

IMPACT OF TREASURY EURODOLLAR (TED) SPREADS

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WHAT IS A EURODOLLAR?

USD denominated deposits at foreign banks / overseas branches of US banks.

WHAT IS A EURODOLLAR RATE?

Refers to the interest earned on USD deposits outside the US banking system.

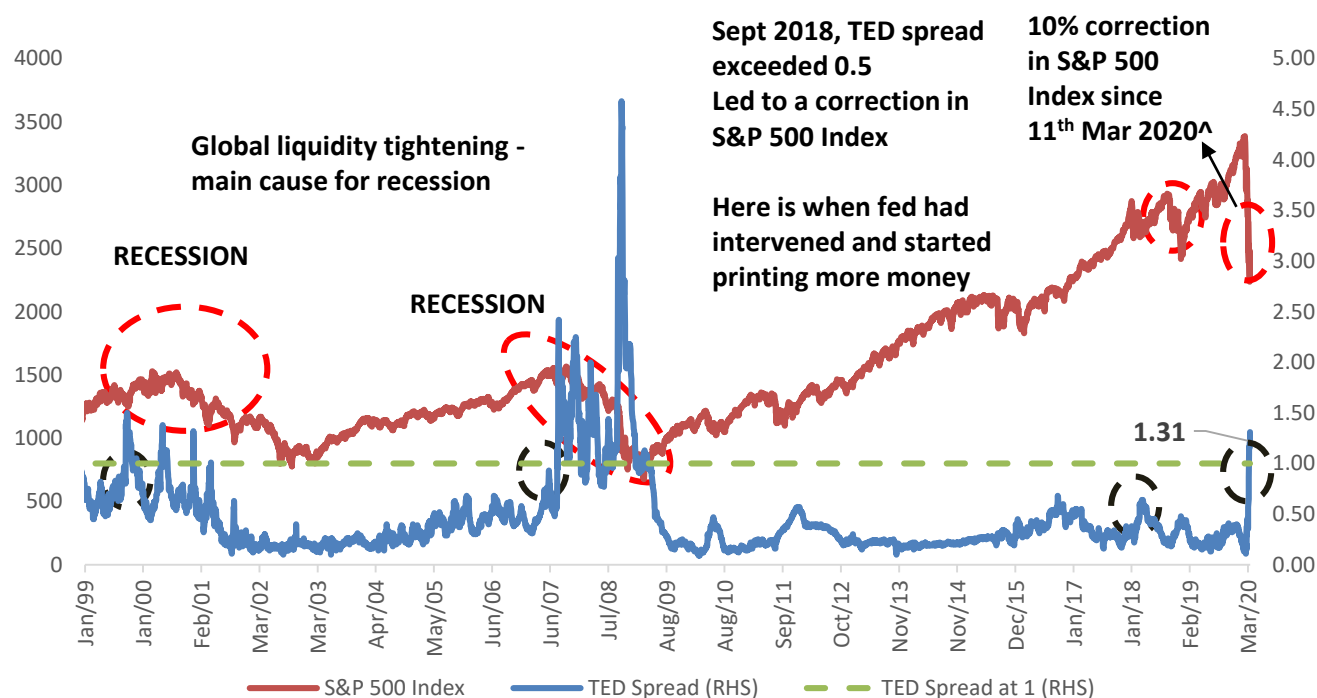
WHAT IS A TED SPREAD?

Treasury Eurodollar (TED) Spread = 3 month Eurodollar Rate - 3 month US Treasury Bill.

Higher TED Spread signifies a shortage of USD globally ex US leading to a higher borrowing rate.

WHY IS IT IMPORTANT TO ANALYZE TED SPREADS?

Indicator of global liquidity which in turn impacts risk assets and economic activity



WHEN TED SPREADS ARE CLOSE TO 1 => POTENTIAL RECESSION + DECLINE IN S&P 500 INDEX.

Source –Yahoo finance, Research of Federal Reserve Bank of St. Louis | Data as on 25th March 2020 | These figures pertain to performance of the index and do not in any manner indicate the returns/performance of any Scheme of DSP Mutual Fund. It is not possible to invest directly in an index | [^]Spread has increased from 0.36 to 1.31 during period of 11th March 2020 to 25th March 2020

PRACTICAL IMPLICATIONS OF TED SPREADS -

- Currently Global liquidity condition has tightened (TED Spread >1 as on 25th March 2020). This has been a major reason for correction in asset prices and rise in Dollar Index.
- Factors which could affect global liquidity are issues in credit market, etc. The current decline in crude oil prices, might affect the debt servicing capability for many energy producing companies, thereby having a negative impact on pricing of High Yield bonds**.
- Current global trade is denominated in US Dollars, but with the US being < 20% of Global GDP, this is causing potential imbalances in Dollar funding markets globally *

* Please read the views of Mike Carney – Governor of Bank of England – who advocates for an new financial and monetary system due to above mentioned USD imbalance (Click [here](#))

** Bloomberg Barclays US Corporate BBB (ex Financials) Average OAS has jumped up since the time oil prices have corrected

WHAT IS SWAP LINE?

