No Second Thoughts In Eurodollars

In late January 2009, I penned (OK, actually I typed) a column entitled, "Recovery Signals In Eurodollars." I concluded in part:

> *If implied yields are reflecting credit demands, then the low point in credit demand should be occurring somewhere in the six months between April and September.*

While the National Bureau of Economic Research has not yet determined a date when the recession starting in December 2007 ended, it seems likely a determination will be made sometime in 2010 the recession ended sometime in the second half of 2009. The NBER is deliberate in its proceedings, and if a double-dip forms sometime before a declaration is made, they will classify the W-shaped affair as a single recession.

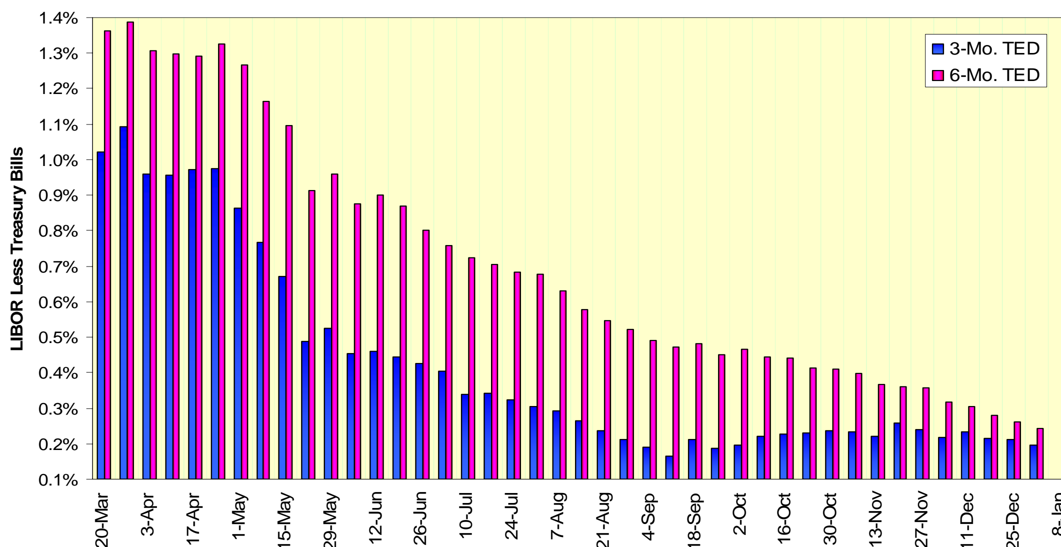
The Eurodollar market, which is based on 90-day strips of dollar deposits held outside of the U.S. and which forms the basis for the pricing and hedging of the interest rate swap and forward rate agreement markets, has an immediate and market-derived assessment of where short-term interest rates and by extension credit demands will be. The outlook is anything but equivocal: Just as last year we could conclude the market was pointing toward a bottom somewhere in the mid-year timeframe, this year we can conclude the recovery is underway and the Federal Reserve is both woefully behind the curve and willfully keeping short-term rates too low.

Let's update the analytic framework from last year as closely as possible to facilitate comparison. Three dates unavailable from last year will show up this year on a weekly basis. The first is March 20, 2009, the Friday following the announcement of quantitative easing. The second is June 5, 2009, the local maximum in short-term rates. The third is November 20, 2009, the local minimum in short-term rates.

TED Spreads

The spread between Eurodollar yields and Treasury bills, or TED spread, is a barometer of credit risk; Eurodollars bear the credit risk of banks with implicit too-big-to-fail guarantees while Treasury bills are backed by the full faith and credit of a Xerox machine. See the difference?

The three-month TED spread moved down continuously from March until it hit a low during the week of September 11, 2009. The six-month TED spread is declining still. There is no way to interpret this decline in perceived risk of the international banking system negatively.

