Look Both Ways When Crossing Bond Street

The toughest course of action for any trader is to stay with an established trend. The temptation to pick tops, bottoms and retracement levels becomes enormous, and who amongst us has not lamented at least once that we sold too soon? In the U.S. stock market, only three trades have been necessary in my lifetime: A purchase on my Eisenhower-era birthday, a short sale on March 24, 2000, and a reversal back to long on March 12, 2003. That's it; all other actions can be labeled superfluous.

The second toughest course of action is to believe a trend breakout has occurred. While it is fashionable to sit around moaning there's just not enough action in the market, the simple fact is we get used to the comfort of buying the lows and selling the highs. Risk management in these markets is easy for the mistakes are relatively cheap and painless.

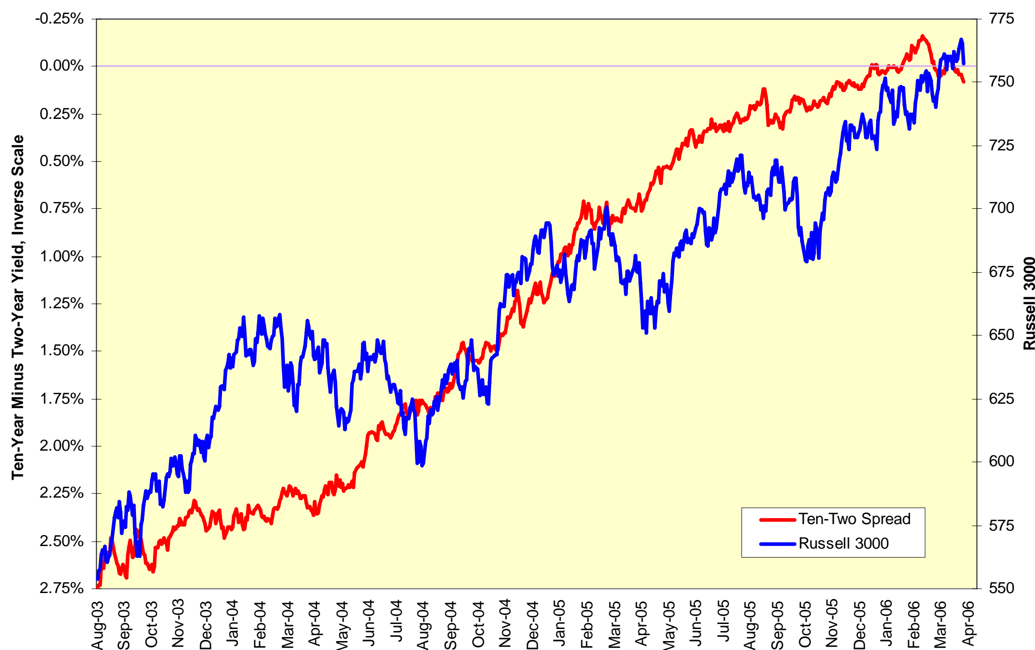
Bond Market Distractions

So it has been in the bond market. As recently as last December, the main question was not whether long-term interest rates were in any danger of breaking out of a range established in May 2003, it was whether the flatter yield curve would invert and lead to a recession. Well, the yield curve did invert, the inversion has not led to a recession and the overall tenor of the bond market has shifted from that of a bullish flattening of the yield curve to a bearish steepening of the yield curve.

A bearish steepening of the yield curve while the Federal Reserve remains on its tightening course is not a trivial matter. An increase in the federal funds rate to 5.00% at the May 10th FOMC meeting is priced into the market already and the odds of another 25 basis point hike on June 29th are just below 50%. If the bond market senses the Federal Reserve is behind the curve in stamping out rising inflation, then all we would need to put the ten-year note yield up to a long-term technical resistance level of 5.75% is the spread between the ten-year note and the federal funds rate seen last December. Some resist this possibility; as noted above, trading ranges induce disbelief at their breakout points.

