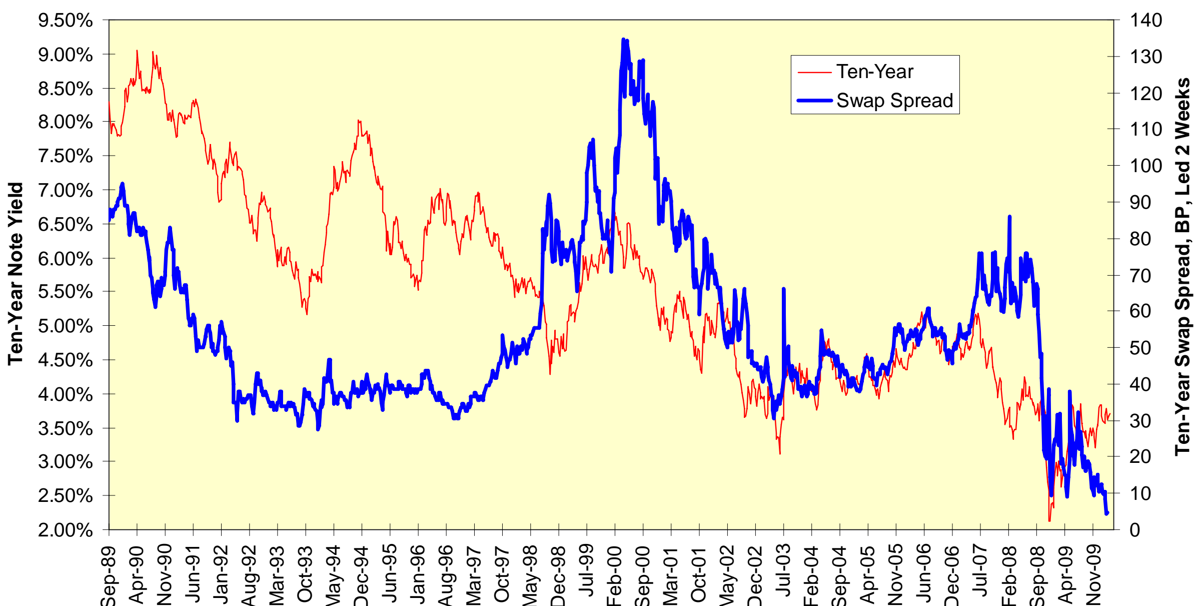
No Worries In Swap Land

The entire edifice of market sentiment analysis and contrary opinion is based on the premise the vast majority of your fellow investors are mindless simpletons who would make lemmings look like paragons of free will. This is a shame; many markets are information-rich as to where the path of least resistance lies, and we ignore them at our peril.

Let's take the case of the interest rate swap spread market. The terminology involved is often confusing when you first start looking at these markets, much like first-time sailors trying to remember which one is port and which one is starboard, but it is really quite straightforward. A fixed-rate payor is like the issuer of a bond with a fixed coupon payment. Someone who is a floating-rate payor and is subject to rising interest payments should rates rise may want to pay a premium, or swap spread, to fix those payments. Rising swap spreads, therefore, indicate increasing fear of rising interest rates.

What we see below is a rather relentless drive lower in swap spreads. Those who would be hurt by rising rates are in no hurry to fix their payments. This was very understandable during periods such as 2001-2002 and against in 2008 when investors were piling into Treasuries to avoid stock market risk, but it is a little less understandable now. Long-term Treasury yields rose for much of 2009 and have given no indication of resuming a decline now. A chart of ten-year Treasury yields year-to-date looks like the textbook version of a trading range.

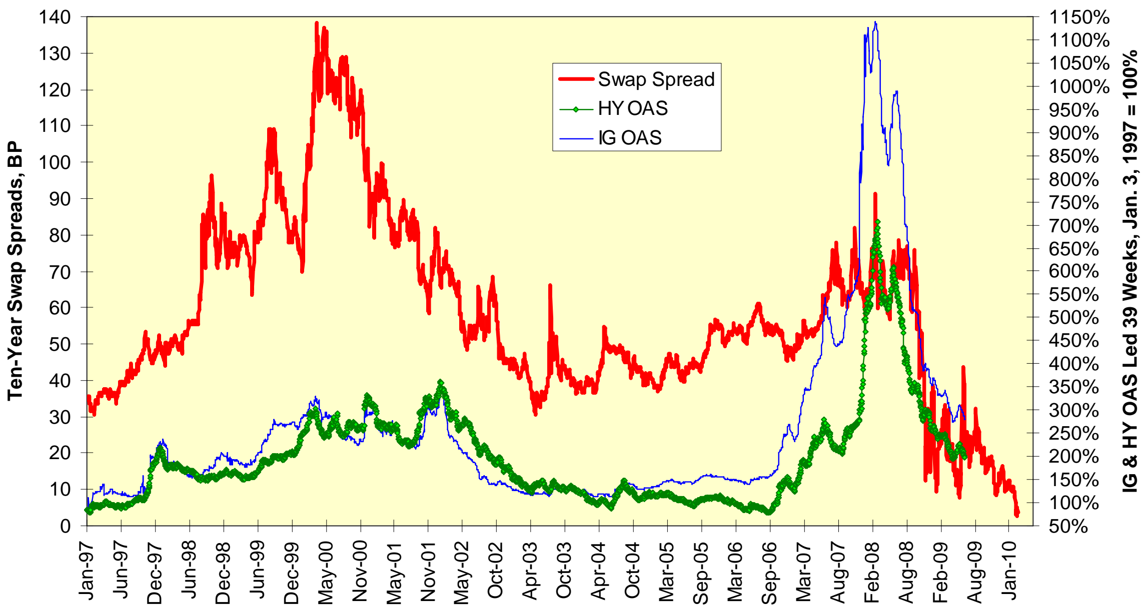
Swap Spreads Driving Lower Relative To Ten-Year Treasury



Swap Spreads And Corporate Bonds

Do these declining swap spreads mean anything to corporate bonds and eventually to equities? The answer here is a most definite, "Yes." Swap spreads actually lead the option-adjusted spreads (OAS) to Treasuries for high-yield and investment-grade corporate bonds by as much as 39 weeks, or three calendar quarters. This makes intuitive sense: As swap spreads narrow in a liquid environment, the cost of capital for corporate bond issuers declines relative to Treasuries. If we extend the matter one step further, declining cost of capital leads to increased corporate profitability, which in turn is alleged to have something to do with stock prices.

Falling Swap Spreads Compress Corporate Credit Spreads



It is hard, therefore, to look at the picture of narrowing swap spreads and conclude anything negative about U.S. financial markets for the remainder of 2010. This statement should scare anyone, contrarian or not, who understands this simple principle markets tend to punish those who pile into the obvious trade. However, as long as we have almost recklessly aggressive monetary and fiscal stimulus, both in the U.S. and abroad, the path of least resistance does not involve fighting it.

If you see swap spreads starting to rise, you will have plenty of warning about when these conditions will change.