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CREDIT MARKET LIQUIDITY and FORECASTING THE TED SPREAD

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June 23, 2010



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Recent Headlines in Major Newspapers & Journals

“TED Spread Blows Past 36, And Pretty Soon Tim Geithner Will Start Getting Nervous”

“TED Spread Begins to Spike: Counterparty Risk Rises”

“Oh Man, Not the “Ted Spread” Again”

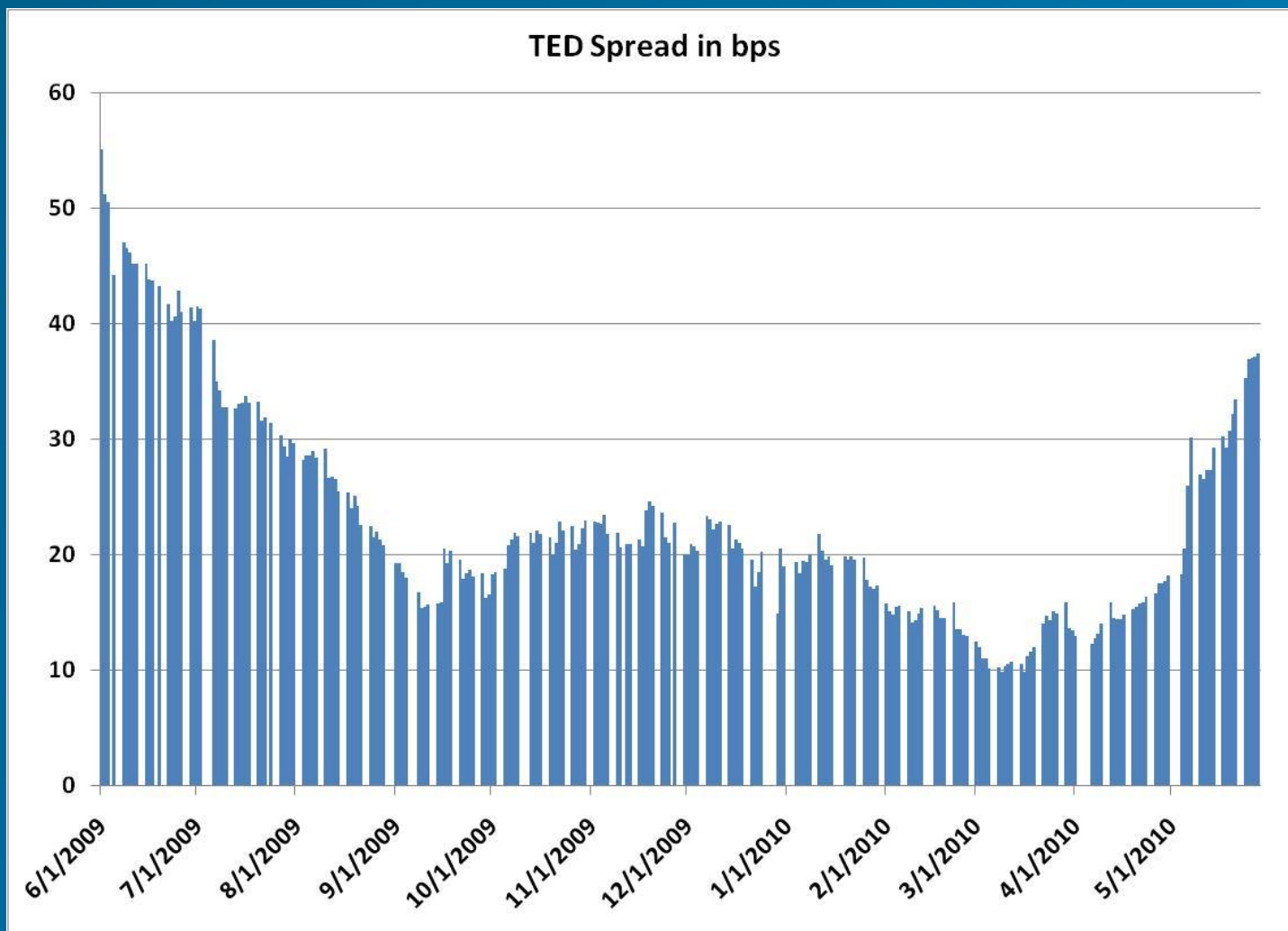
“Where The Stock Markets Are Headed Next: The TED Spread is the Key Indicator”

“Liquidity Situation Gets Worse as Relentless TED Spread Marches Even Wider”

