

Financial Market Electrocardiograms

Presented by ING IM Client Service

The financial market crisis of 2008 has brought forth an historic response from governments around the world.

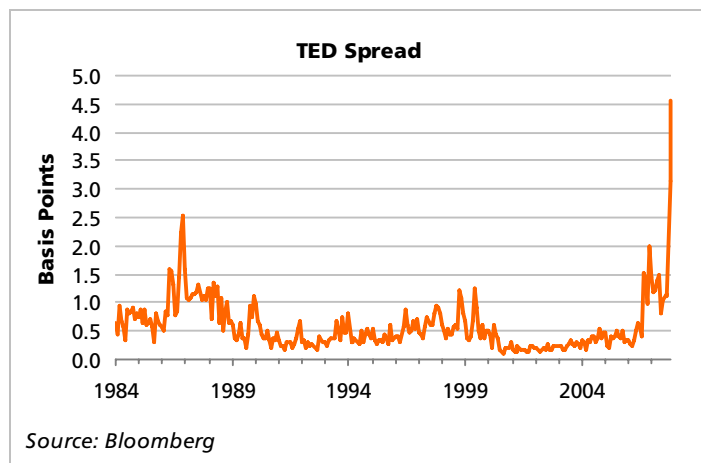
This coordinated exercise of political will has a high likelihood of being effective in arresting the downward spiral of confidence that has been reflected, first, in a virtual paralysis of trading in many interbank funding markets and, second, in a plunge in prices in those markets – such as for equities and commodities – that have been able to trade.

Several indicators of the degree of dislocation in money and credit markets have garnered close attention as investors and others monitor the progress of this worldwide market calamity and the historic official efforts to address it. Among them:

The TED Spread

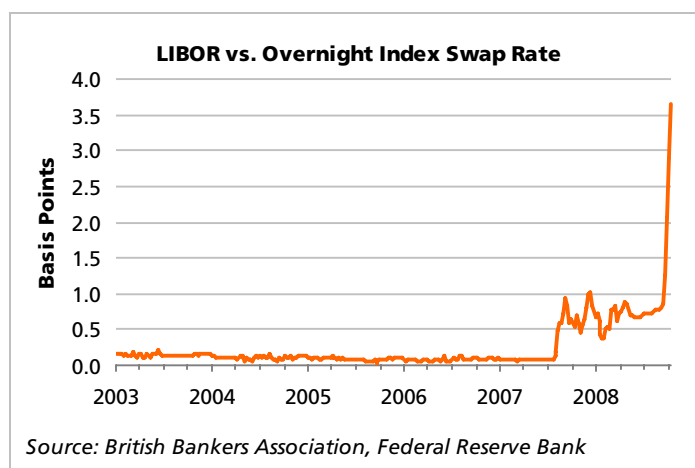
TED is an acronym for the spread between the market rates on U.S. Treasury instruments vs. those on interbank loans as measured by LIBOR (the London InterBank Offer Rate). The “ED” element of the acronym refers to Eurodollars, i.e., U.S. dollar-denominated loans arranged in banks outside the United States.

The spread, or difference, between these two rates is commonly interpreted as a measure of the degree of perceived credit risk in interbank markets and in the economy more generally. Lending among commercial banks involves some (usually minor in normal times) credit exposure while short-term Treasury securities are virtually risk-free. The spread between these two instruments indicates the incremental yield that market participants demand in order to accept the incremental risk involved in bank credit. The difference is usually expressed in terms of basis points.



LIBOR-OIS Spread

The LIBOR-OIS Spread is another carefully watched indicator of credit stress. It measures LIBOR against the Overnight Index Swap rate, which is in effect an expectation for the near-term future Federal funds rate. Like the TED spread, it is quoted in basis points, and like the TED spread, measures the difference between a risky and a risk-free rate.

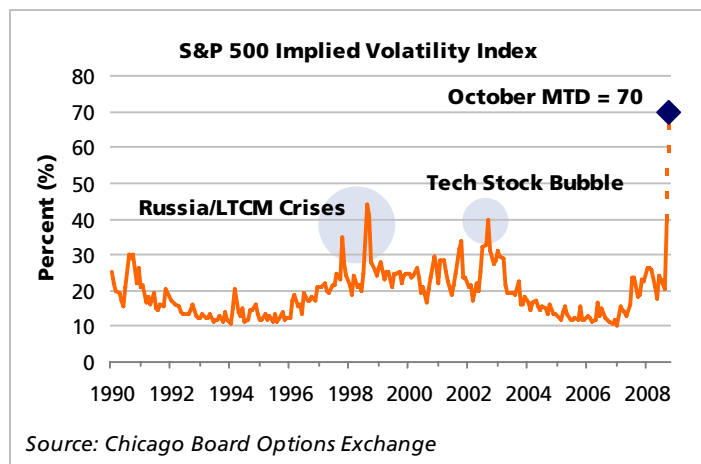


VIX

The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index. It is extracted as a mathematical implication of the expected future volatility of the S&P 500 Index, as derived from the market-clearing prices of put and call options. It is commonly interpreted as a measure of market uncertainty about the forward outlook.

It might also be thought of in insurance terms, as a market process for setting premium levels. Options sellers agree, in consideration for a premium, to buy (in the case of put option sellers) or sell (for call option sellers) equities or indexes for a specific future term at a specific fixed, or strike, price. The option buyer, in paying the premium, is relieved of the anxiety of not knowing what price might be available over the defined future period. When market uncertainty is high, options buyers will be eager to transact and option sellers will be reluctant, so higher premiums – higher readings on the VIX – will be required to clear these options markets. VIX is a measure of this market tension, and therefore an indicator of the degree of investor uncertainty.

Analogous measures exist for the Dow Jones Industrial Average and Nasdaq 100 Indexes; these are the VXD and the VXN, respectively.



Recent readings for the TED and LIBOR-OIS spreads have been “off the charts” in an almost literal sense: they have been, respectively, 3.8 and 5.9 standard deviations from the mean of the past twelve months, both of which far exceed the expected range for 99% of all statistical observations. The significance of this divergence from historical experience cannot be overstated. The recent VIX reading exceeds the high anxiety marks achieved in the 1998 Russia/Long-Term Capital Management and 2002 tech stock crash. The VXN rivals its reading of late September 2001. In the recent 60-70% range, they are over three times the expected historical average – and are clearly unsustainable.

In sum, it is not hyperbole to describe the current crisis as an economic heart attack. Heart attacks can be survived and patients can and do go on to lead long and healthy lives. In this case, the extraordinary initiatives taken by monetary, fiscal, regulatory, and legal authorities around the world to respond to the dangers of this financial seizure go a long way toward insuring the survival of the patient, the global capitalist market system. It is too soon to speculate in any useful detail about the therapies that will be needed to bring about a less risky, i.e., healthier, set of rules and behaviors for financial markets, but almost surely these will follow in train once the critical emergency is past.

We should be able to see progress toward a greater degree of sound fundamental health for global financial markets in their electrocardiogram readings in such measures as VIX and TED and other market measures of spreads and expected volatilities. ■

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