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Commentary

Market Opinions and Topics of Interest

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Overnight Index Swaps And LIBOR

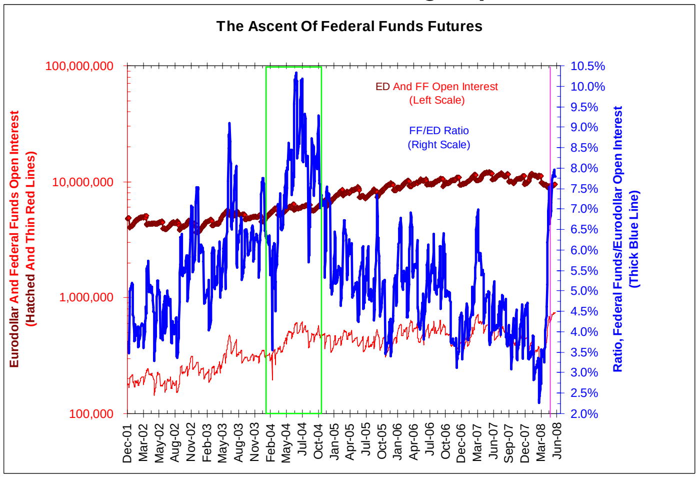
We asked in our most recent Commitment of Traders Report:

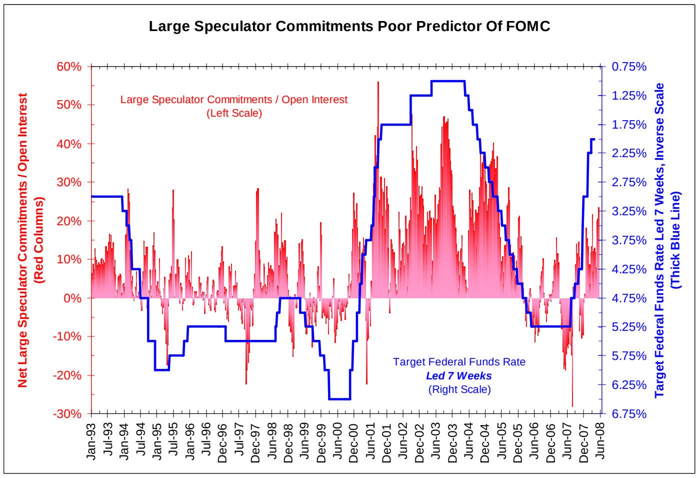
> *If LIBOR is considered unreliable, then overnight index swaps based on the federal funds futures might become more indicative of the short-term market. Is there another explanation of a quadrupling of Large Speculators' net long position in a matter of weeks when the current implied probability of a rate cut on June 25th is 2%?*

The nature of the federal funds futures market has changed. If we map the aggregate open interest for it and for Eurodollar futures (thin and hatched red lines, left-hand chart), we can see an abrupt increase in the ratio of the respective open interests (thick blue line). **The disclosure of irregularities in LIBOR reporting is marked with a magenta vertical line; the increase began prior to the *Wall Street Journal's* report, which raises the intriguing possibility banks changed their trading venue in advance of the news being made public.**

The last such increase in relative open interest occurred in 2004, a time of imminent changes and ongoing uncertainty in FOMC policy (green rectangle). The situation today is quite different.

In addition, the net commitments of Large Speculators as a percentage of total open interest in the federal funds futures contract (red columns, right-hand chart) are a poor predictor of the target federal funds rate led seven weeks (thick blue line, inverse scale). **We can dismiss the notion the outsized net long position on the Large Speculators has a meaningful policy content.**





