

## Recovery Signals In Eurodollars

According to the [Census Bureau](#), the population of the U.S. is approaching 306 million, 305 million of whom have called a bottom in the stock market sometime in the past sixteen months and another million of whom are regarded with fear and loathing.

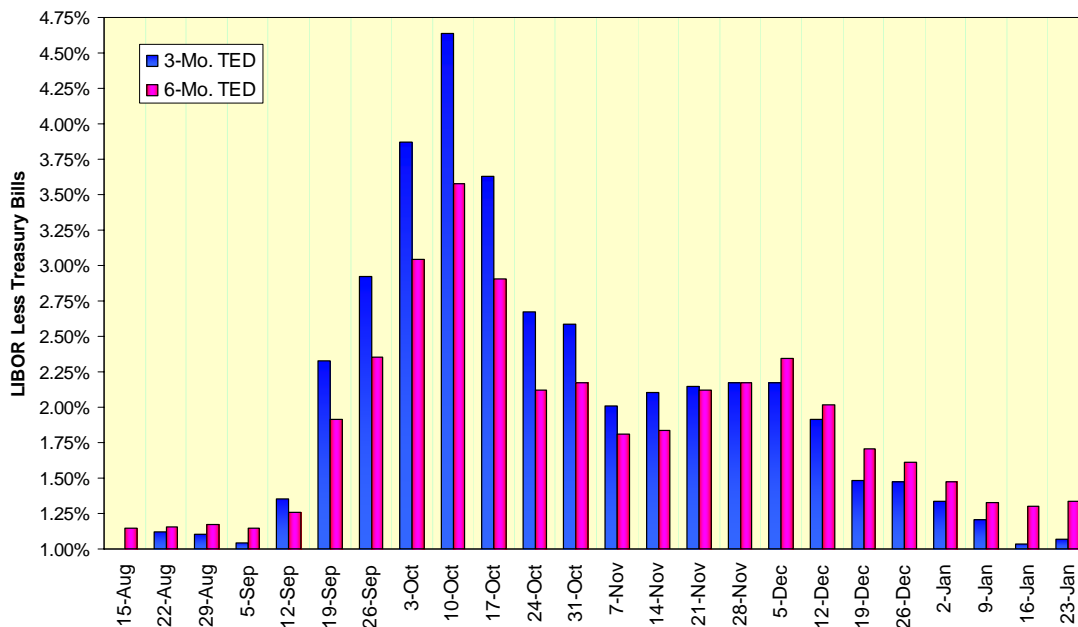
One of the serial bottom-callers' fondest hopes was once short-term interest rates fell from the crisis levels reached in October 2008, everything would return to normal. This ignored the persistence of the interbank market's dysfunctional behavior starting in August 2007 and the shift noted here in [June 2008](#) by traders from LIBOR to the U.S.-centric overnight index swap (OIS) rate. The thought process was a narrower TED (Treasury – Eurodollar) spread between LIBOR and U.S. Treasury rates would signal an easing of the credit crisis and a concomitant restarting of economic activity.

The combination of declining TED spreads, lower short-term interest rates and quantitative easing has done nothing so far to revive economic activity. That is credit supply; economic activity is reflected more closely by credit demand. Let's look at the TED spread and the forward rate structure of the LIBOR-based Eurodollar futures market to see whether they themselves are pricing in stronger credit demands in the foreseeable future.

### TED Over Time

First, let's not diminish the extreme dislocation in the credit markets during the September-October phase of the crisis. The six-month and especially the three-month TED spreads shot higher and reached their peaks on October 10, 2008, a date which marked a local bottom in the bear market. The three-month TED has since returned to late-August levels, but the high on the Russell 3000 broad-based index last Friday was lower than the low of October 10<sup>th</sup>.