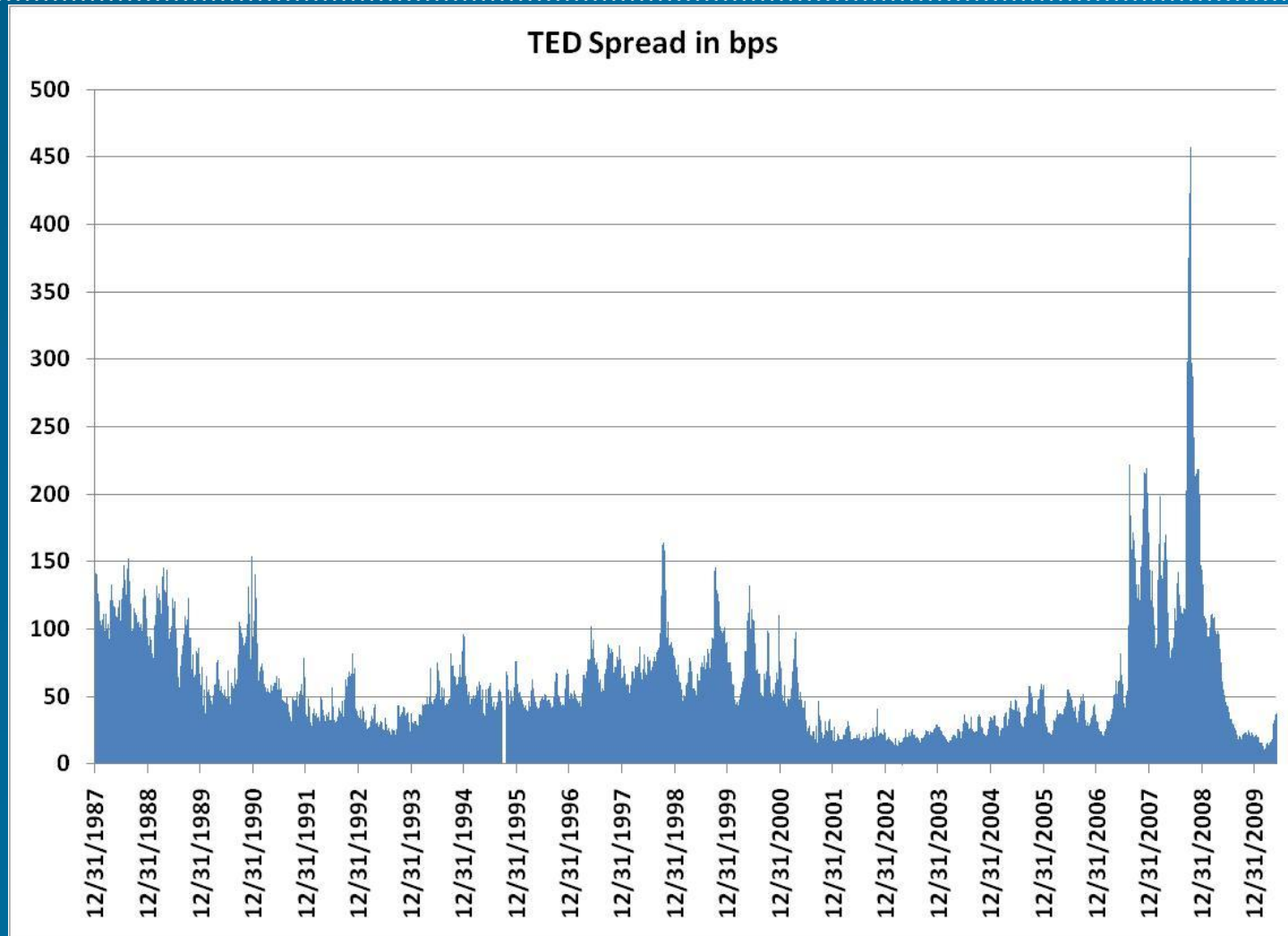
What is the TED Spread?

- **Per Campbell Harvey:**
- The **TED spread** is the difference between the interest rates on interbank loans and short-term U.S. government debt (T-bills).
- Initially, the TED spread was the difference between three-month U.S. Treasuries contracts and the three-month Eurodollars contract as represented by the London Interbank Offered Rate (LIBOR). However, since the CME dropped T-bill futures, the TED spread is now calculated as the difference between three-month T-bills and three-month LIBOR.

So Over the Near-Term



But Over the Long Term...



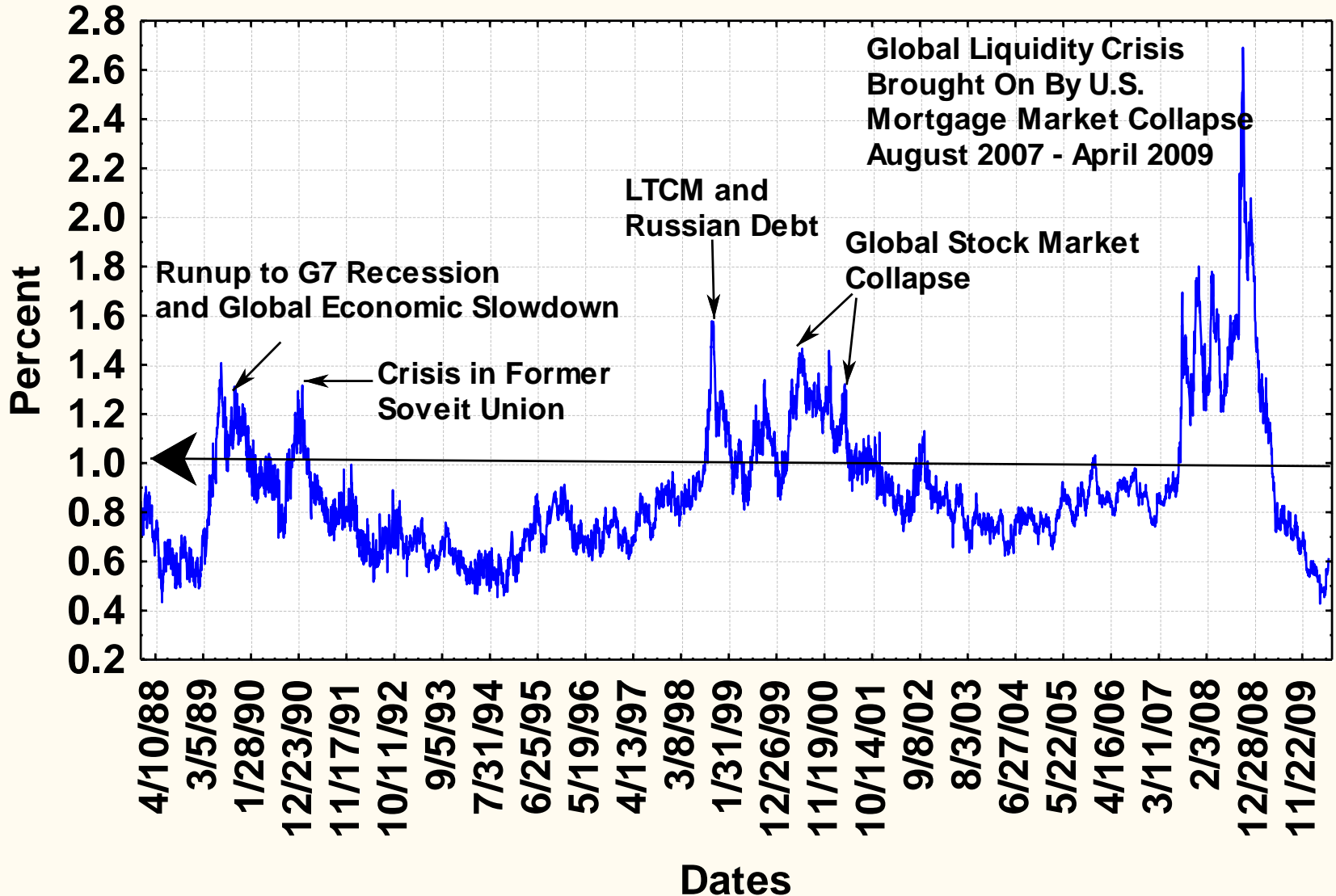
So Should We Be Concerned About Liquidity In the U.S. Credit Markets?

