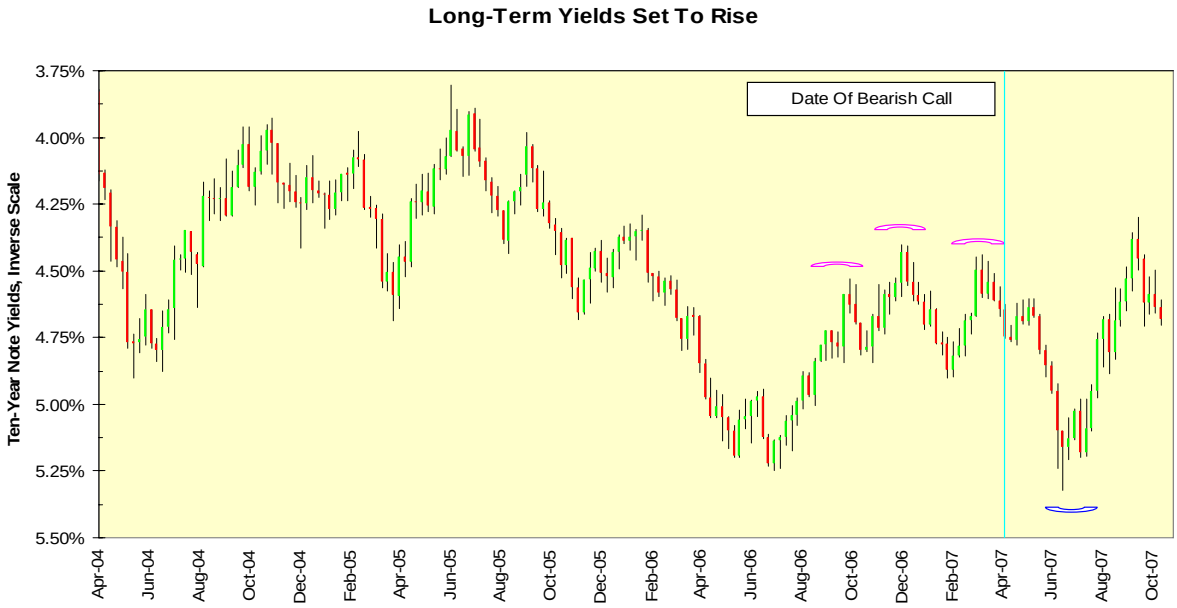
Bonds Are Again Turning Bearish

If anything in your life is going to get interrupted, it might as well be a bear market in bonds. An April column written after a head-and-shoulders bottom in yields, marked with magenta arcs in the inverted-scale chart below and entitled "Bonds Turning Bearish," offered its conclusion in the title. While I was not rooting for death and destruction in fixed-income land, I did take a minor measure of satisfaction for a prescient forecast when yields hit five-year highs in June, marked with the blue arc.

The reasons for this bearish call included the very real possibility of higher short-term rates in Japan, strong global growth and signals from both the Federal Reserve and the European Central Bank they were worried about rising inflation.



What led to *ursus interruptus* and the August-September rally in bonds? The answer, pure and simple, was the credit crisis and subsequent end of civilization as we know it during the same time period. Now that the world has come back from the dead – it's a miracle! – interest rates are set to resume their rise.

We can support this outlook with two unconventional and – apologies in advance – complex indicators.