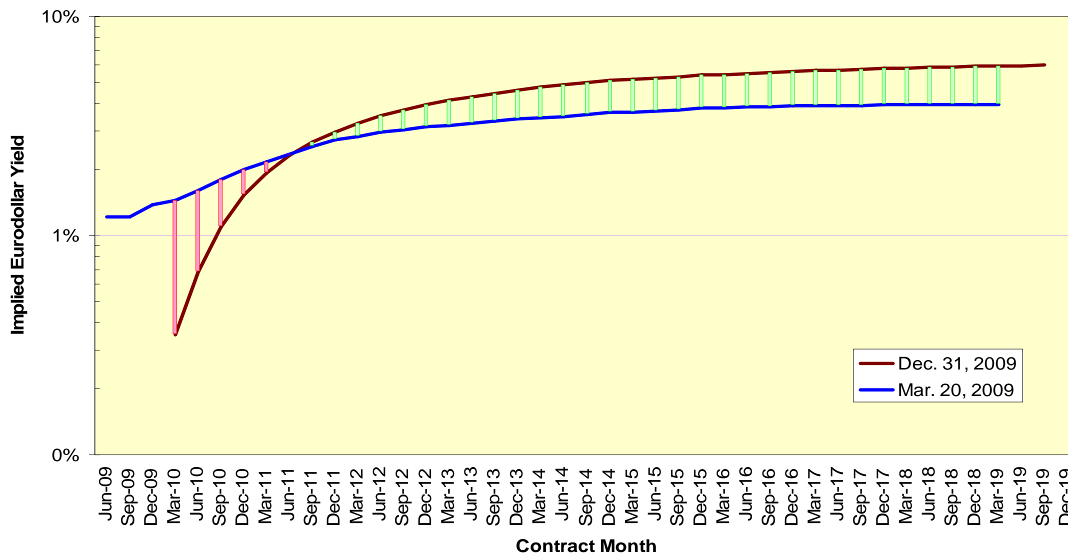


Steep Beyond Reason

Now let's compare the forward curves of the Eurodollar futures market between March 20, 2009 and the end of the year. What you see below is why I can say things such as "artificially low" without a second thought. Even though the economy has pulled back from the abyss, the yields on contracts through March 2011, another five quarters, are

lower than they were in March. The yields on all subsequent contracts all are substantially higher than they were in March.

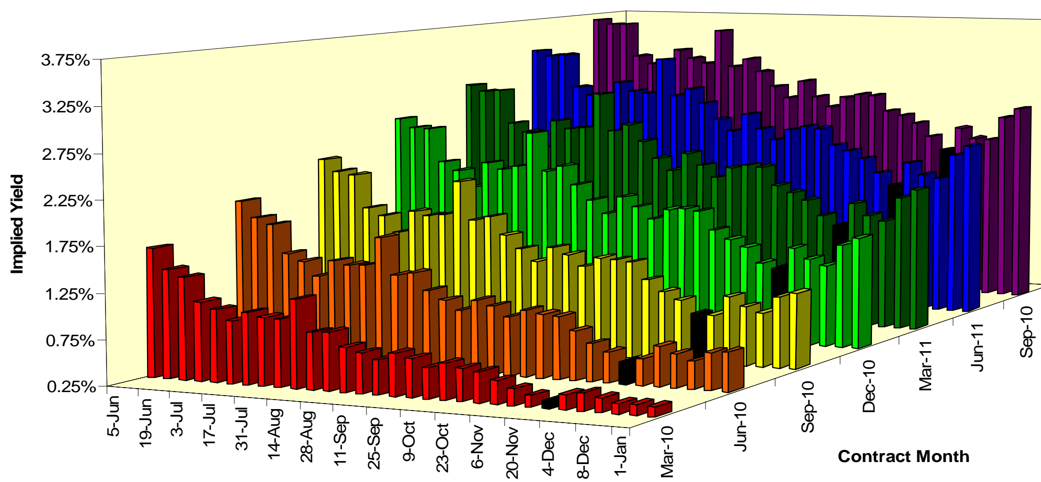
Eurodollar Curve Steepened In Both Directions After March 20, 2009



A yield curve can steepen in one of two ways, lower short-term or higher long-term rates. This yield curve has done both. As decisions on output and employment are made not at the money market horizon but rather at the capital market horizon, this single picture tells us why the Federal Reserve's money flood has been ineffective at ending the recession on Main Street even as it has enriched Wall Street.