- The TED is indeed going up but is only beginning to approach the median value of the past +20 years
- Other indicators of liquidity
 - Swap spread
 - Mortgage spread
- Are tightening but only a smidge
- Is there a way of looking at historical liquidity to see if there is cause for concern given current levels of each?

U.S. Credit Market Liquidity

- Every 6 months, the IMF publishes their *Global Financial Stability Report*
- In it, the IMF measures liquidity using 3 spreads
 - TED
 - 7 Yr Swap vs 7 Yr Treasury
 - 30 Yr Mortgage Rate vs 10 Yr Treasury
- In what follows, we will use the average of these 3 to look at U.S. and by implication Global liquidity

U.S. Credit Market Liquidity Daily From 12/31/1987



Liquidity Review

- Is there a credit crunch approaching
- It looks like the answer is no
- But that's only based upon today data (end of May 2010)

Liquidity Review

- What about the future however?
- Is there a way of forecasting the path of liquidity two weeks to a month ahead?
- And a way of exploiting this knowledge by trading the TED?

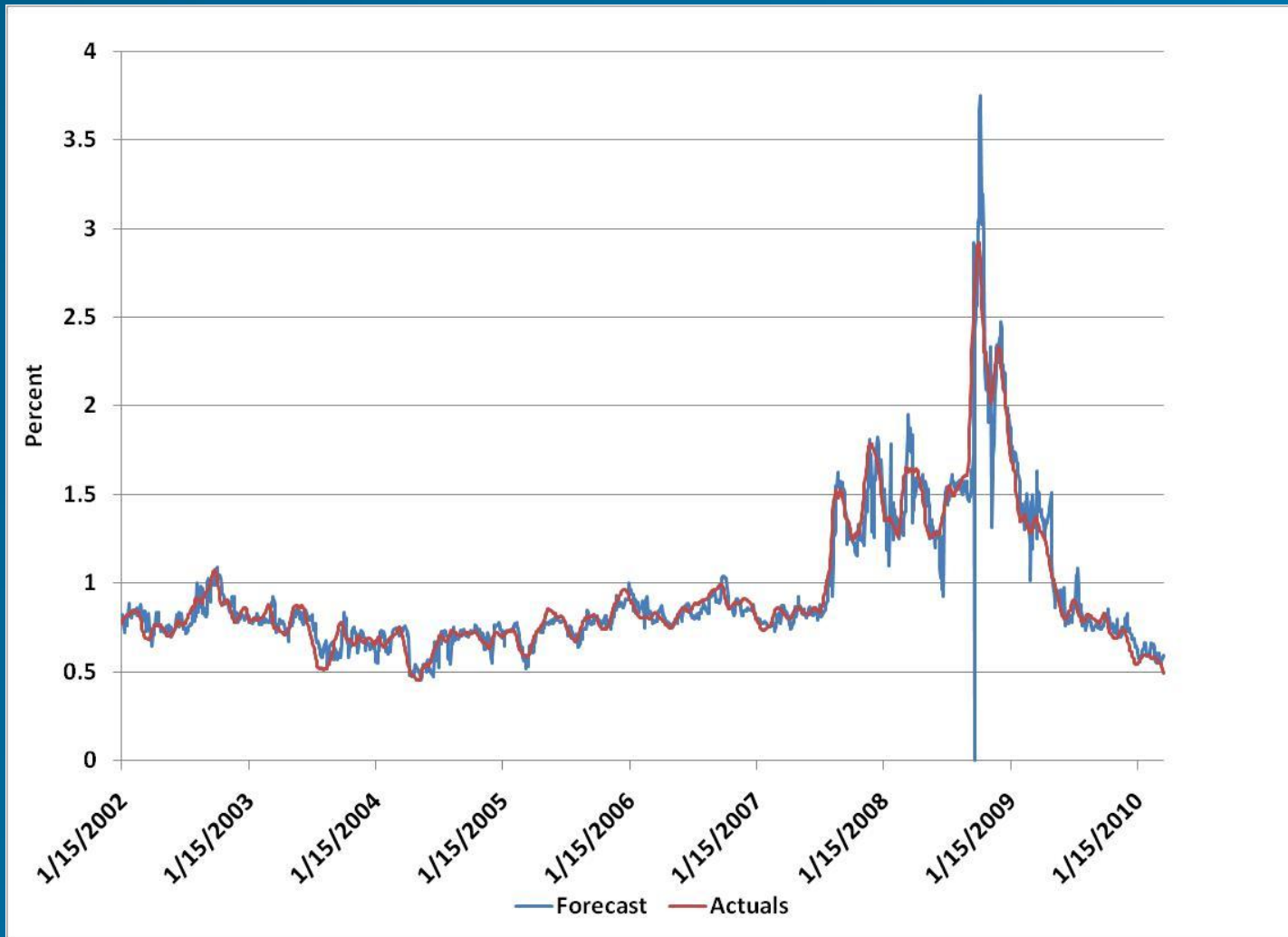
Forecasting



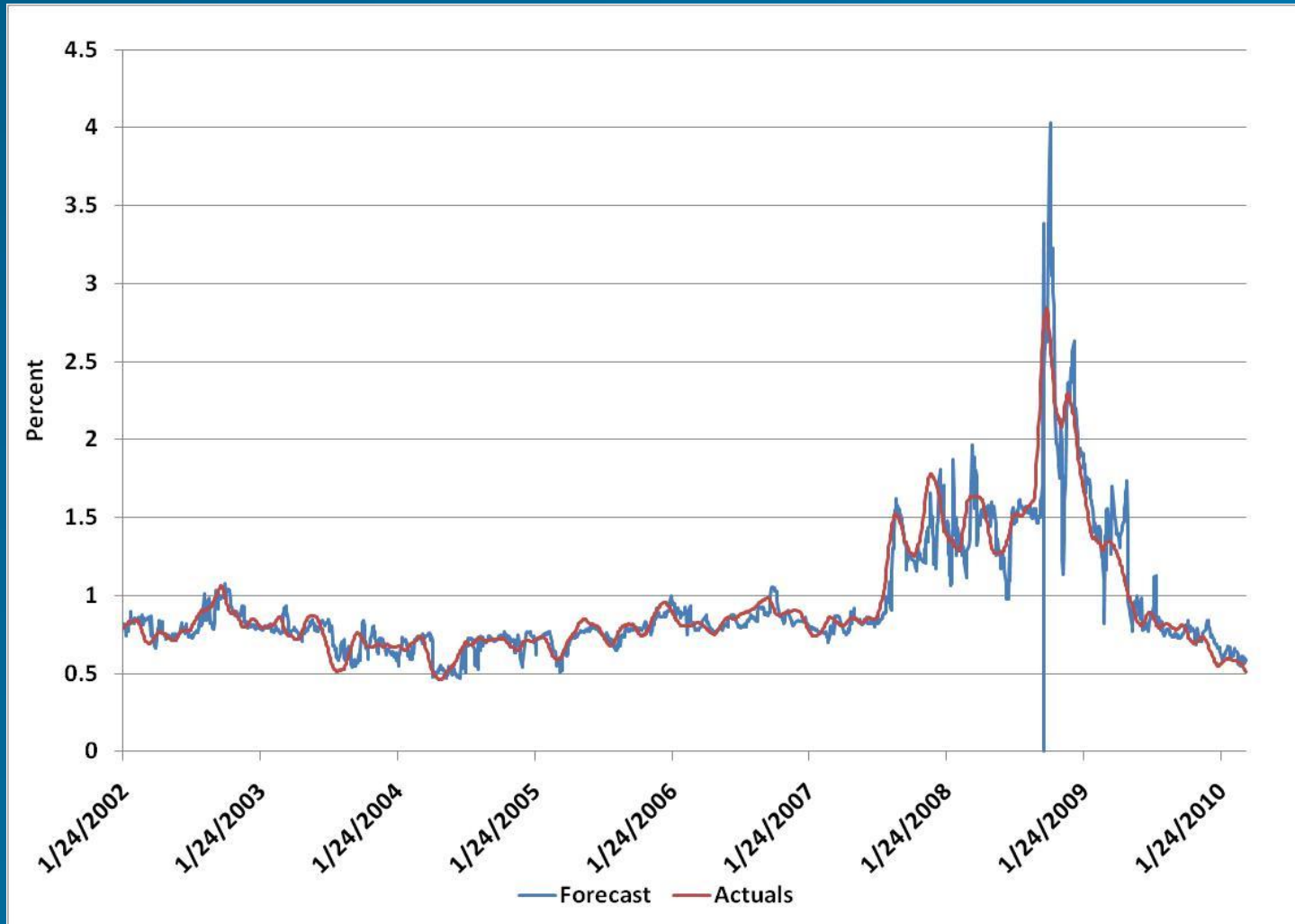
➤ Using techniques similar to what TR has developed to forecast realized volatility

➤ We can forecast the liquidity for the credit markets in general as well as the TED