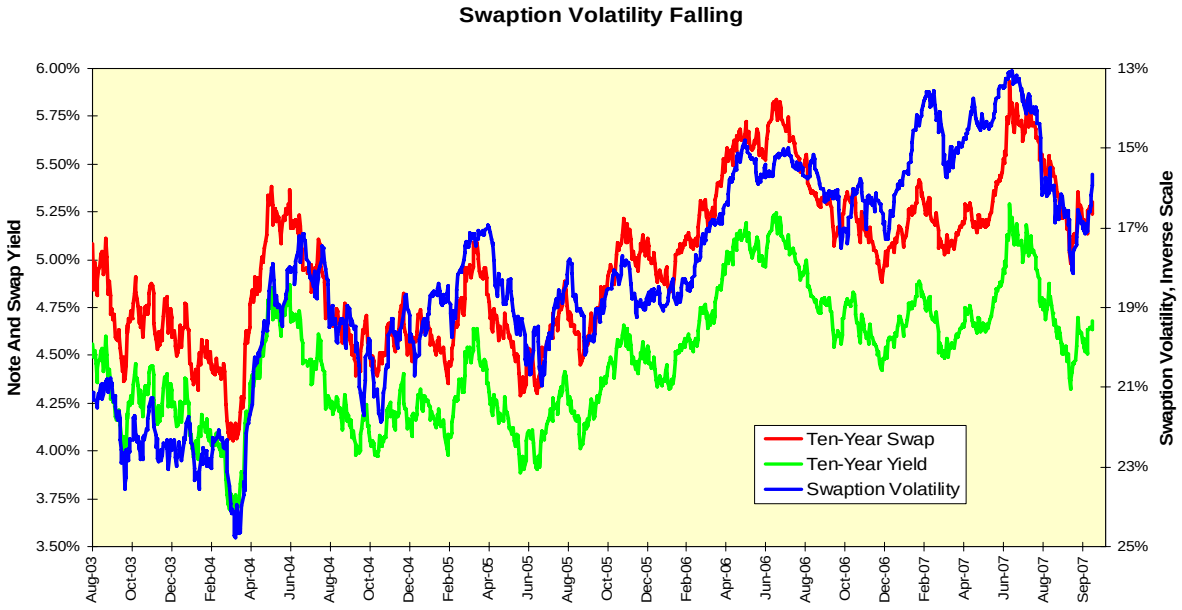
Let's Go Do The Swap

An important starting point for analyzing any market is asking how a manager therein gets fired. One of the best ways for a stock manager to decide to spend more time with his family and pursue personal interests is to be out of the market when it rallies. There's no place to hide; your investors will hunt you down to the ends of the earth. That is one reason why volatility in stocks rises when the market falls: Everyone is long and is seeking protection from their own excesses.

It is different in bonds, or at least in conventional bonds as opposed to the various fixed-income derivatives that got people in so much trouble over the summer. Here managers get shown the door when the duration of their portfolio is too long when yields rise. That shows they were taking too much risk. Paradoxically, bond volatility rises when yields fall and prices rise; this is viewed as the unsustainable environment.

This relationship was used in a December 2005 column on using swaption volatility as a bond market indicator. 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.

Swaption volatilities, plotted inversely, have been moving closely with swap rates since the yield curve began to flatten. And the pattern has been for yields to have bottomed at high swaption volatilities and for yield to have peaked at low swaption volatilities.



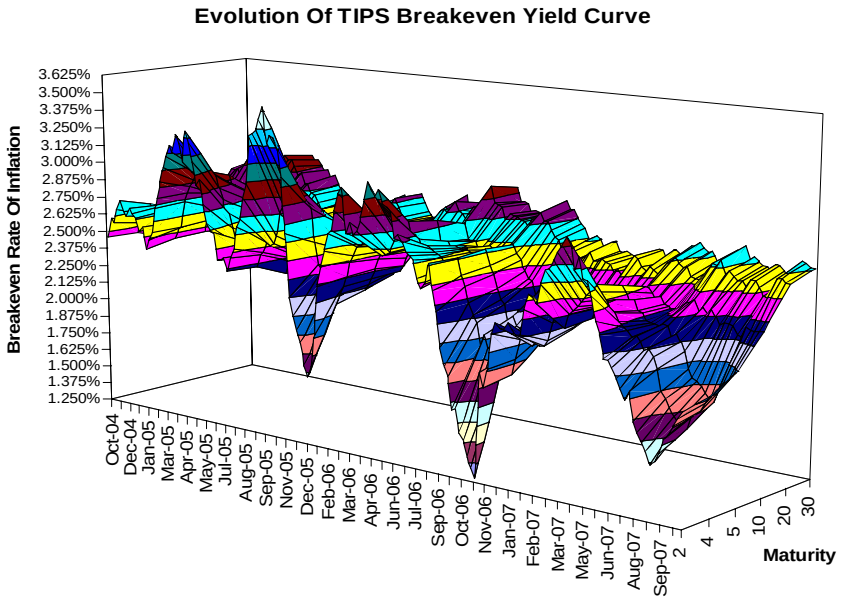
Swaption volatility has been falling rapidly since yields for both ten-year notes and ten-year swaps bottomed in early September. This suggests market participants are comfortable with the trend of rising rates, and that is true for players on both sides of the market. Someone who is paying a floating rate might believe the current rise in yields is temporary and is in no hurry to swap this into a fixed rate. Someone who is paying a fixed rate is in no hurry to expose himself to paying higher floating rates anytime soon.

