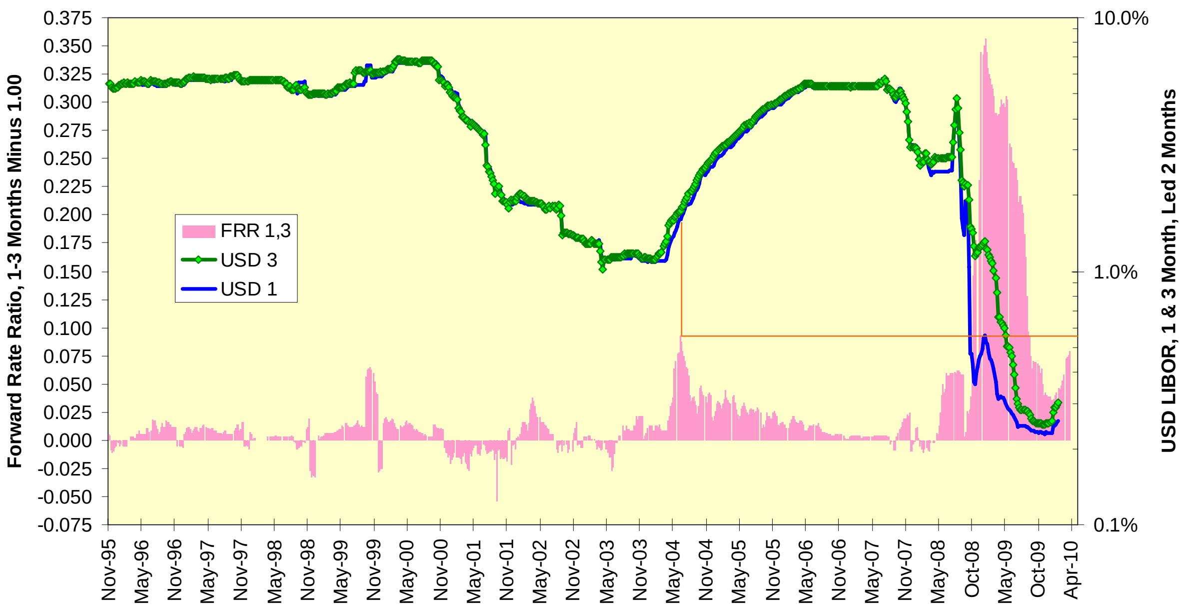
Short Rates And The New Abnormal

We noted yesterday how the yield curve was being steepened artificially by suppressing short-term interest rates. One day those rates shall rise like a bubble in the bathtub of life, but in our world of short-term thinking by long-term investors in mid-cap stocks, that will be then; this is now.

Can we confirm the assertion short-term interest rates are artificially low (Really; would I pose this rhetorical question if the answer was, "No")? Let's shift the framework to one- and three-month Japanese yen and U.S. dollar LIBOR and to the forward rate structure in each of those markets. We will use the forward rate ratio (FRR) between one and three months; this is the rate at which we can borrow money for two months starting one month from now, divided by the three-month rate itself. The more this $FRR_{1,3}$ exceeds 1.00, the steeper the yield curve is; we will subtract 1.00 from it in the charts below.

The Bernanke era has been characterized by an absolutely astonishing jump in the $FRR_{1,3}$ since mid-2008; the previous peak in June 2004 is highlighted by an orange corner-angle. It does not take a particularly keen eye to note how the jump in the $FRR_{1,3}$ was driven by a relative collapse of one-month LIBOR.

