National Economy:
As Yogi Berra supposedly said, “You can observe a lot by watching.” Data confirm that the recession has ended and growth has resumed. There are also important signs that financial pressures have subsided.

The “Great Recession” officially started in December 2007 and ended in August or September 2009. Real Gross Domestic Product (GDP) provides the clearest proof. After falling sharply through mid-2009, GDP rose 2.2 percent in the third quarter and roughly twice that in the fourth thanks to the “cash for clunkers” and smaller inventory liquidation. GDP is expected to rise less than 3 percent this year.

As we’ve mentioned before, when economists say the recession has ended they simply mean the overall economy, as measured by GDP, has stopped declining. Not all major indicators have started to improve nor have they recovered to normal levels.

At the end of 2009, jobs were still declining even though GDP was rising. This is similar to what happened following the past two recessions when firms produced that extra GDP by improving efficiency and increasing the length of workweeks.

Labor markets have, however, shown major signs of improvement. Monthly job losses have shrunk from around 700,000 at the start of 2009 to well under 100,000 in the final months of the year. And layoffs, as measured by new claims for unemployment insurance, have also dropped. However, hiring has yet to resume on a large scale, but should pick up soon.

The unemployment rate, which currently stands at 10 percent, is likely to decline slowly. One reason is that real GDP is forecast to rise modestly since credit will be less readily available than in the past.

Some very dramatic improvements have taken place in financial markets, which endured the most severe crisis since the Great Depression of the 1930s.

The stock market rise has been extraordinary. After plunging in half from the October 2007 peak to March 2009, the Dow Jones has rebounded better than 50 percent – one of the largest rallies on record! Even so, it still stands 25 percent below October 2007. Where stocks go from here is anybody’s guess. Sure, GDP growth will lift corporate profits, but much of this has already been anticipated by the stock market rise thus far. Furthermore, higher interest rates could pose a significant headwind. So could uncertainties over the future of economic policies.

I’ve always been intrigued by the signs posted in the London subway system saying “Mind the Gap.” It’s a very British way of warning about the space between the platform and the subway cars. Well, when financial markets get stressed, the gaps or spreads between various financial instruments also bear close watching. They are much like the blood pressure readings or electrocardiogram of the financial system. We’ll examine three of the most important spreads.

My favorites is the “TED Spread,” which I first heard about when I was a young economist wandering the trading floor of a large financial institution. TED is the difference between the yield on the 3-month Treasury bill (the “T”) and 3-month Eurodollar borrowings (the “ED”). Eurodollars have nothing to do with the Euro currency. Rather, think of Eurodollars as a big offshore Fed funds market where the European subsidiaries of U.S. banks borrow and lend dollar denominated funds to each other.

### Interest Rate Spreads

<table>
<thead>
<tr>
<th>Spread</th>
<th>Jan ‘07</th>
<th>Oct ‘08</th>
<th>Jan ‘10</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-month Euro$</td>
<td>5.35</td>
<td>6.00</td>
<td>0.45</td>
</tr>
<tr>
<td>− 3-month T-Bill</td>
<td>5.05</td>
<td>0.58</td>
<td>0.06</td>
</tr>
<tr>
<td>= TED Spread</td>
<td>0.30</td>
<td>5.42</td>
<td>0.39</td>
</tr>
<tr>
<td>Conv. Mortgages</td>
<td>6.18</td>
<td>6.52</td>
<td>5.04</td>
</tr>
<tr>
<td>Minus 10-year T-Note</td>
<td>4.66</td>
<td>3.91</td>
<td>3.83</td>
</tr>
<tr>
<td></td>
<td>1.52</td>
<td>2.61</td>
<td>1.21</td>
</tr>
<tr>
<td>Muni Bonds</td>
<td>4.15</td>
<td>6.01</td>
<td>4.31</td>
</tr>
<tr>
<td>Minus 20-year T-Bond</td>
<td>4.84</td>
<td>4.60</td>
<td>4.60</td>
</tr>
<tr>
<td></td>
<td>-0.69</td>
<td>1.41</td>
<td>-0.29</td>
</tr>
</tbody>
</table>

Source: Federal Reserve. Data are relevant weeks during 2007 and 2008 and first 2 weeks of 2010.
Normally, the TED spread is quite small, averaging around 30 basis points. But it soared during the recent financial crisis, with the biggest spike of more than 500 basis points occurring shortly after the collapse of Lehman Brothers in the fall of 2008. There was extremely high anxiety about the ability of financial institutions to survive and pay back borrowed funds.

