Industry Group Impact Of Rising Swap Spreads

You've got to hand it to Uncle Sam – and you might as well, because he will take it anyway – for finding a way of announcing they are going to purchase $600 billion of Treasury bonds with money printed in the basement and then watching as their price fall. I am sure, though; they will find a way to say this was their intention all along.

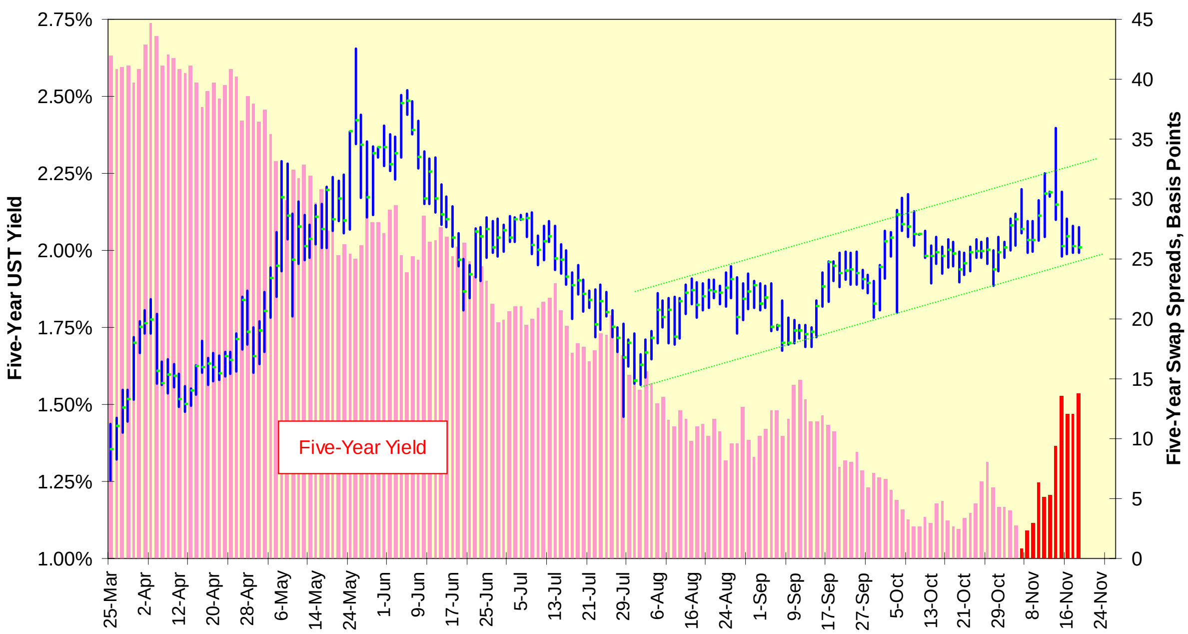
Military history buffs may recall a similar tactic used by British General Bernard Montgomery during the Normandy campaign: After his troops failed to seize the town of Caen immediately after the landings and after failing for weeks to take it thereafter, he told his American counterparts that his eventual and belated capture of the town, ten miles inland from the beach, was part of his plan all along and that had the Americans been better military men they would have understood it!

Swap Spreads

Let's return to the topic of rising swap spreads, last addressed in March. A rising swap spread reflects a combination of greater financial system stress and a belief rates are poised to rise; they reflect a greater demand by floating-rate payors to fix their payments before rates rise further.

Five-year swap spreads have been rising gently since late July, as highlighted in the trend channel below. The sudden jump in five-year Treasury rates themselves, emphasized with the bright red data points since the last FOMC meeting, arrived two months after the rise in swap spreads, so score one for the cautious and diligent.

Five-Year Swap Spreads Rising Since July



Impact

Now let's look at the industry group impact of rising swap spreads will be using the same methodology discussed in May. A total of 39 industry groups representing 23.38% of the S&P 1500 Supercomposite's market capitalization, concentrated heavily in the financial sector, will be affected negatively (left-hand cells of the table) by rising swap spreads. Thirty-six groups representing 38.53% of market capitalization and concentrated in the healthcare, utility and consumer staple sectors can be expected to outperform in a rising swap spread market.

The net impact is a negative 0.13%. Each one percent increase in swap spread levels can be expected to reduce the S&P 1500 by 0.0013%, all else held equal.

