TED Spread And Fair Value

Interbank Stress Is Out Of The Picture For Now

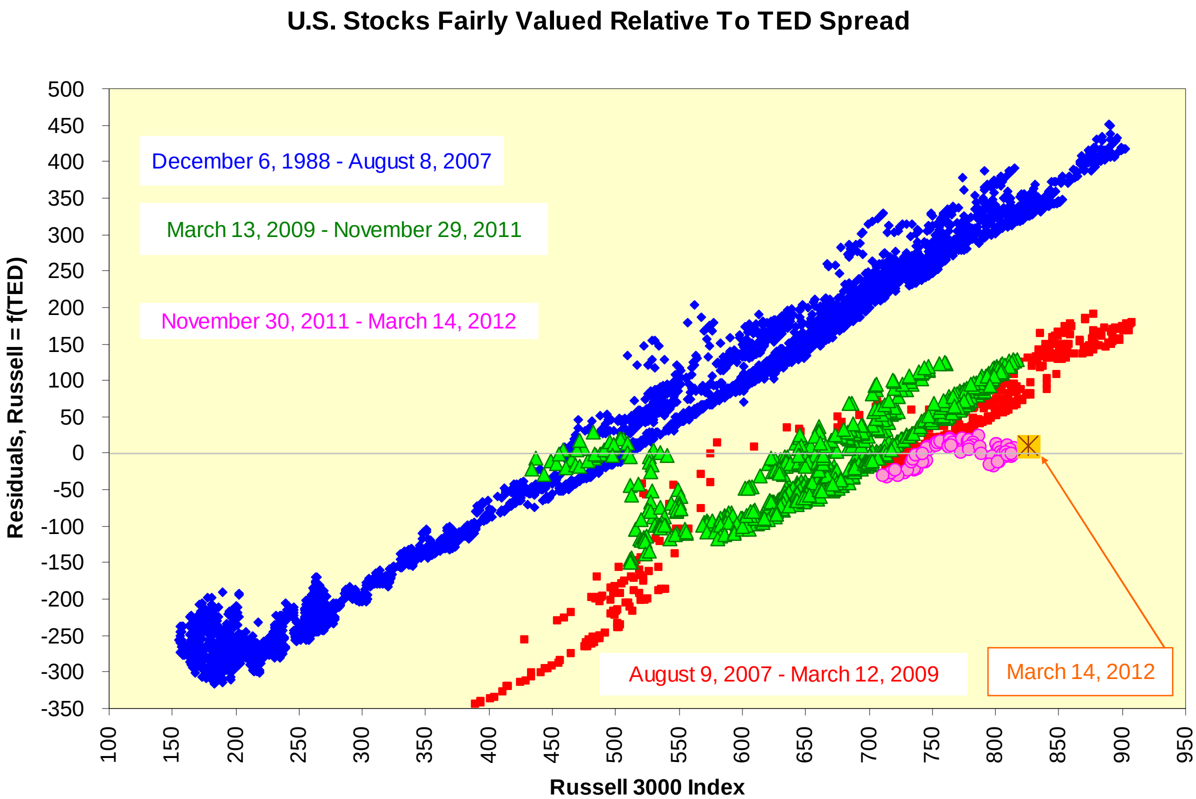
In case you were wondering, this is not only a great country, it is a great world. Who knew a story letting all and sundry know you had best pay attention when dealing with your investment banker (think GS) could garner so much attention? We have been dealing with a similar international story involving the behavior of major international banks (think BAC, C, JPM) and their reporting of LIBOR to the British Bankers Association for more than three years. A few wags have come to calling the key interbank interest rate Lie-BOR. Now that is comedy.

Back on our side of the pond, we have the Treasury bill market, which has been knocked so off course in the past year by various default scares, flights-to-quality, flights-from-quality, quality-time-in-flight (if you know what I mean and I think you do) that we have seen negative T-bill rates. Yes, you can pay Uncle Sam for the privilege of lending to him; may I have another, sir?

TED Spread

When you subtract the artificial T-bill rate from the made-up LIBOR number you get the TED spread, often used as a measure of interbank stress even though no one who lived through 2008 will ever allow a major bank to push up daisies on their watch. Let's revisit and update an analysis from April 2010's No Dread in TED Spread.

I divide the December 1988-onwards sample up into periods based on the degree of central bank interference; the first demarcation occurred in August 2007 with the European Central Bank's backstopping of BNP-Paribas (BNPQY). Others then go to QE1, from QE1 to last November's expansion of currency swap lines by central banks, and the period thereafter. These are attractively color-coded in the chart below.



What do the markers depict? These are the regression residuals of the simple model Russell 3000 = f(TED). What you see in the last period, marked with magenta, is a sideways-slide around zero. This indicates the Russell 3000 (IWV) is fairly valued given the current TED spread. Not over-valued; not under-valued, but rather almost exactly fairly valued.

But here is the bullish news: The current TED spread is still higher than it was in August 2011, a period when various European commercial banks looked as if they were going to choke on sovereign debt. Twenty-four years of data indicates a lower TED spread is conducive to higher stock prices.