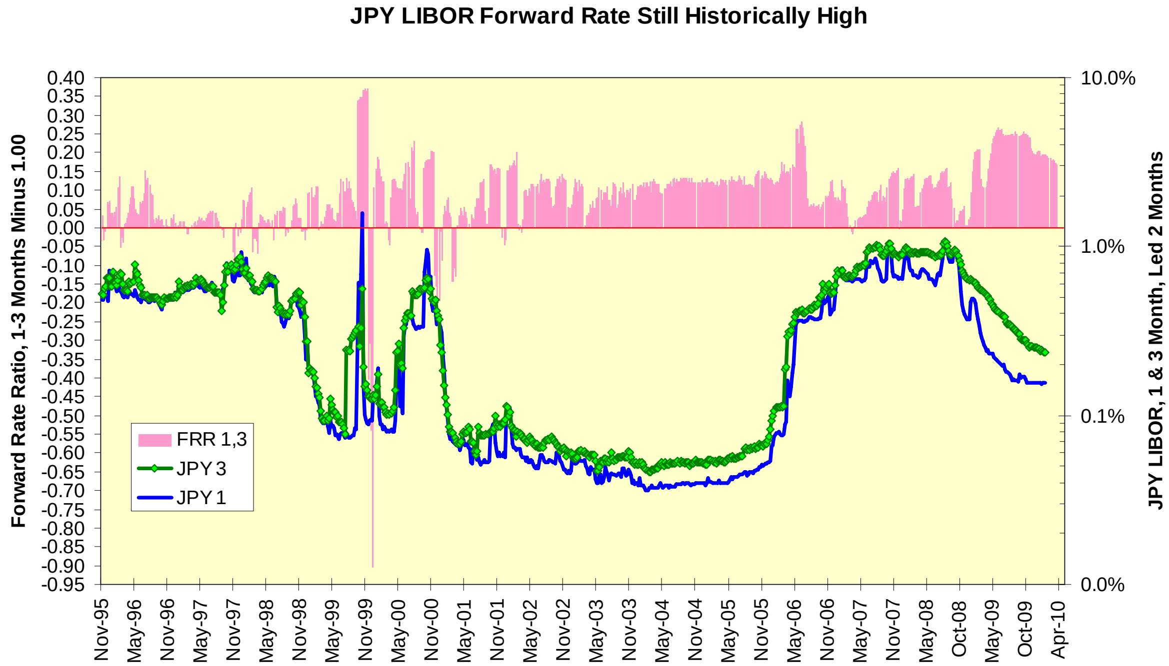
USD LIBOR Forward Rate Structure No Longer Renormalizing



But now take a look at where the $FRR_{1,3}$ peaked; it was in January 2009, one month after the target federal funds rate was pushed below 25 basis points and while the U.S. was still reeling from a financial crisis and an ongoing sharp recession. The $FRR_{1,3}$ then fell throughout 2009 only to re-steepen starting in January 2010. Here the re-steepening is not the result of one-month LIBOR falling, but rather is the result of three-month LIBOR rising more quickly. Restated, the market wants rates to go higher, but someone is putting their thumb on the scale and yelling, "Look! Deflation! Over there!"

Japanese Analog

Japan has a much longer experience with near-zero interest rates, quantitative easing and other assorted monkeyshines. Their $FRR_{1,3}$ has been steep for a long time, but it never reached the excesses seen here in the U.S. Note how their $FRR_{1,3}$ is flattening bullishly by three-month LIBOR declining; this is a market-driven move; we can infer this by virtue of the one-month rate's stability. If the Bank of Japan was forcing rates lower artificially, we would see the one-month rate declining as well.



The argument the U.S. needs to maintain ultra-low interest rates to forestall deflation is not a convincing one; Japan has had deflationary pressures for as long as it has been pouring money on the floor. If all it took to end deflationary pressure was monetary incontinence, Japan would have seen results by now. After all, they went to zero percent in February 1999, and I am not aware of any economic indicator that works with more than an eleven-year lag.

Several Federal Reserve chairmen have claimed you cannot see a bubble forming while it is forming. Let's see what they say after the one forming now bursts. Marx' observation history repeats itself, the first time as tragedy and the second time as farce is going to be put to the test of a three-peat. Whether you want it to or not.