Swap line is a term for temporary currency exchange between central banks.

WHAT IS THE PURPOSE OF SWAP LINE?

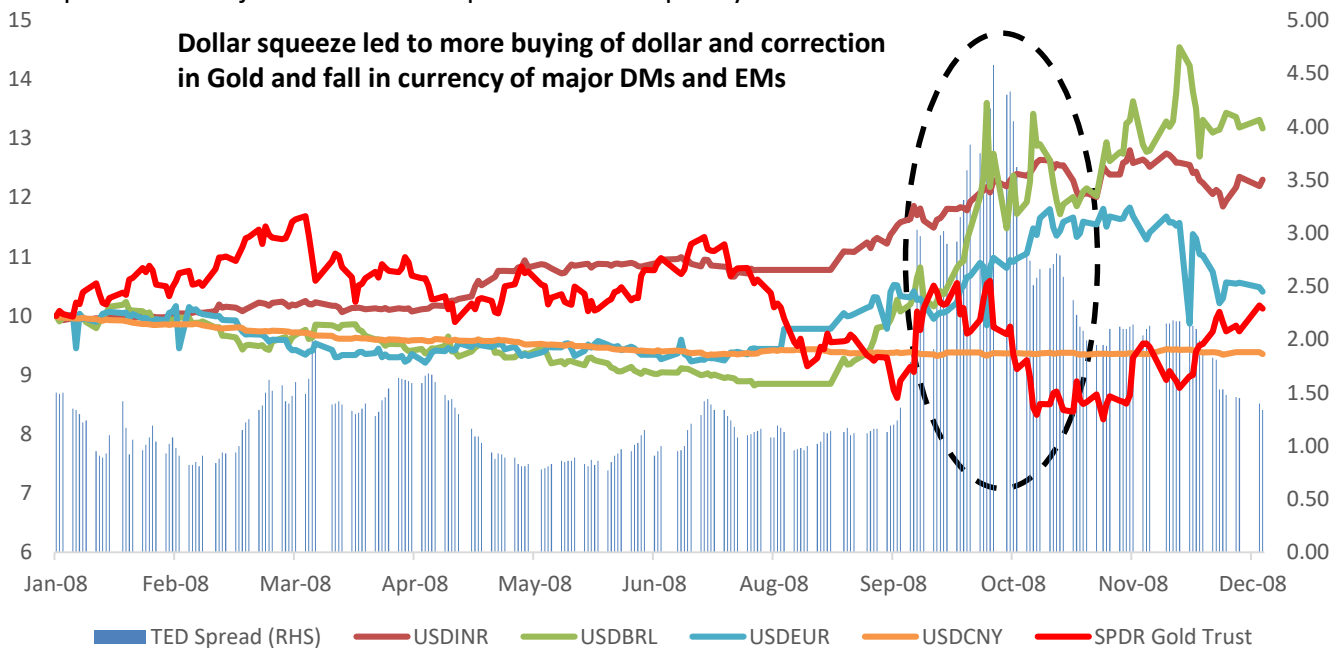
To provide liquidity in the currency to other central banks, for further lending to commercial banks for their requirements. It reassures banks and investors on the availability of that currency. When global liquidity tightens (reserve currency shortfall) and TED Spreads rise, the FED tries to restore liquidity by opening dollar swap lines with other major central banks.

HOW DOES THE SWAP LINE WORK?

When Swap lines are opened, the central banks exchange currency with an agreement to buy back the same at a future date and at an exchange rate which is fixed today. At the conclusion of swap, obligated bank pays an interest (usually a spread over Overnight Index Swap (OIS)) on the currency borrowed that is equal to the funding rate of the voluntary bank.

WHAT HAPPENED IN 2008?

Between Sept and Oct 2008, TED Spreads had gone up very high (>1) and the FED had to open dollar swap lines for major economies to provide USD Liquidity**.



IMPLICATIONS OF THE RECENT ANNOUNCEMENT BY US FED -

- To avoid global liquidity tightening, US FED has opened dollar swap lines with 5 major economies – Bank of England, European Central Bank, Bank of Canada, Bank of Japan and Swiss Bank to meet the needs of financial institutions /corporates rushing for USD due to the current financial stresses
- The funding by US FED would be done at a rate which is 25 bps above OIS and the duration of the funding would be 84 days.
- No dollar swap line has been opened with Public Bank of China. If the PBOC has a USD shortfall, it might force them to sell US Treasury bonds i.e. negative impact on US treasury bond rates*.
- On 19th Mar 2020, FED extended \$450 billion dollar swap lines to other 9 central banks[^].

*A note by Credit Suisse's Zoltan Pozsar in Financial Times refers to such a situation. Please Click [Here](#)

** To know more on how FED used Dollar swap line in 2008, please Click [Here](#)

[^] To get more details on the recent announcement on dollar swap lines by FED, please Click [Here](#)

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