Three- And Six-Month TED Spreads' Long, Strange Trip



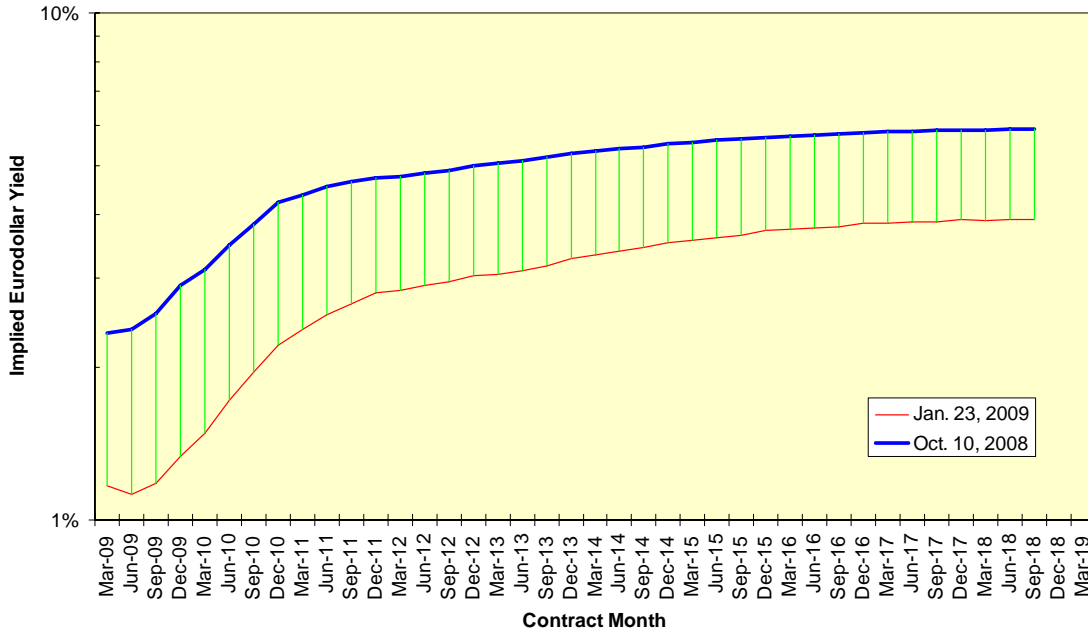
At best we can hope that what was a coincident indicator on the way lower morphs magically into a leading indicator on the way higher. But do not hope too strongly, please. The last sustained drop in the TED spread occurred between October 1999 and August 2001. The total return on the Russell 3000 over this period was -6.24%. Then the bear market got worse over the next fourteen months.

### Steeper And Lower

The lower TED spreads reflect the enormous drop in short-term interest rates since October. If we map the shift in implied yield for a series of quarterly Eurodollar futures contracts since that time on a logarithmic scale, we can see

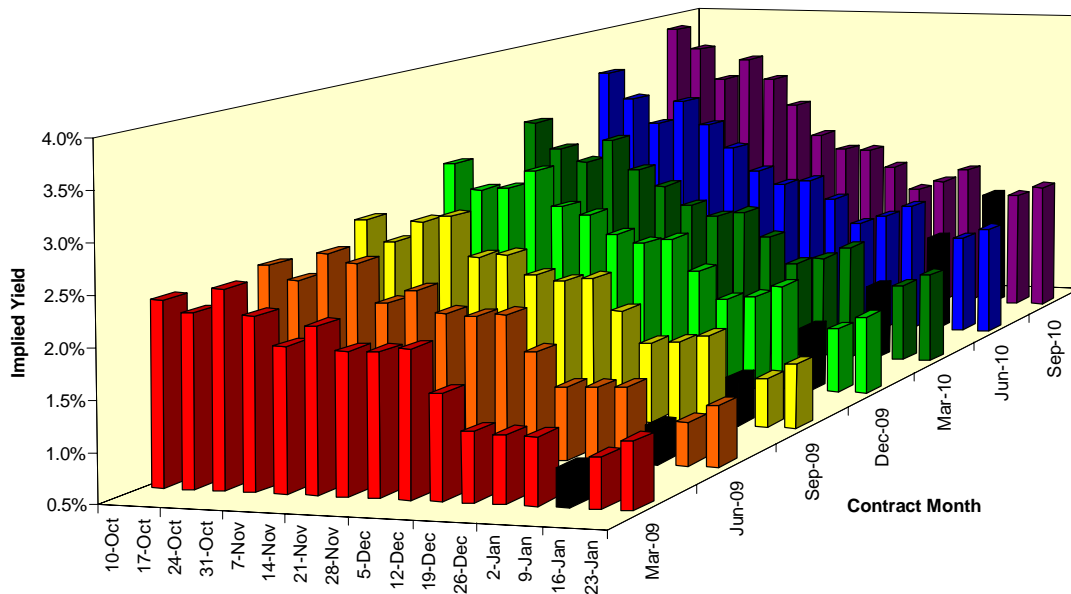
how the larger percentage declines in yield occurred in the March, June and September 2009 contracts. The declines in implied yield for later contract months were parallel.