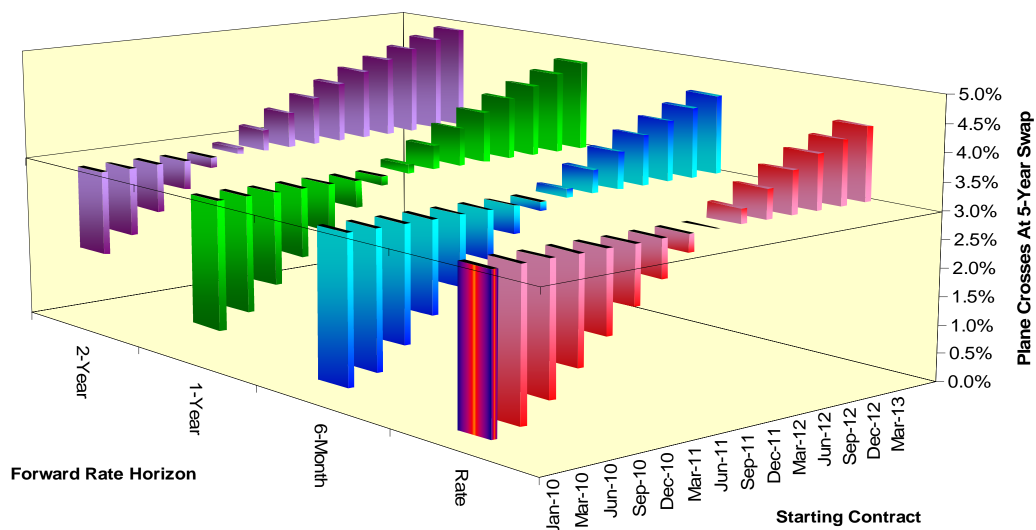
There are signs, however, the market is pulling away from the Federal Reserve's senselessness. If we map the yields on the individual contracts from the June 5, 2009 local maximum through year-end and mark the nadir with a black column, we can see how short-term rates have risen since the week before Thanksgiving…and the week before credit troubles began in Dubai, etc. Please recall how Treasury bills rates were trading at or even below 0% during this window. Yields now are in the process of renormalizing; the aberration is 0% money for Uncle Sam when the economy was either improving or certainly not getting any worse.

Implied Eurodollar Yields Since June 5, 2009 Peak



Forward, March!

Now let's return to the forward rate structure. The map below displays the current implied yields for a series of Eurodollar contracts and then the forward rates starting at the six-month, one-year and two-year horizons. The data point marked with the vertical stripe can be verbalized as "the rate at which you can lock in borrowing for six months starting with a 70-day cash market loan."



The forward rates are arranged over and under the five-year swap rate of 2.9837%. Six-month forward rate agreements exceed the current five-year swap rate beginning with the expiration of the December 2011 contract; comparable points for one- and two-year FRAs are September 2011 and March 2012, respectively. Once again, unless a business believes it can operate continuously by rolling over short-term money (ask the Bear Stearns alumni organization about this strategy), the current forward rate structure is telling them to lock in borrowing costs now before they rise further.

Of course, if you believe my maxim a credible forecast of interest rates is inherently self-defeating as market participants will accelerate borrowing and defer lending and thus capitalize the interest rate forecast immediately, you will say all of this is an interest rate scare. To which I will respond: It is a scare only if rates rise insufficiently to derail the recovery likely under way. As rates tend to move to the point where they change behavior, we could be in for one mighty convincing rate scare.