Five-Year Swap Spread Beta-Weighted Impact On S&P 1500

	SPR Weight	SWSP5 Beta	Weighted Beta
Industrial REITs	0.09%	0.074	0.000
Other Diversified Financial Services	3.31%	0.072	0.002
Diversified Banks	1.67%	0.071	0.001
Life & Health Insurers	1.04%	0.065	0.001
Investment Banking & Brokerage	1.27%	0.061	0.001
Tires & Rubber	0.02%	0.061	0.000
Multiline Insurers	0.40%	0.059	0.000
Asset Management & Custodial Banks	1.15%	0.056	0.001
Diversified Metals & Mining	0.33%	0.056	0.000
Homebuilding	0.16%	0.055	0.000
Diversified REITs	0.17%	0.055	0.000
Consumer Finance	0.80%	0.054	0.000
Coal & Cons. Fuels	0.26%	0.053	0.000
Office REITs	0.31%	0.051	0.000
Automobile Manufacturers	0.39%	0.047	0.000
Retail REITs	0.52%	0.044	0.000
Steel	0.38%	0.041	0.000
Residential REITs	0.36%	0.041	0.000
Regional Banks	1.46%	0.041	0.001
Multisector Holdings	0.04%	0.041	0.000
Aluminum	0.10%	0.038	0.000
Specialized Finance	0.40%	0.037	0.000
Specialized REITs	0.71%	0.036	0.000
Construction & Engineering	0.29%	0.036	0.000
Construction & Farm Machinery	1.14%	0.029	0.000
Paper Products	0.14%	0.029	0.000
Construction Materials	0.10%	0.028	0.000
Building Products	0.10%	0.026	0.000
Oil & Gas Equipment	1.60%	0.026	0.000
Hotels	0.33%	0.024	0.000
Thrifts & Mortgages	0.23%	0.024	0.000
Commercial Printers	0.05%	0.023	0.000
Industrial Conglomerates	2.11%	0.022	0.000
Oil & Gas Refining	0.18%	0.022	0.000
Auto Parts & Equipment	0.25%	0.018	0.000
Diversified Chemicals	0.84%	0.016	0.000
Oil & Gas Storage	0.33%	0.016	0.000
Railroads	0.73%	0.015	0.000
Electrical Components & Equipment	0.63%	0.010	0.000
Subtotal:	24.38%		-1.08%

	SPR Weight	SWSP5 Beta	Weighted Beta
Pharmaceuticals	5.51%	0.024	0.001
Household Products	2.30%	0.038	0.001
Soft Drinks	2.30%	0.036	0.001
Packaged Foods	1.66%	0.034	0.001
Electric Utilities	1.96%	0.026	0.001
Integrated Telecommunications	2.45%	0.019	0.000
Biotech	1.42%	0.031	0.000
Tobacco	1.48%	0.029	0.000
Multiline Utilities	1.47%	0.028	0.000
Hypercenters & Superstores	1.19%	0.034	0.000
Systems Software	2.95%	0.013	0.000
Restaurants	1.29%	0.029	0.000
Computer Hardware	3.12%	0.011	0.000
Healthcare Services	0.75%	0.038	0.000
Data Processing & Outsourcing	1.27%	0.021	0.000
Managed Health	0.90%	0.029	0.000
IT Consulting & Services	1.81%	0.013	0.000
Drug Retailers	0.59%	0.026	0.000
Healthcare Distributors	0.42%	0.037	0.000
Healthcare Equipment	0.42%	0.032	0.000
Life Sciences Tools & Services	0.48%	0.023	0.000
Food Retailers	0.31%	0.030	0.000
Gold	0.25%	0.037	0.000
Environmental Services	0.35%	0.019	0.000
Healthcare Facilities	0.16%	0.038	0.000
Personal Products	0.24%	0.022	0.000
Food Distributors	0.19%	0.024	0.000
Gas Utilities	0.37%	0.011	0.000
Education Services	0.15%	0.026	0.000
Healthcare Suppliers	0.12%	0.029	0.000
Automotive Retailers	0.23%	0.014	0.000
Leisure Products	0.17%	0.014	0.000
Distillers & Vintners	0.09%	0.027	0.000
Distributors	0.09%	0.020	0.000
Brewers	0.07%	0.023	0.000
Water Utilities	0.03%	0.032	0.000
Subtotal:	38.53%		0.96%
Total:	**62.91%**		**-0.13%**

While this may seem like something of a minor impact, please remember five-year swap spreads never rise at a convenient time; they rise during financial crises to levels four and five times today's levels. Whenever corporate bonds are being dumped and stocks are on the ropes, that is when players in the interest rate derivatives market decide now is the time to buy insurance. As the swap market worldwide is dominated by a handful of large banks too-big-to-you-know-what, they will avail themselves of the opportunity to engage in another crisis and stick you and me with the tab.

Those banks are the very same ones affected negatively by rising swap spreads. They are gambling with our money once again knowing they, under Dodd-Frank, are "systemically important." Failure: It's the new F-word.