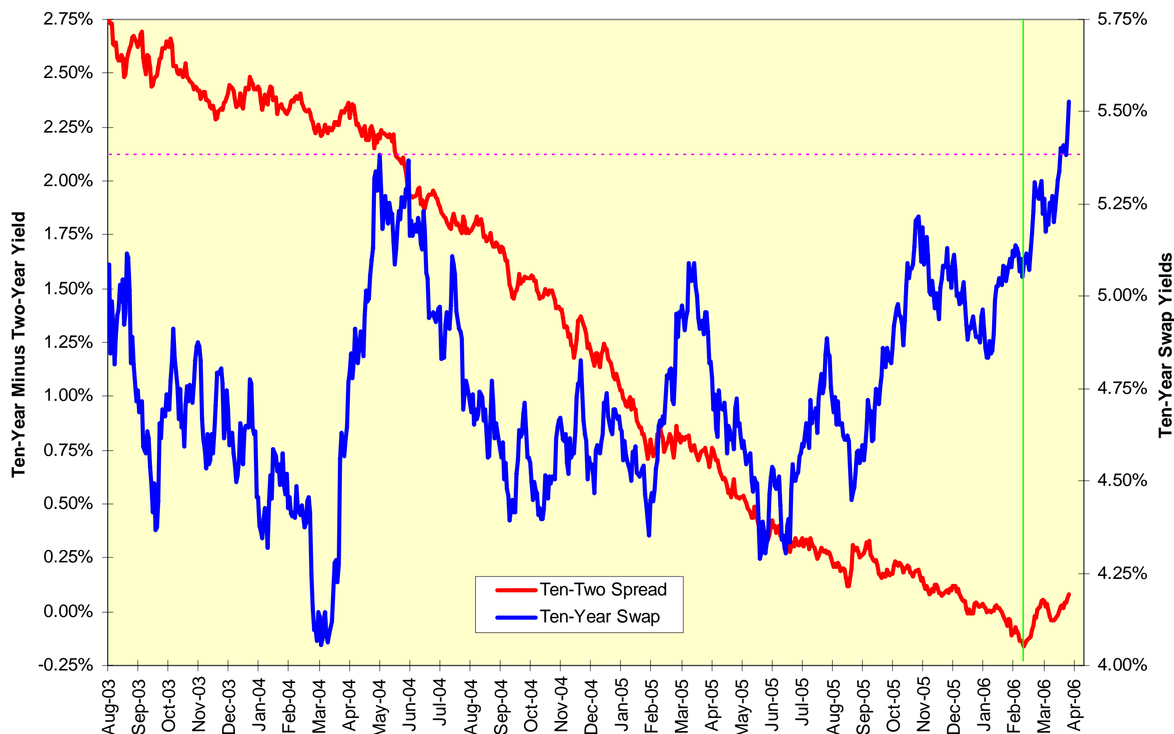
Levels Matter

Let's review some of the concepts discussed last December. First, for all the misguided concerns over the yield curve, the bumper stickers have it right: Spreads don't kill people. The broad-based Russell 3000 rose as the yield curve, plotted inversely as the spread between ten-year and two-year notes, narrowed and then inverted.



The message from the equity market was as clear as it should have been. For all of the misguided time and attention devoted to the Federal Reserve, the simple fact remains only a few financial firms are in the business of borrowing short and lending long. Everyone else looks at the swap curve for their costs of capital. A ten-year swap curve is the present value of all the intervening cash flows and therefore subsumes both the terminal rate and the shape of the intervening yield curve.

The yield curve reached its maximum inversion point of 16.33 basis points on February 23rd and has steepened 24.5 basis points since; ten-year swap rates have risen 44.2 basis points over the same period and have vaulted out of the top of the trading range.