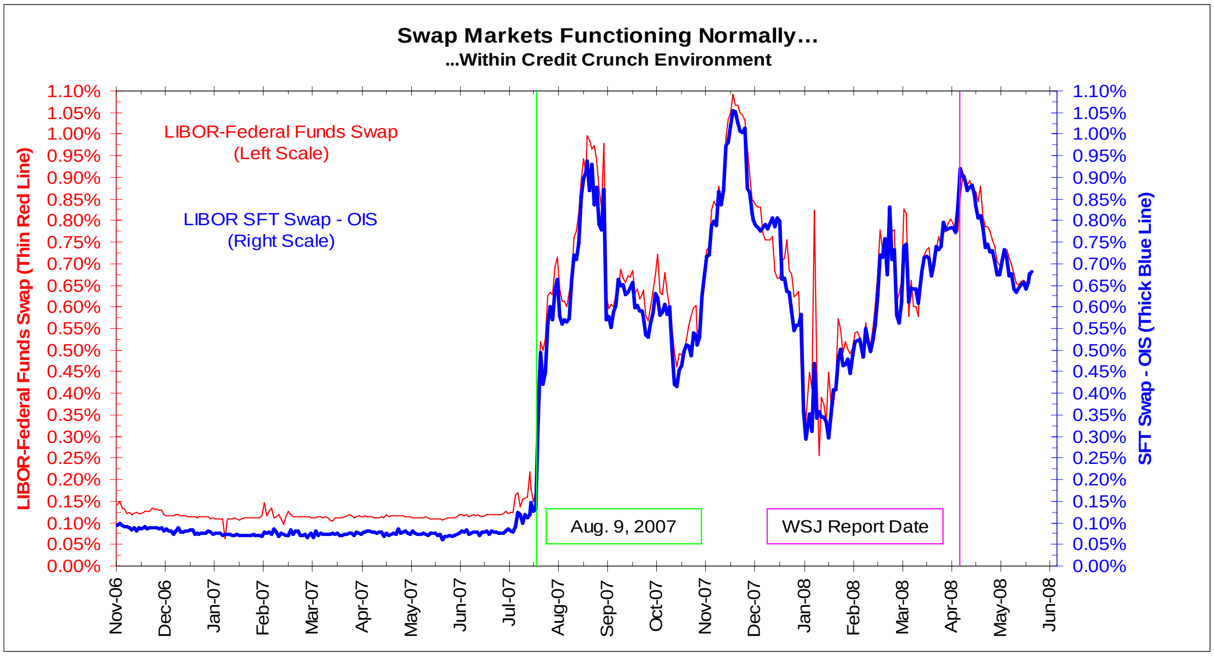
Market Impact

Now let's ask the tough question: Was the disclosure of LIBOR reporting irregularities the major event in these markets over the past year? The answer, quite simply and forcefully, is "No." That event, in retrospect, can be traced back to August 9, 2007 (green vertical line, following page) and the infusion of €94.8 billion in credit into the banking system by the European Central Bank.

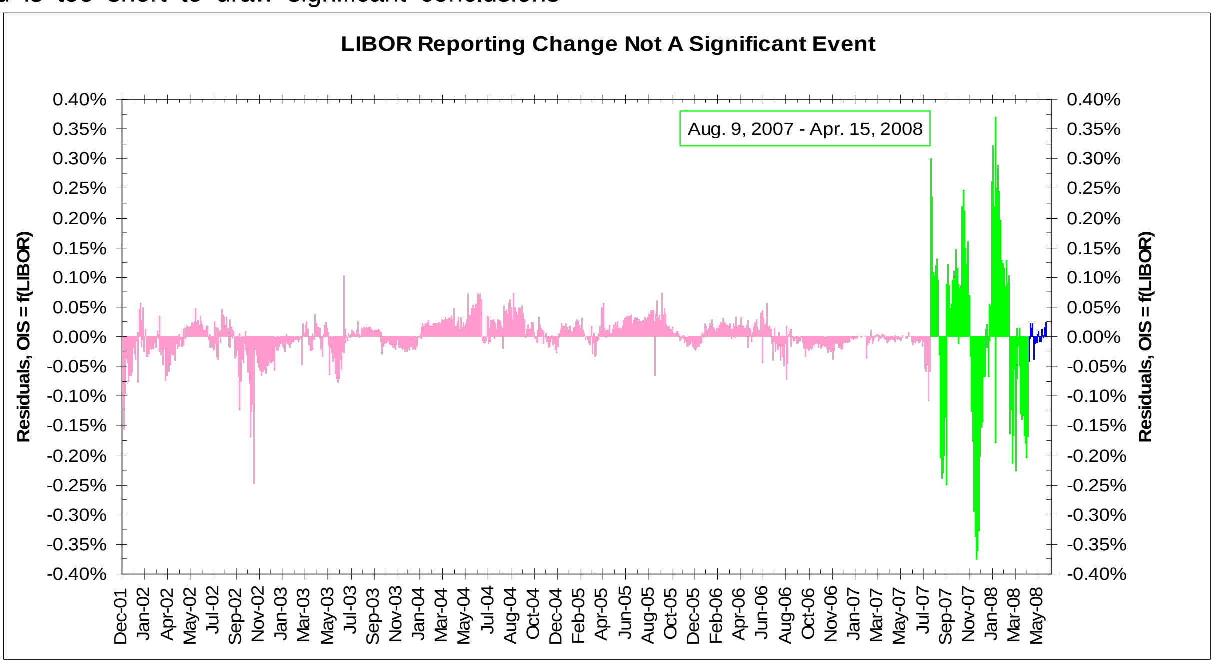
Both the LIBOR-federal funds swap and the spread between the LIBOR set-for-tomorrow swap and the overnight index swap (thin red and thick blue lines, respectively) jumped significantly on that day and with the exception of a handful of days in February 2008 have remained over that level.

Moreover, both measures have declined since the *Wall Street Journal's* report (magenta vertical line). **For all of the evidence of misfeasance and underreporting of borrowing costs, two different**

measures of the spread between LIBOR and federal funds have retracted since the news.



Now let's regress the overnight index swap against LIBOR over three different periods, December 2001-August 2007, August 2007-April 2008 and thereafter. The residuals for each regression are displayed in roseate, green and blue columns, respectively. While the post-*Wall Street Journal* period is too short to draw significant conclusions therefrom, we can state the credit crunch period is different from the pre-credit crunch period with near-100% confidence. **The *Wall Street Journal* report did not affect the relationship between LIBOR and federal funds; evidence of bank system problems in August 2007 most certainly did.**



Conclusion

The assumption generally is when news affects volume or trading patterns, it must affect price as well. We can infer a profound shift in trading from LIBOR to OIS from changes in the Commitment of Traders data. However, this shift in trading has not affected price: While we would have every reason to expect a wider set of spreads, the opposite has occurred. The markets have accommodated the shift with a minimum of disruption.

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