As interest rates on Eurodollar borrowings rose those on U.S. Treasuries bills (short-term securities) sank to almost nothing when investors fled to the safety of U.S. debt! As they say on Wall Street, “Sometimes the return of the principal is much more important than the return on the principal.” The TED spread is back down to a more normal 30 basis points. While financial conditions have improved greatly, there may also be some betting on the belief that many of these participants are “too big to fail.”

More relevant for the folks on Main Street is the spread between mortgages and U.S. Treasury bonds. By the way, the reason why we use U.S. Treasury obligations in these comparisons is because they are universally considered to be free from default risk. The normal spread between, say, 30-year mortgages and 10-year Treasury notes is around 150 basis points. The shorter maturity for U.S. bonds is used because most 30-year mortgages don’t last that long as households move and homeowners refinance.

Mortgages command a higher yield than Treasuries even in good times. If interest rates fall, borrowers can refinance and their lenders face the risk of earning less when they make new mortgages. There’s no such risk with Treasuries since the government is still obligated to pay whatever the coupon stipulates. The ability to refinance mortgages is often referred to as an “embedded option” and markets charge for writing options.

During the worst of the crisis, mortgage spreads widened dramatically. This had little to do with pre-payment risk. Instead, there was widespread concern over the viability of Fannie Mae and Freddie Mac who had securitized (packaged) trillions of dollars and guaranteed that the borrowers would repay. With house prices falling and unemployment rising, doubts arose about those guarantees. Again, there was the “flight to quality” as investors such as pension funds and insurance companies preferred the safety and liquidity of U.S. Treasury notes. The mortgages shown in the table are conventional loans of prime quality. The spreads for those infamous subprime loans vs. U.S. Treasury obligations swelled much more.

The gaps have narrowed dramatically. House prices have started to stabilize in much of the country. However, the biggest reason may well be is that the Federal Reserve has become the purchaser of most of the mortgage backed securities in the United States. Accordingly, there are concerns that mortgage spreads will rise when the Fed starts cutting back on its purchases, which is supposed to begin in March.

Finally, there’s the spread between tax-free municipal bonds and Treasuries. In contrast to the previous examples, “muni’s” normally have lower yields than Treasuries. It’s not because they carry less credit risk. Muni’s have traditionally had relatively low default risk but are not risk free. Rather, the lower yield reflects the fact that they are usually exempt from federal income taxes and from state income taxes for investors who live in the state where the security was issued. Hence, investors often look at the “tax equivalent” yield on muni’s. Suppose you are in a combined 35 percent federal and state income tax bracket. You’d have to earn 6.2 percent on a fully taxable bond to equal a muni bond paying 4 percent.

Municipal yields rose dramatically above Treasuries around the time Lehman Brothers failed in September 2008. The 6.5 percent municipal bond yield in October 2008 translates into a 10 percent tax equivalent for someone in a 35 percent bracket. Long-term Treasury bonds paid less than 4 percent at the time!

This highly unusual development reflected concerns over the credit worthiness of some municipal borrowers as well as their insurers. The companies that insured many state and local bonds against default found themselves in trouble during the past couple of years as they strayed into riskier areas such as providing guarantees for risky mortgage securities. There was also the flight to the safety of U.S. Treasuries (also known as “guvvies” to us old timers).

Spreads have become more normal in recent months. However, a fiscal problem in a major state such as California might cause municipal bond yields to rise relative to Treasuries. On the other hand, increases in incomes tax rates would cause muni yields to fall as the “tax exemption” becomes worth even more.

All in all, the economic and financial data support the consensus view of moderate economic growth in 2010. However, we don’t know how much of this narrowing of interest rate spreads reflects fundamental improvement in financial markets compared to the fact that the Treasury, FDIC and Federal Reserve have become “guarantors of last resort” for vast amounts of privately issued debt.

Happy New Year.

Musings & Amusings: More Yogi-isms

“If I didn’t wake up I’d still be sleeping.”

“We made too many wrong mistakes.”

“The future ain’t what it used to be.”