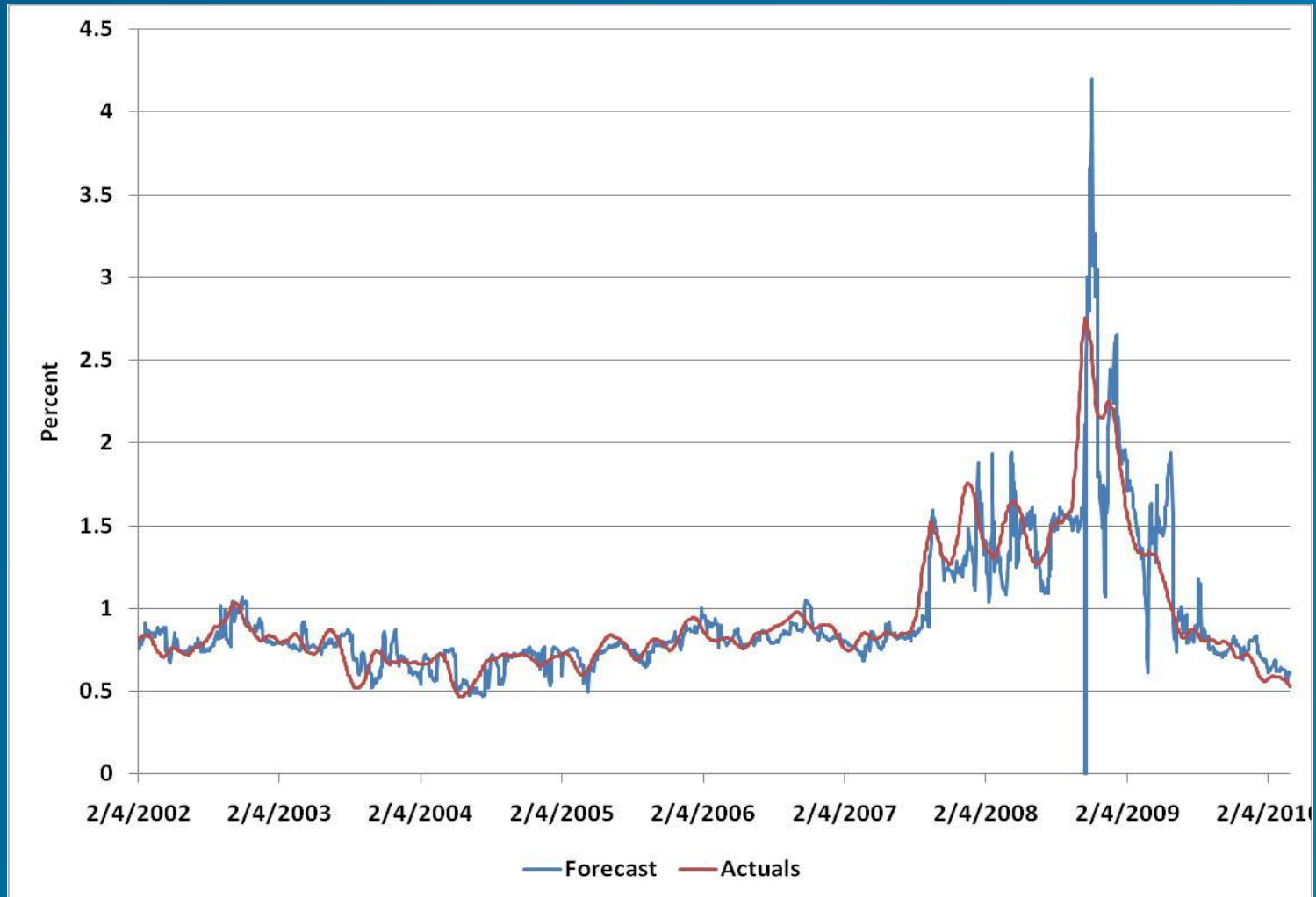
Credit Market Liquidity – 10 Day Ahead Forecast vs Actuals



Credit Market Liquidity – 15 Day Ahead Forecast vs Actuals



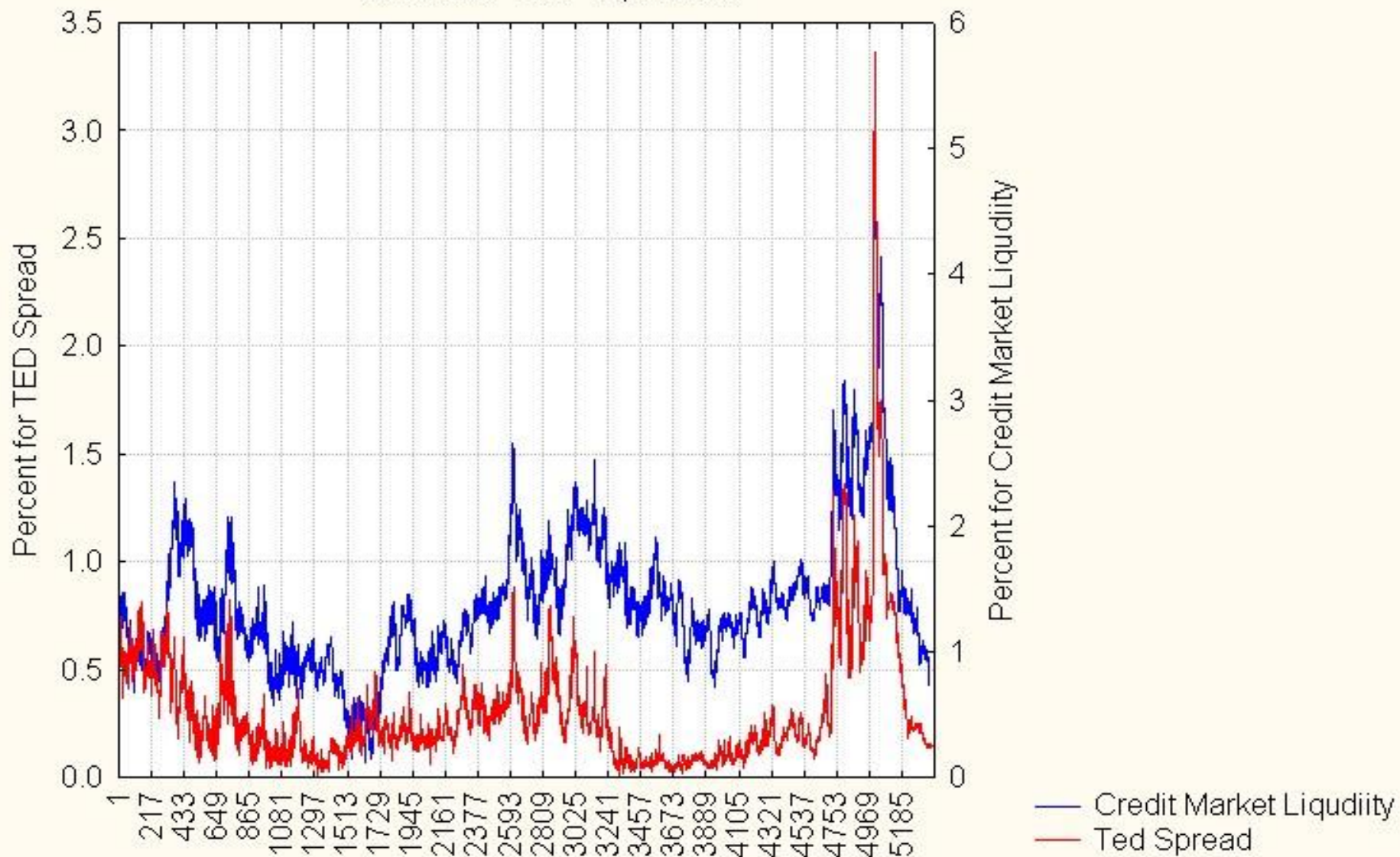
Credit Market Liquidity – 21 Day Ahead Forecast vs Actuals