**Eurodollar Curve Shifted Downward And Steepened After October 10, 2008**



This suggests a fairly continuous drive by LIBOR toward zero and an impending face-plant on the sidewalk by the economy. But as any avuncular bartender will tell you, looks can be deceiving. If we rearrange the data to display each contract's implied yield over time and highlight the low-yield point in black, another picture emerges.

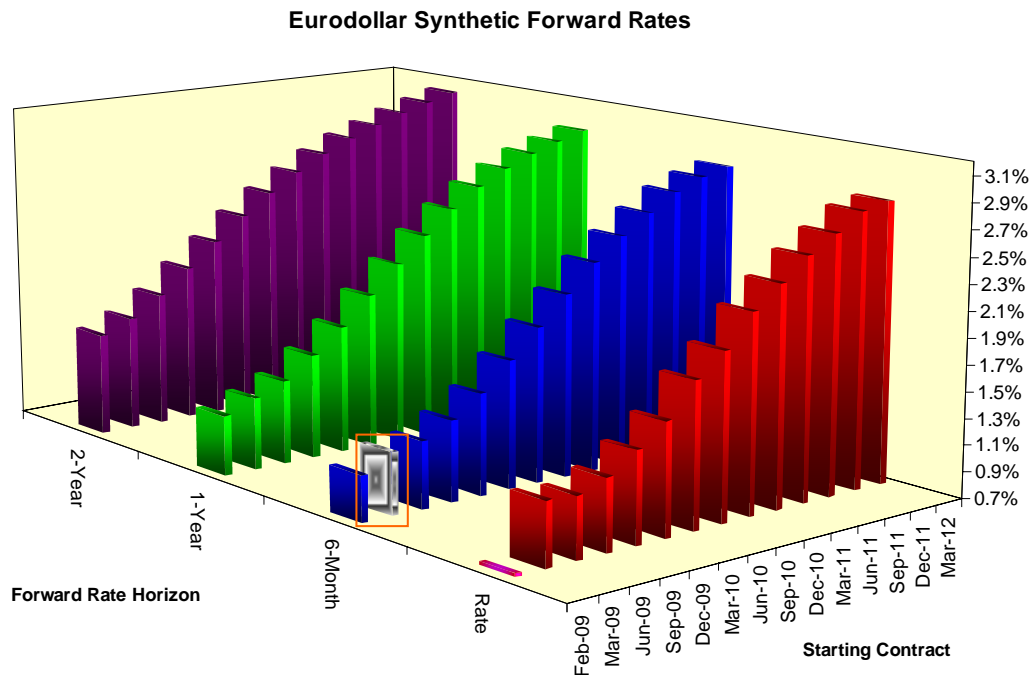
**Implied Eurodollar Yields Since TED Spread's Peak**



The low in implied yields for each quarterly contract between March 2009 and September 2010 occurred on January 9, 2009, two weeks ago. The small rise in implied yields since then could be either evidence of renewed credit deterioration in the interbank market – after all, this has not been a happy time for any of the major British banks such as Royal Bank of Scotland or Barclays or for such American banks as Citigroup or Bank of America – or it may be some evidence of renewed short-term credit demand.

## The Forward Rate Structure

Let's see if the forward rate structure of the Eurodollar market can provide us with any clues as to which force may be operating. 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 an orange rectangle can be verbalized as "the rate at which you can lock in borrowing for six months starting with the expiration of the March 2009 contract."



Please note how implied yields, the red columns, start rising noticeably with the December 2009 contract and how each successively longer forward rate borrowing horizon has a higher implied yield. If the rise in implied yields noted above was the result of the spate of bad news over the past two weeks, then we should expect to see a different picture, one where the spot yield curve had a very steep positive slope and the forward rate structure did not rise with time. As seen in the first chart of TED spreads, this is how a shock affects the LIBOR market.

That orange rectangle-highlighted data point is also the lowest part of the forward rate map. 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. If this sounds suspiciously like an exercise in economic bottom-calling, then so be it. After all, 305 million people cannot be wrong, can they?