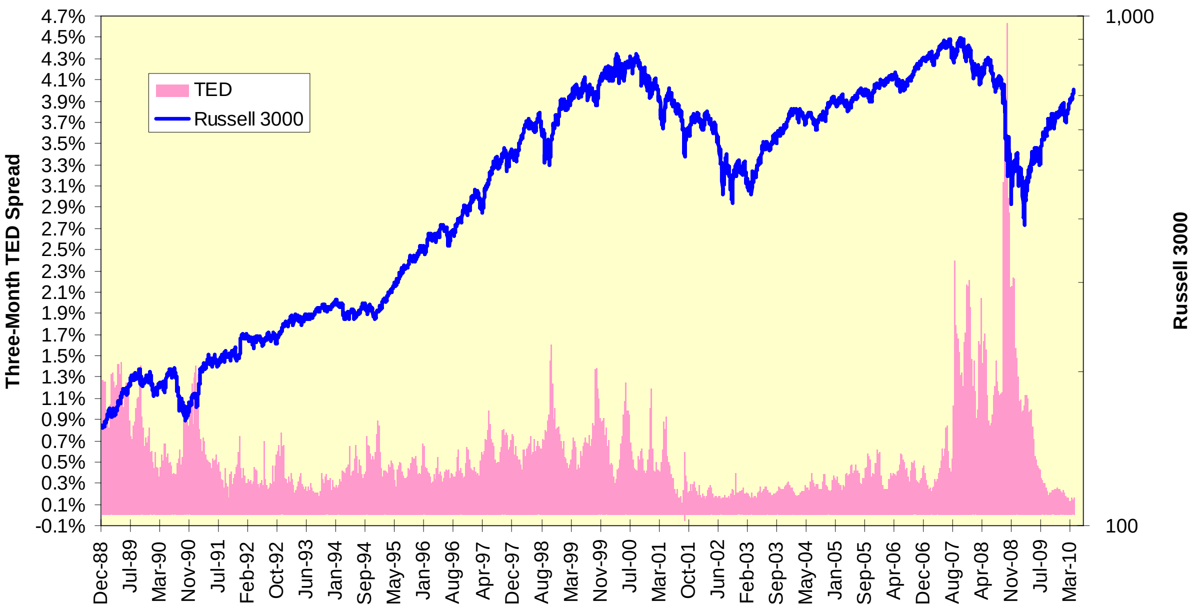
No Dread In TED Spread

Prior to the credit crisis starting in late 2007, only veterans of the 1980s could remember what the TED spread, or the yield difference between three-month Eurodollars (the ED, not to be confused with anything involving a pair of bathtubs parked out by the edge of the Grand Canyon) and three-month Treasury bills (the T) signified.

The answer on most days over the past three decades has been, "Nothing." The TED spread only matters as a risk barometer during times of enormous stress in the banking system as Eurodollar certificates of deposit are dollars held outside of the United States are therefore carry no regulatory protections or deposit insurance (just an open-ended checkbook from you, the taxpayer).

It is only when the health of the commercial banking system is threatened and banks have to start liquidating their leveraged assets in a falling market to raise cash do we see the TED spread spike higher. Each such occurrence has coincided, and not coincidentally, with a downturn in stocks.

Did The TED Spread Matter For U.S. Equities?

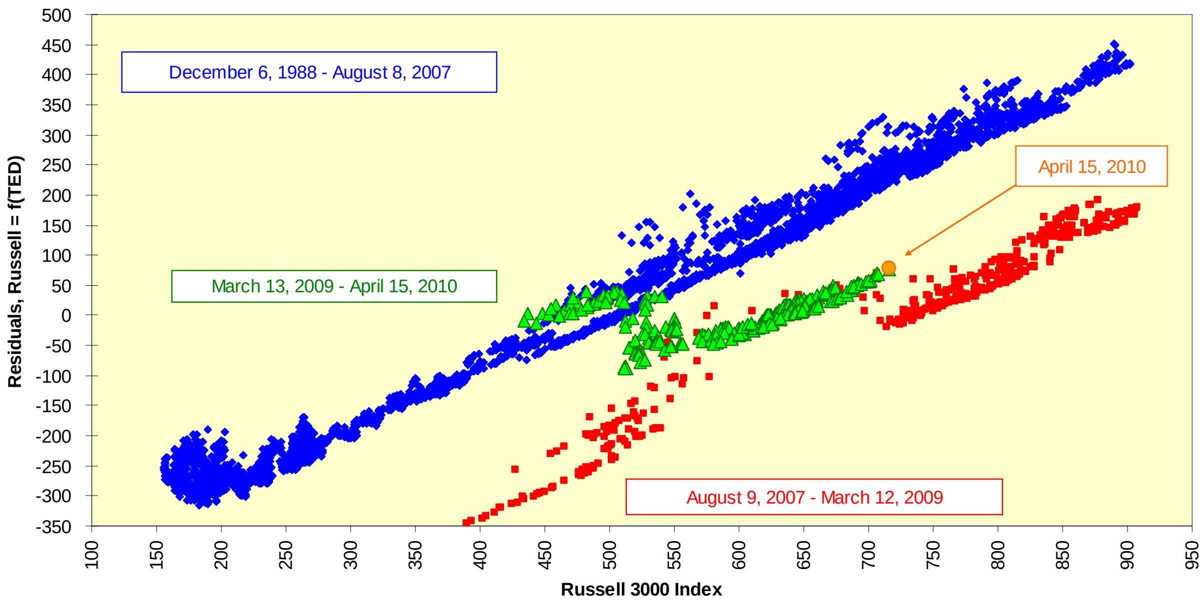


The credit crunch peaked in October 2008 with a TED spread of 464 basis points on October 10. It had to be forced lower by the creation of various extraordinary facilities on both sides of the Atlantic; this was a little more difficult to do than driving domestic short-term rates lower as the Euromarkets were created by intrepid free-market bankers seeking to escape government regulation. Their extraterritorial status made changing their diapers tougher than it would have been otherwise.

Artificially Low

The two previous articles this week on the liquidity premium and the short-term LIBOR curve both concluded short-term interest rates are way too low. The relationship between the TED spread and U.S. equities affirms this conclusion. We can regress the Russell 3000 against the TED spread over three different periods and map the residuals, or unexplained portion, against the Russell 3000 itself. The first period, marked in blue, extends from December 1988 to August 2007, when the European Central Bank backstopped BNP-Paribas. The second period, marked in red, goes to the March 2009 date when LIBOR rates started to decline. The third period, marked in green, goes until the present, with the last datum highlighted in orange.

U.S. Stocks Remain Undervalued Relative To TED Spread



Please note how the green markers start to shift down in the 500-550 price band for the Russell 3000; this corresponded to the late May-mid July 2009 period last year when the Russell 3000 stalled while the TED spread continued lower. Once the market became convinced the Federal Reserve would not raise rates anytime soon or even anytime later, the July-October 2009 rally began, followed by this year's rally from February onwards.

In all cases, however, the Russell 3000 did not move as high as we could have expected by the TED spread moving that low. Incredibly, the U.S. stock market is undervalued relative to the TED spread unless – and here is the big "unless" – the stock market recognizes the TED spread is just too low and will renormalize eventually.

Abraham Lincoln observed you can deceive all the people part of the time and part of the people all of the time, but not all the people all the time. Even the local misanthrope must agree. This wisdom has not been received yet by the Federal Reserve.