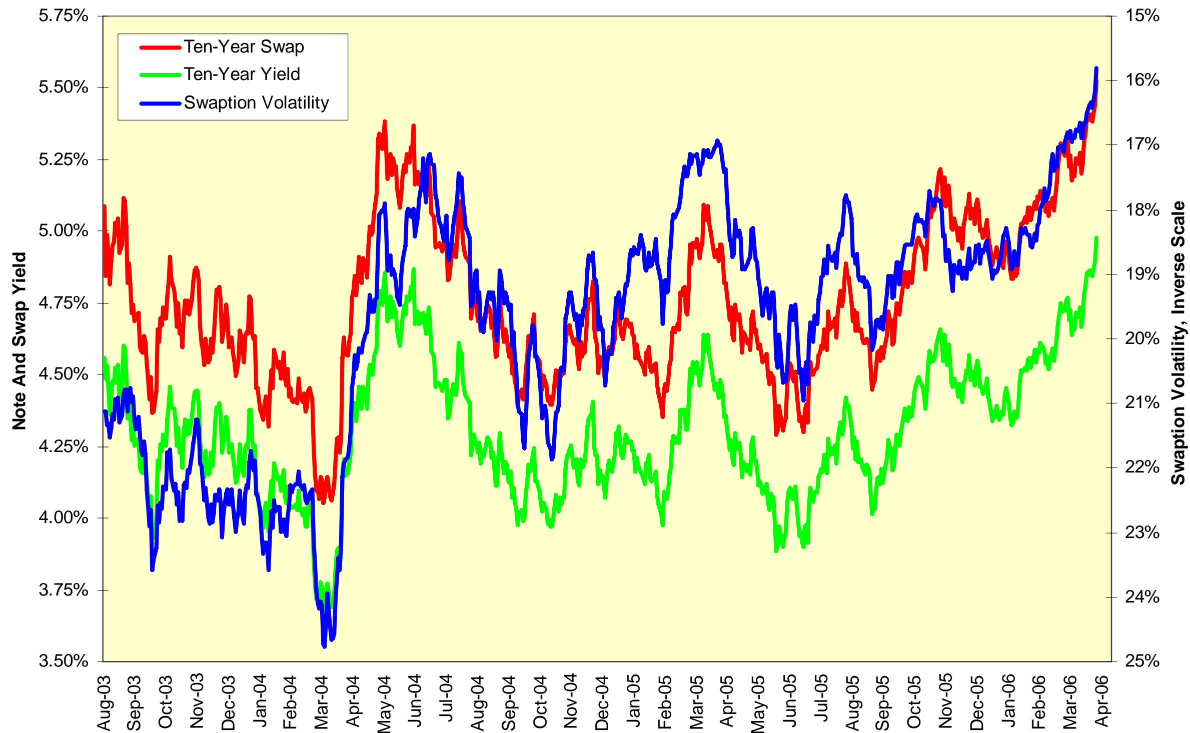
Swaption Signals

Let's revisit an esoteric topic from last December, swaption volatility. A swaption is the right but not the obligation to enter into a swap at some point in the future. A call swaption gives the buyer the right to receive the swap's fixed rate of interest and pay the floating rate of interest. This is a bullish position in bonds as you profit if rates fall in the future. A put swaption buyer has the right to receive the floating rate and pay the fixed rate; this is a bearish position in bonds as you profit if rates rise in the future.

We noted in December how swaption volatilities, plotted inversely, had been and still are moving closely with swap rates. The pattern has been for yields to peak at low swaption volatilities. Five months ago, swaption volatility had not fallen as rapidly as we might have expected, and we concluded that either volatility or swap rates were too high and:

> The most probable convergence given the widening spread between swaps and Treasuries is a downturn in swaption volatility at higher swap rates… If swaption volatility rises rapidly in a rising rate environment and then turns, then we can start speculating whether the Federal Reserve's rate-hike campaign is over and whether the yield curve will stop flattening. Until then, the risk is for higher rates and that, and not any particular level of the yield curve, should be the focus of our attention.

As swaption volatility is still falling rapidly, we have to conclude the risk for higher yields remains.



Winners And Losers

Let's return to an analysis first presented in February 2005 and revisited since. The table below lists the S&P 500 industry groups most and least sensitive to higher ten-year note yields. The negative numbers at the top are the victims. Unsurprisingly, the list is dominated by housing-related issues, financial firms and utilities. The positive numbers at the bottom are those least sensitive to higher rates. Interestingly, Automobile Manufacturers, for all of their other problems, are the least-affected by higher long-term interest rates. Their other problems dominate this concern.

S&P 500 Industry Group Sensitivity To Ten-Year Note Yields

Group	Relative Performance Beta
Homebuilding	(0.378)
Gold	(0.269)
REITs	(0.210)
Electric Utilities	(0.153)
Specialized Finance	(0.136)
Multiline Utilities	(0.135)
Construction Materials	(0.111)
Gas Utilities	(0.098)
Managed Health	(0.095)
Thrifts & Mortgages	(0.090)
Diversified Banks	(0.081)
Regional Banks	(0.065)
Consumer Finance	(0.060)
Office Services	0.042
Computer Hardware	0.047

Aerospace & Defense	0.048
Systems Software	0.052
Data Processing	0.061
Advertising	0.061
Environmental Services	0.063
Drug Retailers	0.068
Apparel & Accessories	0.072
Specialty Stores	0.075
Diversified Chemicals	0.079
Applications Software	0.082
Railroads	0.112
Department Stores	0.118
Motorcycle Manufacturers	0.121
Steel	0.140
Internet Retailers	0.141
Employment Services	0.143
Automobile Manufacturers	0.154

A final note of caution is in order. If the accepted financial theory that stocks are the discounted stream of future dividends has any validity whatsoever, either earnings growth will have to outstrip the increase in interest rates or investors will have to become more risk-seeking for the market to rise. As we saw in both 1987and 1999, neither alternative is impossible. Just ask yourself how both those market cycles ended and invest accordingly.