This odd agreement by both fixed-rate payors and fixed-rate receivers that the current rise in yields is to be expected is oddly reminiscent of the backwardation situation in crude oil discussed here two weeks ago. There backwardation meant both buyer and seller of crude oil agree the current price is too high and should fall. Here declining swaption volatility means both borrower and lender of money agree the trend of rising yields has further to go.

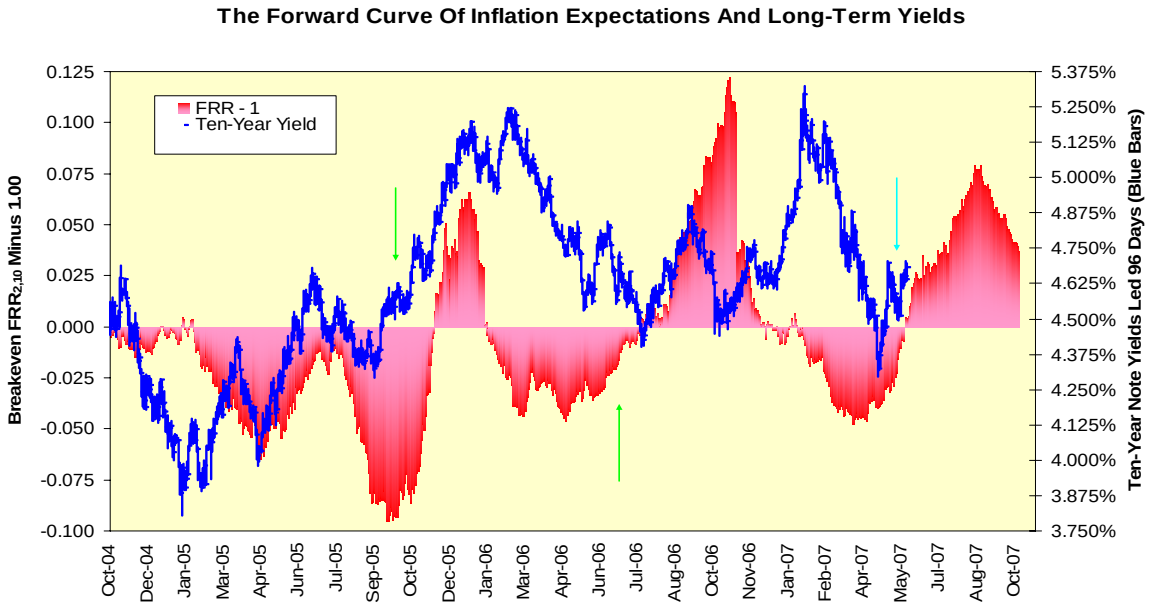
Inflation Expectations

The only difference between people who believe inflation is running at a 2.0% rate and those who believe in the Tooth Fairy is most of us received money from a Tooth Fairy-wannabe at some point in our lives. Still, enough people are drinking the Kool-Aid to keep at least the ten-year TIPS breakeven rate hovering near 2.3%. I discussed some distortions of this breakeven rate last month.

But thanks to the government – imagine those words rolling off my tongue – we have both TIPS and Treasuries of various maturities and can construct a forward curve of TIPS breakevens. Over the past three years, the term structure of TIPS breakevens has oscillated between an inverted curve, implying declining future rates of inflation, and a positively sloped curve, implying rising future rates of inflation.



If we distill the surface plotted above into a single segment, that between two and ten years, and express it as the forward rate ratio (FRR) minus one, we see a very distinct picture emerge. The FRR here is slope of the breakeven curve for eight years starting two years from now divided by the ten-year breakeven rate of inflation. The more this exceeds 1.00, the steeper the yield curve of inflation breakeven rates.



This FRR leads ten-year note yields by 96 days on average. Two previous episodes of a rising FRR in the fall of 2005 and again in the summer of 2006, both marked with green arrows, led ten-year note yields higher. Our current configuration, marked with a turquoise arrow, is poised to do the same.

The implications are clear. Avoid long-term bonds and stocks such as utilities and banks that are interest-rate sensitive. Short-term aggressive traders may want to start trading interest rate proxies such as the iShares 20+ Year Treasury Bond ETF (TLT) from the short-side.