Forecasting Liquidity

- A good forecast for 2 weeks to 1 month out can be done for credit market liquidity in general
- Is there a way of exploiting this ability to forecast?
- The TED's a possibility but let's review the relationship between the TED and credit market liquidity in general

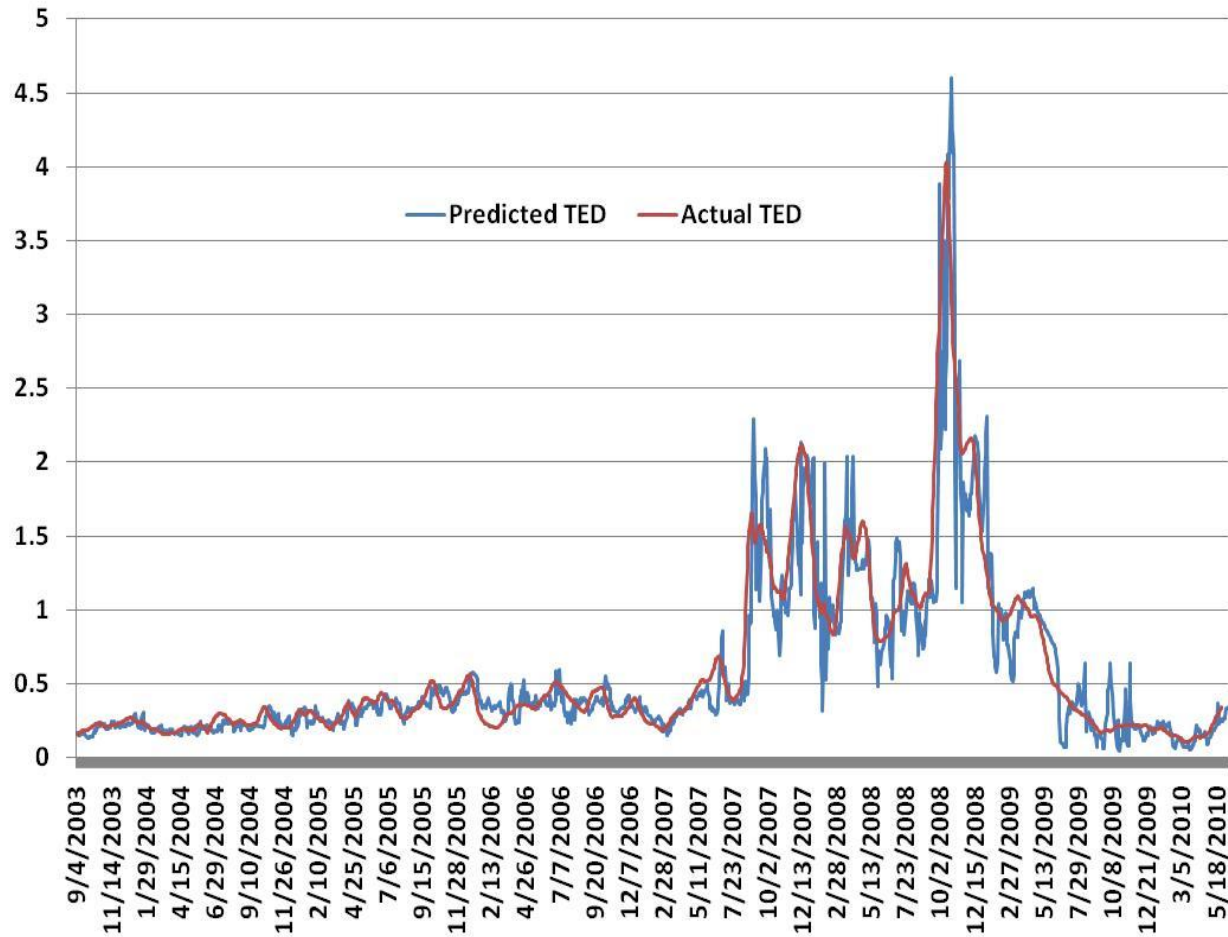
U.S. Credit Market Liquidity and TED Spread December 1987 - April 2010



