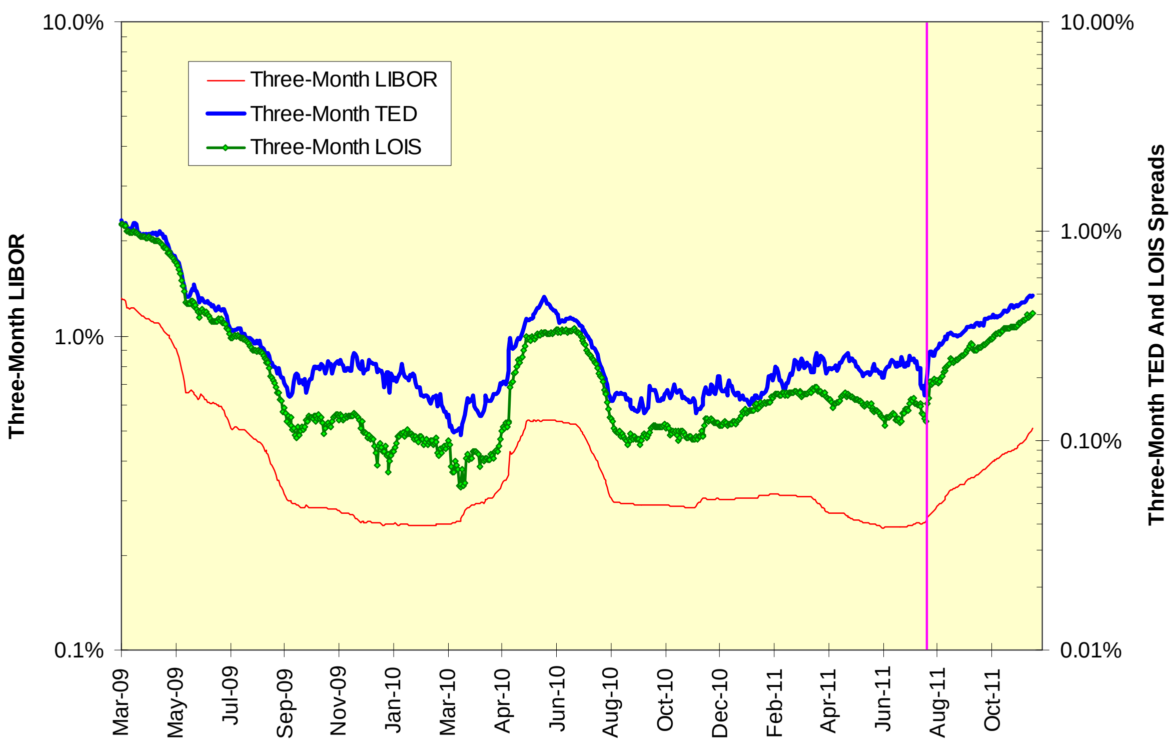
The moral of the story is simple: Just because traders use something every day does not mean they understand it.

Exponential Stress

While we are on the subject of logarithmic scales are the like, let's take a look at LIBOR and two spreads based thereon, the TED spread between LIBOR and Treasury bills and the LOIS spread between LIBOR and a strip of federal funds. These spreads were discussed in the context of Treasury default risk in August's Is TED Spread Being Distorted By LIBOR?

Right now, LIBOR and these two associated spreads are rising in a linear manner on a logarithmic scale, which my long-ago options traders could have told me was equivalent to saying they are rising exponentially…and have been doing so since the start of August, marked on the chart with a vertical line.

Three-Month TED And LOIS Spreads Rising Exponentially



On one level, it is easy to say, "So what? Three-month LIBOR is just over 50 basis points, and these spreads are not much greater, 49 bp for the TED and 40 bp for LOIS." That is true, but I rejoin, "The time to nip a problem is when it is small. If you wait for the interbank market to lock up completely, for LIBOR to surge and for these spreads to look like they did in October 2008, it will be too late."

And indeed it will be too late. Remember that alphabet soup of facilities the Federal Reserve created then to restart the flow of funds into the commercial paper market, into the term repo market and the like? Those were not created because the stock market was being beaten like a rented mule, they were created to avoid the shutdown of the entire banking system as we have come to know and hate it. Those facilities broke the fever of the credit crunch by mid-December, but only at the cost of going to 0% interest rates three years ago and to QE1 in March 2009. Those moves have been notably ineffectual in restarting real economic growth; I can say this with complete confidence as we had to go to QE2 in 2010 and are discussing QE3.

Pay attention to these short-term interest rates. They are easy to ignore but cause immense damage when they go haywire. Exponential growth rates lead to some very big numbers after a short period of time.