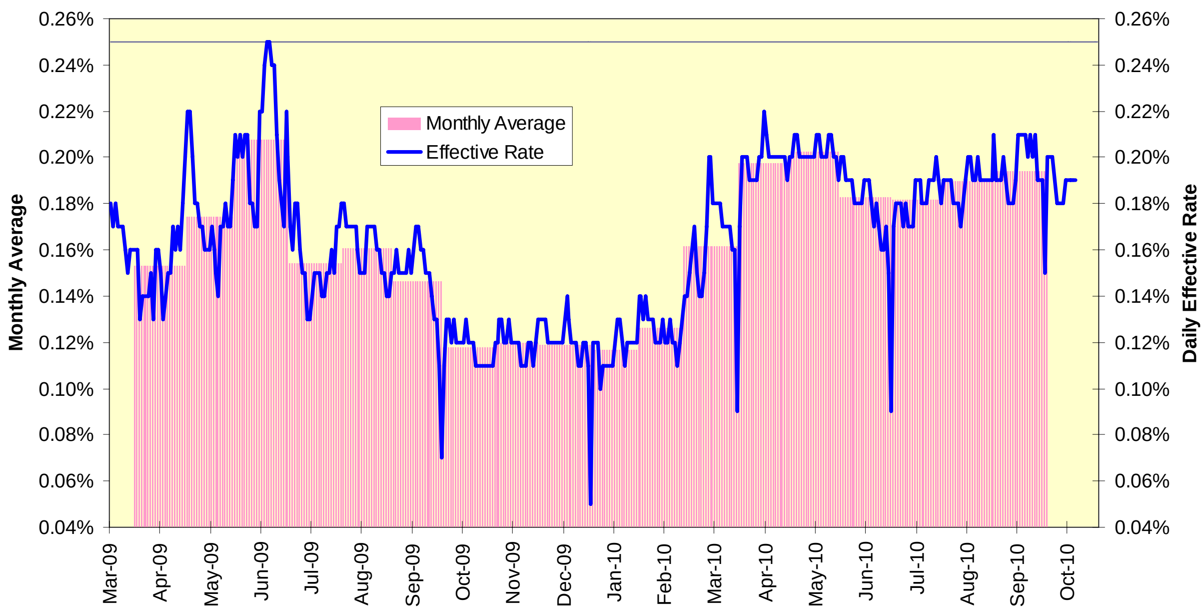
When A Bet Is Not A Bet

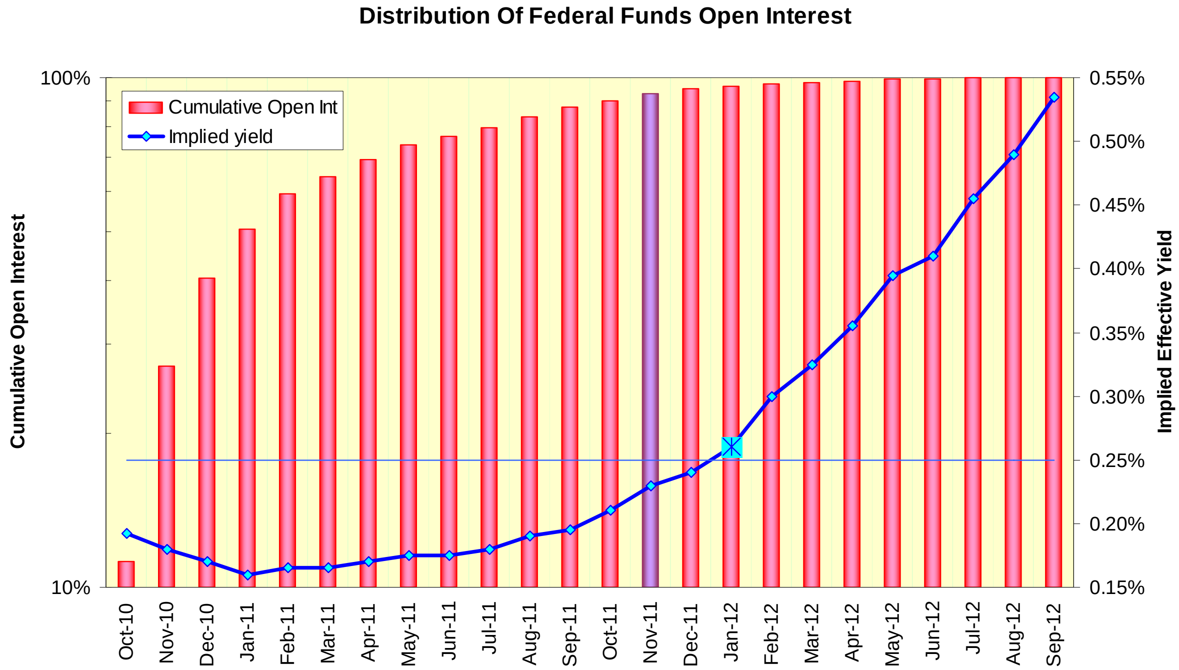
Has any carnival-barker ever drawn a crowd with, "Step right up and refloat your fixed-rate overnight index swaps!"? Probably not; traders are supposed to be risk-takers, cool and calculating, skirting along the edge of the road and asking passersby for the telephone number for 1-800-GAMBLER.

How, then, can we account for the rather massive net long position by non-commercials in federal funds futures reported by the Commodity Futures Trading Commission in their weekly Commitment of Traders report? As the contract is settled against the monthly average of effective overnight federal funds, there just does not seem to be much of an upside. Let's map those monthly averages and daily effective federal funds since the March 2009 advent of quantitative easing. The maximum of the Federal Reserve's target range since December 2008, 0.25%, has been hit once, in June 2009.

Effective Federal Funds Since QE1



Moreover, the market is pricing in more of the same for a long time to come. Here is a snapshot of the contract chain going forward taken on October 21, 2010. More than 90% of the total open interest lies before the November 2011 contract, highlighted with a violet column, and the 0.25% level is not reached until January 2012, highlighted with a large blue marker.



While it is technically possible for a trader to bet, say, the October 2011 contract will rally from its present 0.21% to the January 2011 level of 0.16%, that strikes me as a "why bother?" trade with a poor risk/reward ratio, especially once the total transactions costs are involved.

The answer, I am certain, lies in that refloating of fixed-rate overnight index swaps (OIS). A fixed-rate payor in the OIS market is someone who has borrowed a strip of overnight federal funds at a fixed-rate. Once those rates, which I will go out on a limb and guess looked incredibly low at the time, became incredibly lower, the fixed-rate payment position looked like a loser for the very good reason it was. To unwind the bad loan, the trader could go long federal funds futures.

Trades such as these in the federal funds or Eurodollar futures markets are a reason why everyone should be careful using the Commitment of Traders data. What may look like an outsized or puzzling bet may in fact be a spread or hedged trade that has little or nothing to do with a directional bet. The net non-commercial position in ten-year note futures had been negative for months while the market was rallying, and some contracts such as RBOB gasoline or silver always show net long non-commercial positions.

It is easier to explain someone paying their money and taking their chances. But the simple answer is not always the right one, and that is a pretty good bet.