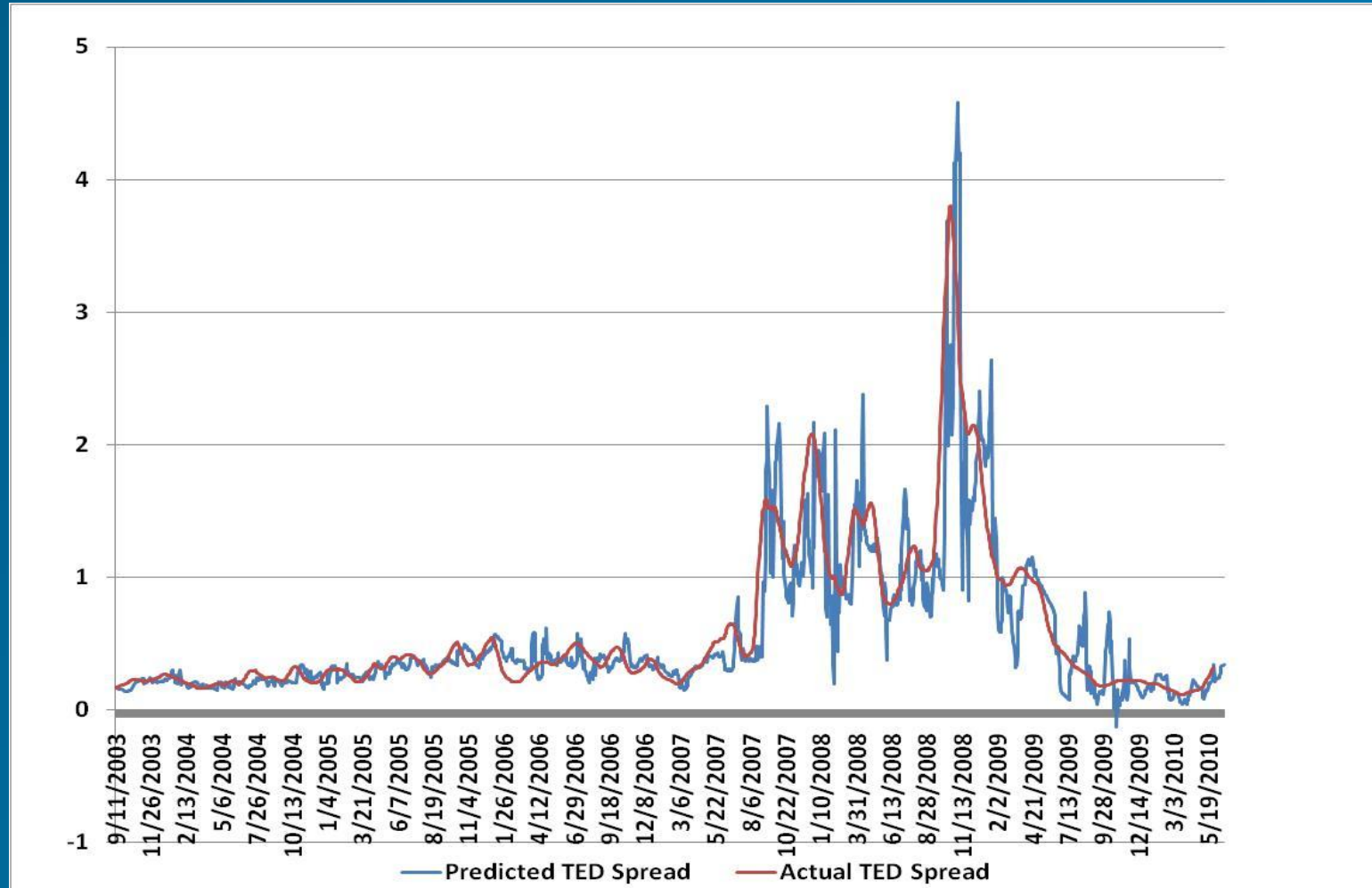
3M Bills and the TED

- So an ok correlation exists though it does not always catch the important peaks – when liquidity really does tighten
- The better relationship is the mortgage spread but this can be a difficult spread to create or capture
- So given the liquidity on both sides of the TED
 - Would (or could you) benefit from a TED forecast?
 - The answer is yes, esp. for the TED in most environments

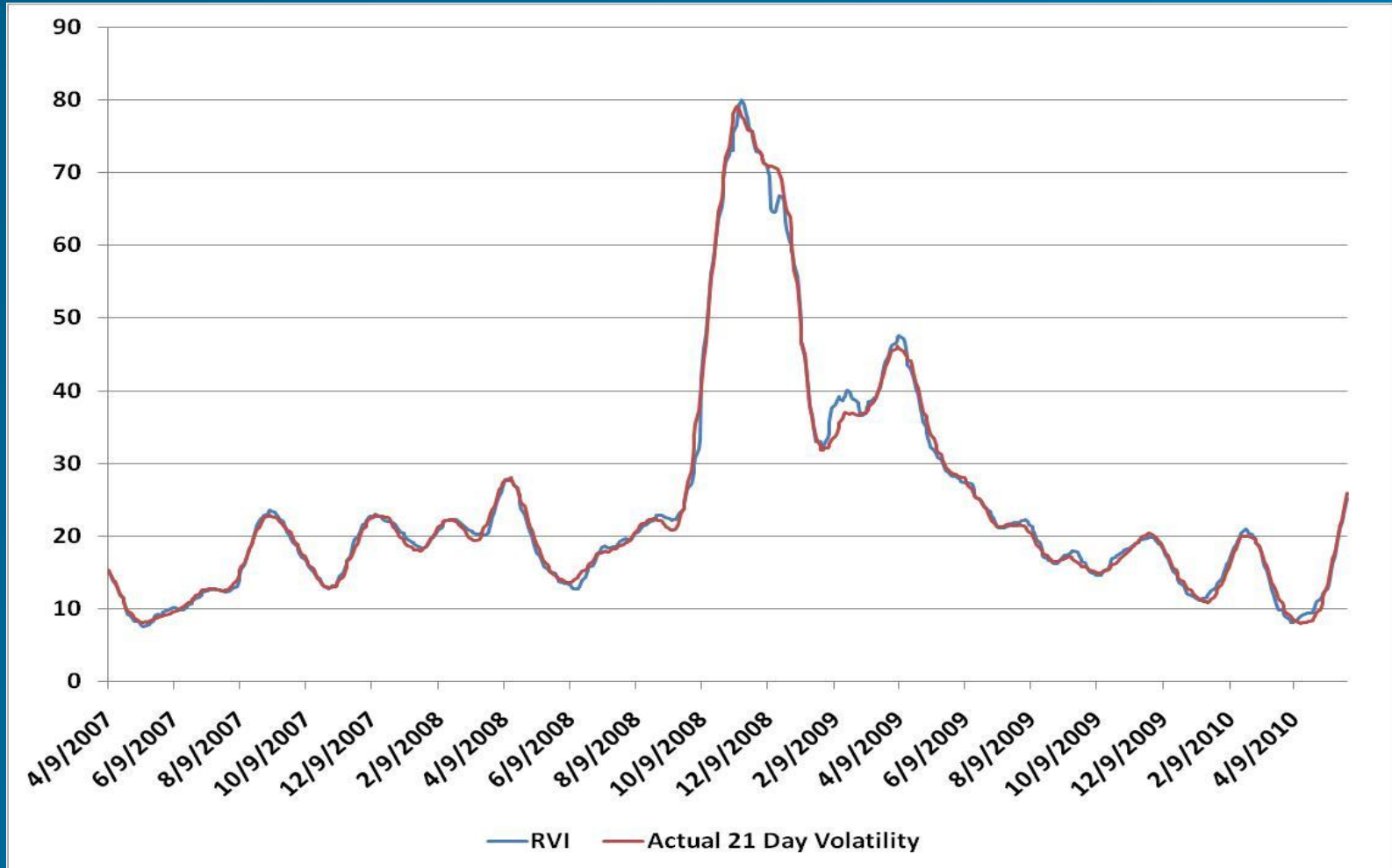
TED Spread – 10 day Ahead Forecast vs Actuals



