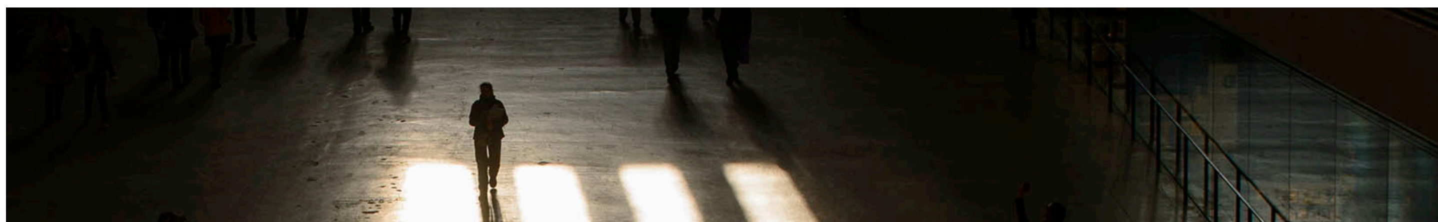
insightpaper

AMP CAPITAL

WATCHING THE TED SPREAD AGAIN - THOUGH WITH LESS TREPIDATION

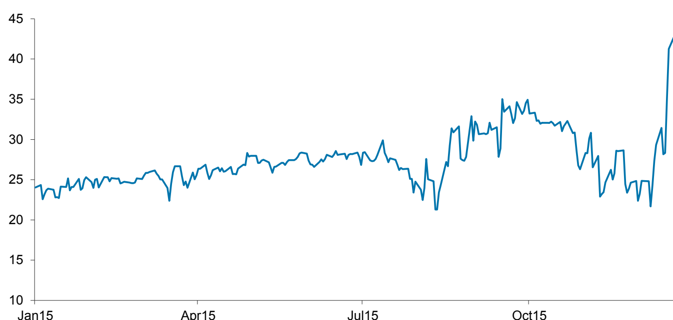
DECEMBER 2015



Remember the Ted spread - the difference between 3 month US interbank and T-bill rates? This was the most watched financial risk metric during the financial crisis. As it indicates short term interbank risk relative to government risk, essentially it indicates how much (or how little) US banks trust each other.

The Ted spread has moved a bit higher recently to 42 basis points (bps) following the recent troubles with three US credit funds. However, this is not a big move in the scheme of things, being less than 20 bps above the average of the last three years.

US TED SPREAD

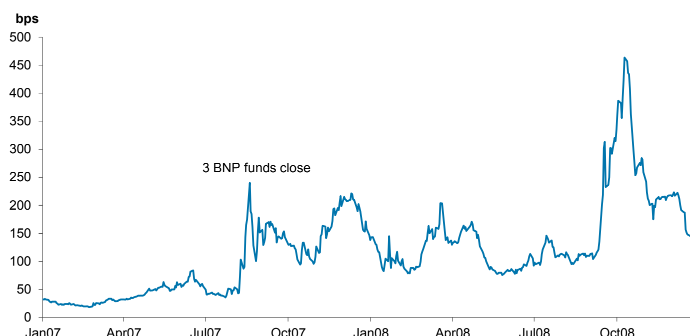


Source: Bloomberg, AMP Capital

The rise in the Ted spread may have little to do with the credit funds and could be simply a consequence of open market operations associated with this month's US Federal Reserve rate hike. Even so, there are some echos with 2007 that should put the spread back on investors' radars.

In August 2007, BNP froze three credit funds that invested in US subprime securities. These were the first dead canaries that flagged the coming financial crisis. The Ted spread rose to 240 bps in the weeks following the closing of the BNP funds.

US TED SPREAD 2007-08



Source: Bloomberg, AMP Capital

The recent US credit fund closures are not a harbinger of financial crisis, but more a mismatch between retail client liquidity expectations and actual credit market fundamentals. However, both the financial crisis and the spike in US high yield share real causes.

The financial crisis was largely due to low rates, excessive household borrowing and unrealistic assumptions about future US house price gains.

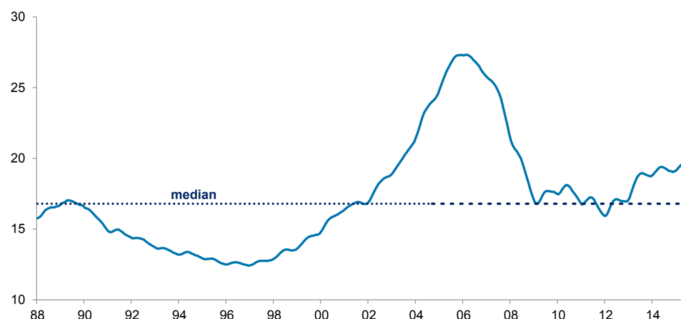
The high yield scare is about low rates, excessive energy company borrowing and optimistic assumptions about future oil prices. There the similarities end.

First and foremost, US residential and commercial property represents the lion's share of bank assets whereas energy loans are relatively small in comparison.

For example, Citigroup's energy portfolio, including loans and unfunded commitments, was $59.7 billion as of 30 June, Bank of America's to $47.3 billion, and JPMorgan's to $43.6 billion, according to company filings. This represents a combined 2.3% of these three banks' total assets.

In contrast, the entire US housing market (and hence bank asset valuations) was materially overvalued in 2007.

US HOUSING PRICE-TO-RENT RATIO

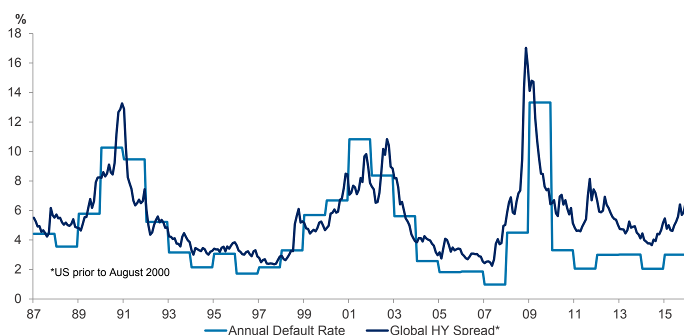


Source: S&P/Case-Shiller, BEA, AMP Capital

It is hard to say that about the entire credit market, or even high yield.

The global high yield market is pricing in a jump higher in default rates next year to around 6%, while Moody's are picking 4.1%, up from 3.0% in 2015.

GLOBAL HIGH YIELD AND DEFAULT RATE



Source: Barclays, Moodys, AMP Capital

The other key difference between 2007-9 and now is consumers are benefiting from much lower fuel prices.

So there is a large positive consumer offset to the weak energy-related industrial weakness. Hence the difference between the services and manufacturing purchasing managers indices.

In contrast, during the financial crisis households were hit with sharply higher fuel prices, until they collapsed in late 2008.

So the recent fund closures and tick up in the Ted spread is not a cause for investor angst. But keep watching the spread.

KEITH POORE
Head of Investment Strategy

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