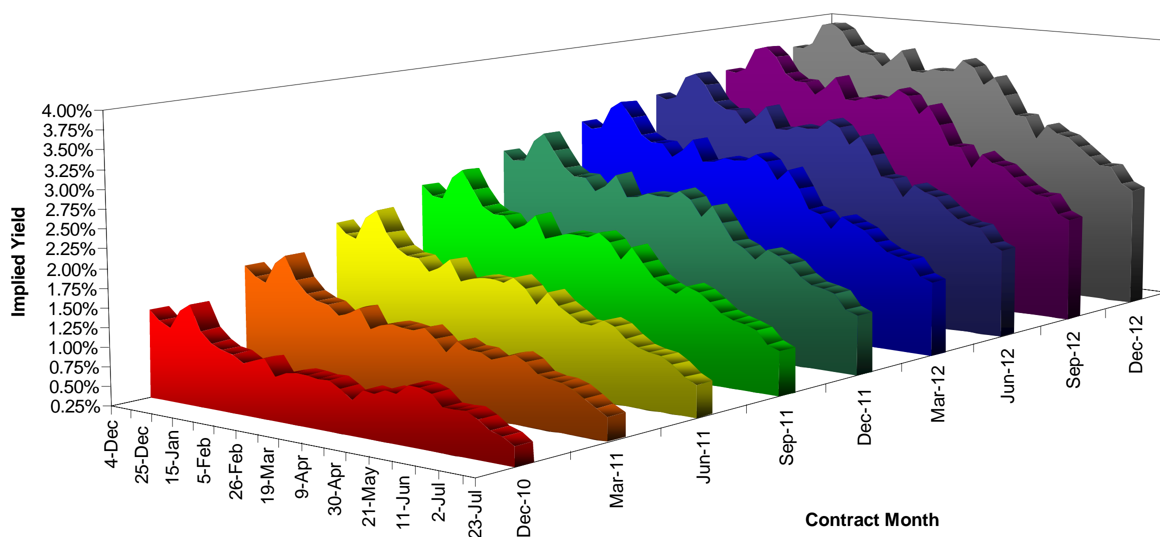
Low, But Not Low Enough

The late Jacqueline Susann published a potboiler in 1973 entitled "Once Is Not Enough." I am not sure whether I agree with the title, as the issue whether once can be enough is, as the management consultants might say, context-sensitive, but she wrote a best seller and I have yet to do so.

All of this raises the question whether our very low short-term interest rates are in fact low enough. At first, this may sound like an absurdity given everyone's inability to earn any sort of return on cash, two-year note yields heading towards the fixed-income version of the Mendoza Line (50 basis points) and a virtual pledge by the Federal Reserve to keep on doing more of the same that has yet to work.

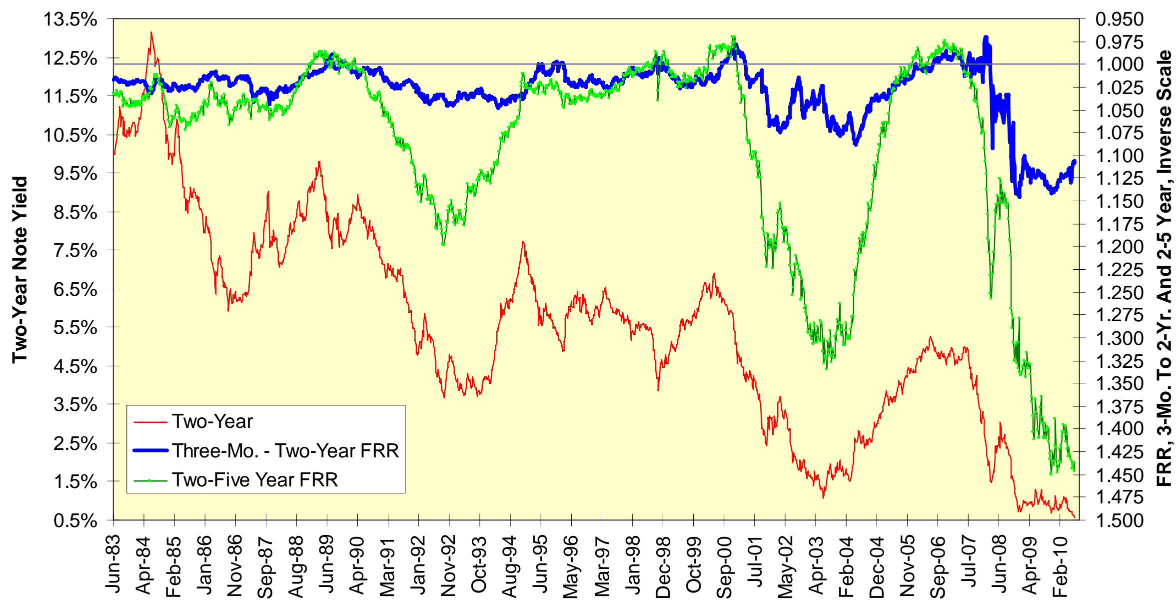
But absurd it is not. First, there is a general sense the recent downturn in short-term rates is something new, or at least something that began only after May's European sovereign debt crisis. In reality, the forward curve of Eurodollar futures, which are based on 90-day LIBOR, has been steepening bullishly since my Thanksgiving was disrupted rudely by news of out Dubai that maybe a 250-story building in the desert was not such a good idea after all. Contracts out to December 2012 have been trending lower, with the shorter-term contracts diving the most.

Implied Eurodollar Yields Since November 2009



What is even more amazing is the TED spread, the difference between Eurodollar and Treasury bill rates discussed here in April, has been expanding. LIBOR is falling, but it has not fallen faster than have Treasury-bill rates.

Next, let's take a look at the two-year Treasury note yield and its place on the yield curve in two directions. While the forward rate ratio between two and five years, the rate at which we can lock in borrowing for three years starting two years from now, divided by the five-year rate itself, has expanded (plotted inversely as the green line), the forward rate ratio between three months and two years has flattened bullishly all through 2010. The short-term yield curve is pancaking lower.



Why is this so important? Banks ultimately depend on a yield curve spread as they fund themselves with shorter-term paper than they either lend or are supposed to lend. If the yield curve flattens, their margin between borrowing short and lending long narrows and this will force them to take on lower-quality activities. We know where that leads.

The upshot, then, is the Federal Reserve is going to have to find some way of lowering the cost of funds at the low end of the yield curve. Possibilities include another round of quantitative easing – as if that is politically palatable – or elimination of interest payments on excess reserves to encourage banks to lend to someone other than the Federal Reserve or Treasury or even negative interest rates. That last move would involve a penalty on savings accounts or other short-term instruments.

The risks of all this include these excess dollars being borrowed abroad in carry trades or a wholesale jump in long-term Treasury rates if global creditors fear complete dollar debasement. Beneficiaries of such actions would more likely be located outside of the U.S. This has been the Japanese experience. They went to near-zero interest rates in February 1999 and have found over the years too low is not low enough.