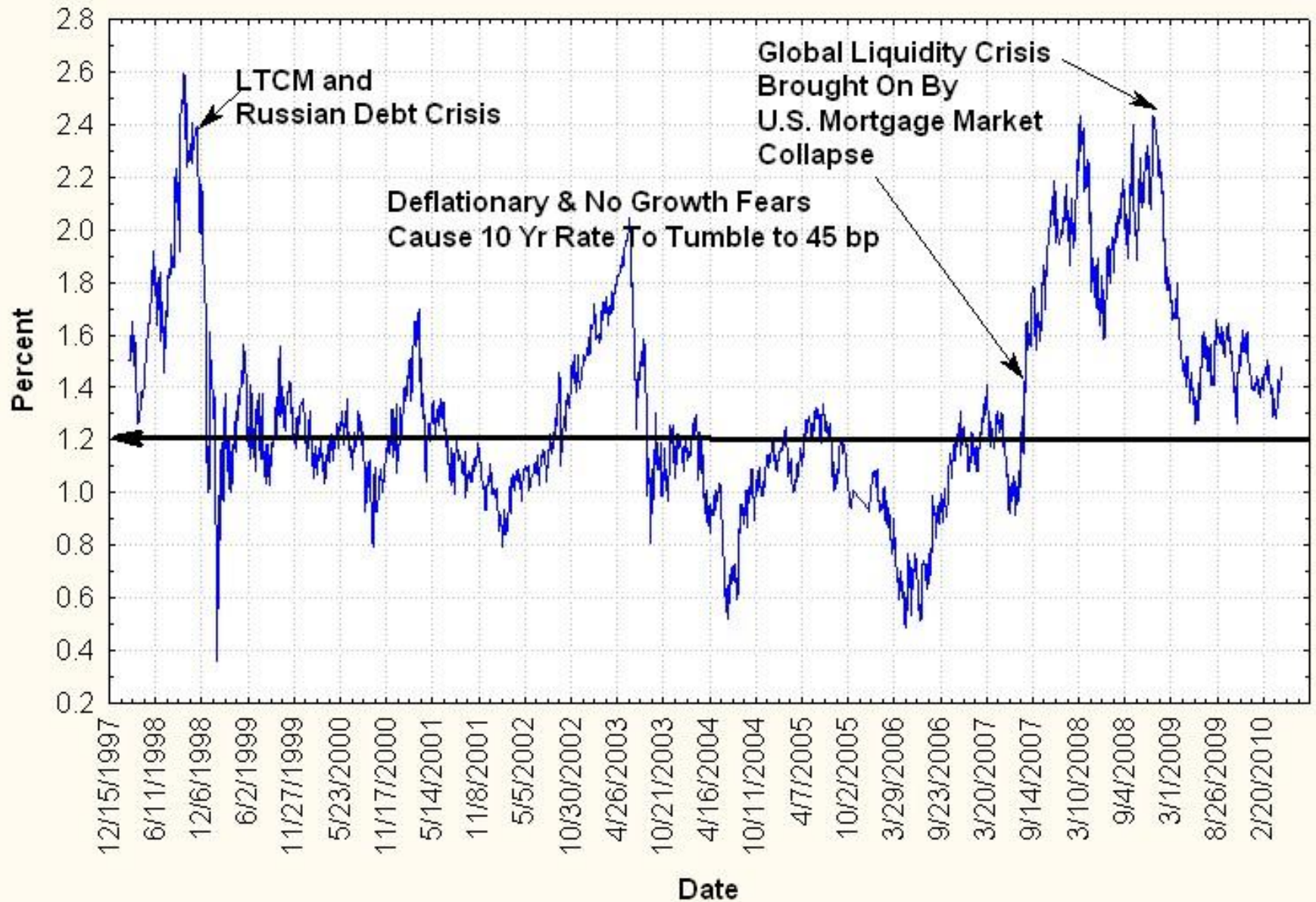
TED Spread – 15 day Ahead Forecast vs Actuals



TR RVI for the U.S. Stock Market



Japan Credit Market Liquidity Daily From 2 March, 1998



Conclusions

- Though the TED has bumped up recently
- There are no signs that other important liquidity measures are also on the rise
- It could be that the interbank rate (LIBOR), which is often viewed as a “European” rate, is reflecting nervousness about European banks vs liquidity contraction on a broader scale



Conclusions

- This is not to say that concerns about the TED
- Or good strategies involving the TED
- Are mis-placed
- Clearly, stock markets are still volatile, though the TR RVI is forecasting a down turn (of sorts) in volatility during the next month



Conclusions

- So a way to keep on top of:
 - U.S. Credit Market Liquidity
 - Credit Market Liquidity in other G7 countries
 - The TED
 - And stock market volatility
- Is to subscribe to the TR Indices for each of these “risk” measures
- As these indices can tell you how things are today
- And how things may be 2 weeks to 1 month in the future