Look Out, Here Comes Tomorrow

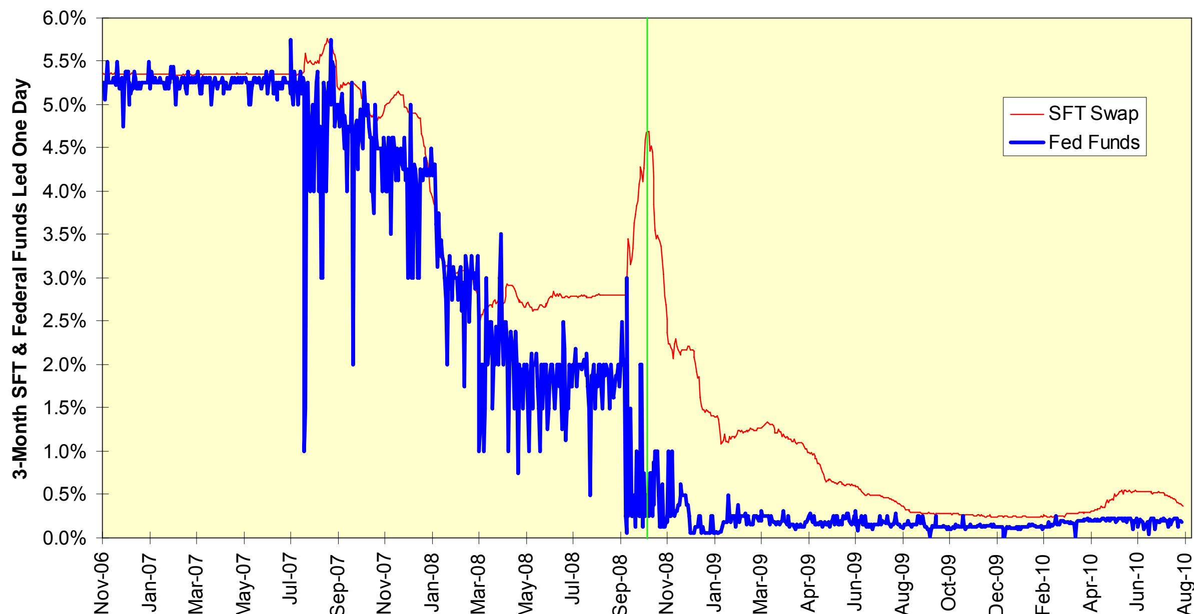
"Look out, here comes tomorrow / That's when I'll have to choose
How I wish I cold borrow / someone else's shoes" -- Neil Diamond

The world of finance is replete with inside baseball markets, the sorts of things no one notices until they go wrong. Commercial paper went on for years like this; no one paid it any attention until money market funds started disappearing.

Another such market has to be an ancillary to the gigantic interbank market from which LIBOR, currency trades, the bases for many mortgages and corporate floating-rate bonds are derived. There is a little doo-hickey called the set-for-tomorrow (SFT) swap. As the name implies, it allows a buyer to fix tomorrow's LIBOR rate today. This may not sound like a big deal, but once you start bouncing tens of billions of dollars around every day you will see how small differences can accumulate.

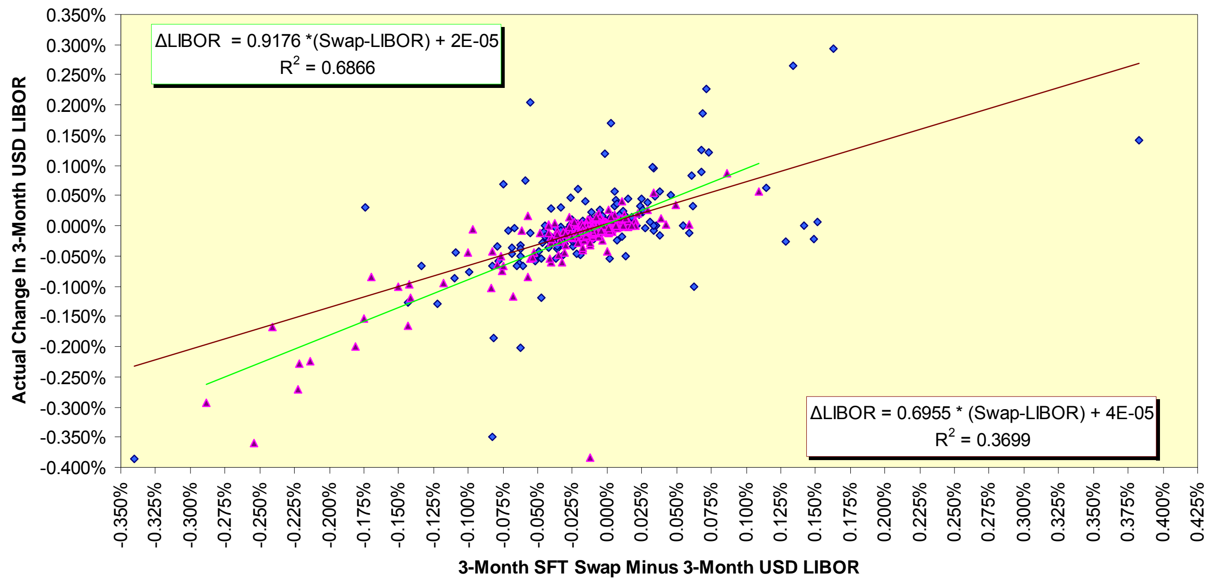
Like pretty much everything else, this market blew up in the crisis of 2008. The Federal Reserve began paying interest on excess reserves held there by its member banks in an effort to better target the effective federal funds rate; this is marked with a green line on the chart below. Along with a number of extraordinary facilities the Federal Reserve and sister central banks created, both LIBOR and the SFT swap fell and converged downwards to the federal funds rate. For most of 2009, the SFT swap was an excellent predictor of where both LIBOR and its domestic cousin, the effective federal funds rate, would be trading tomorrow.

Expected 3-Month LIBOR And Effective Federal Funds In Interest-On-Deposits Era



This was an unalloyed good for most of 2009 and the first quarter of 2010; indeed, the predictability of short-term funding is why firms such as Goldman Sachs, J.P. Morgan Chase and Morgan Stanley were racking up perfect trading quarters as if was taking candy from a baby.

However, all good things come to an end. The interbank stress associated with the sovereign credit crisis in Europe knocked the SFT market off track; the r^2, or percentage of variance explained, of the SFT swap for next-day federal funds fell from more than 84% to just under 69%.



Once again, it may not sound like much and it is a market largely invisible to the public, but a declining inability for participants in the interbank market to price and hedge their next-day cost of funds can wreak havoc on traders trying to dance between raindrops in our high-frequency world. The lower the interest rates, the greater the percentage each missed basis point is for a trade.

How bad is it? Goldman Sachs actually lost money trading on a couple of days last quarter. I could do that, and no one has prepended “fabulous” to my name or keel-hauled me in front of Congress to explain why I am so evil.

If we start raising uncertainty at the very shortest end of the markets, it will have amplified costs at the longer end of all fixed-income and currency markets. Tomorrow is to be greeted, not to feared.