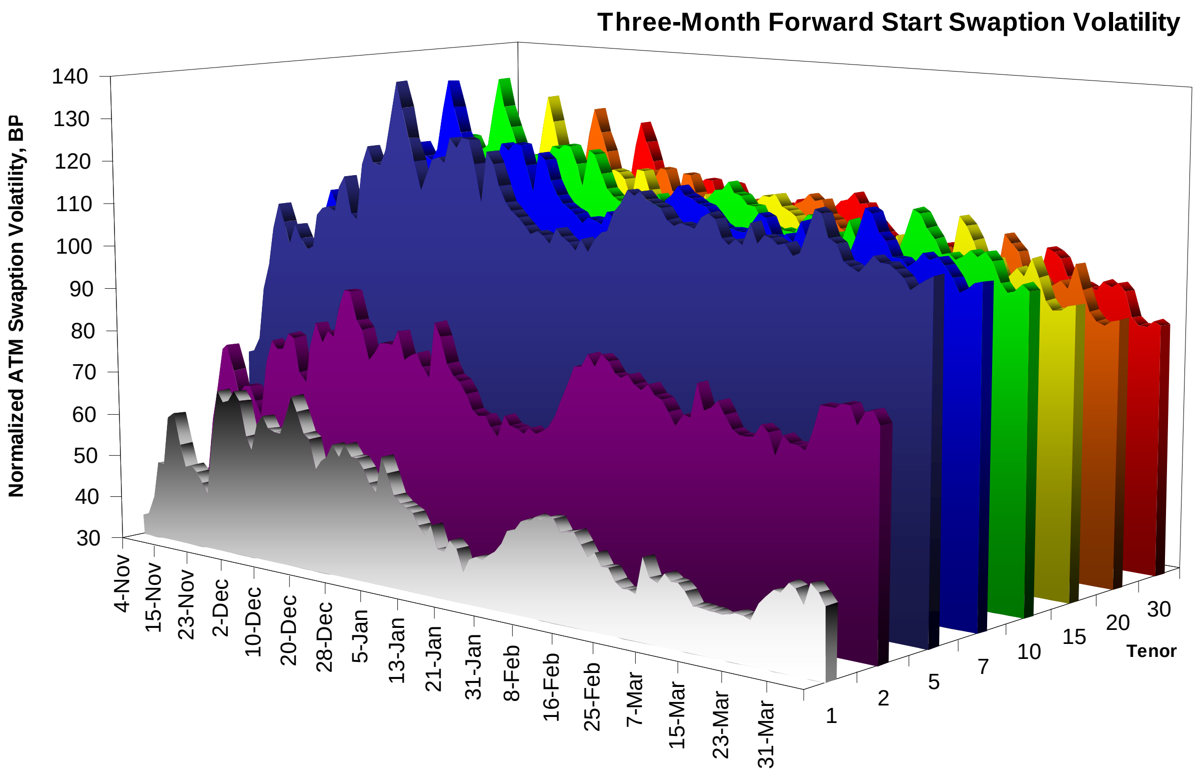
Swap Market's Path Dependency

You will often hear some Wall Street gasbag described as "often wrong but never in doubt," and there is a good reason for that person to be GWA (Gasbag With Attitude). Regardless of what today brings in this business, you have to have an opinion for tomorrow.

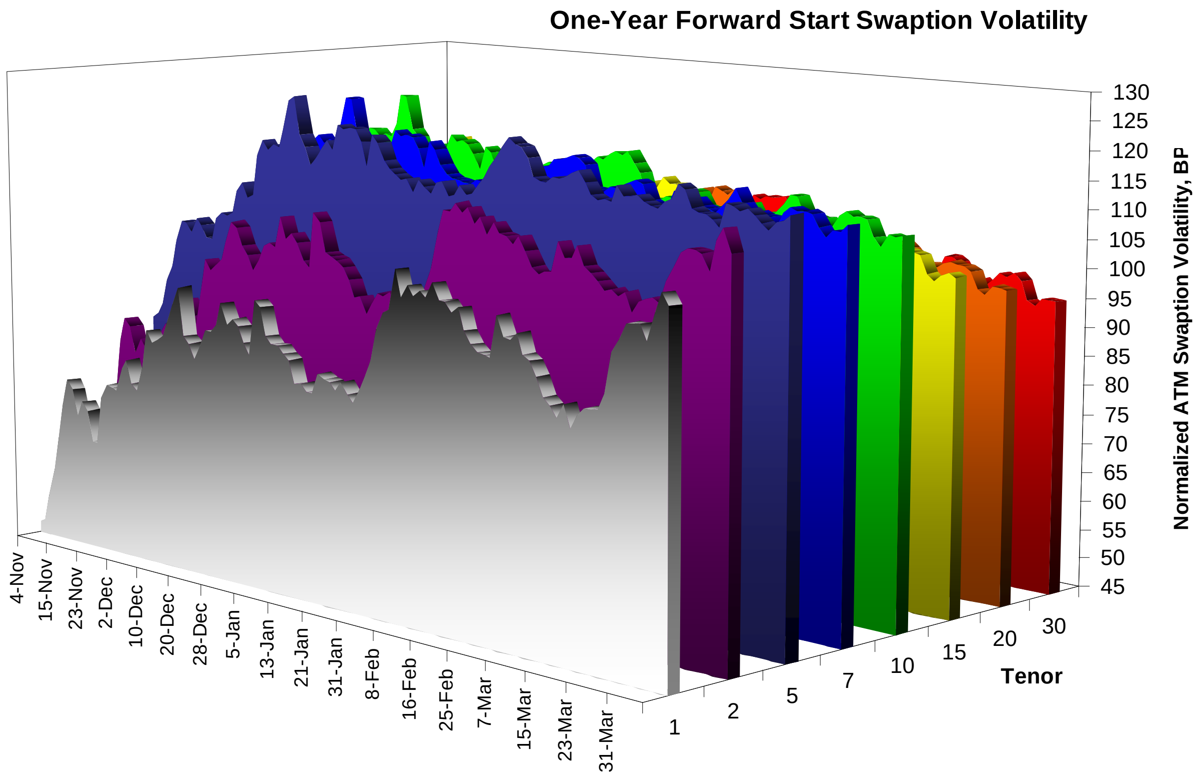
If we combine this with the precept markets measure but do not forecast, the result is each day's matrix of spreads, forward rates, option prices, etc, is an exquisitely detailed and internally consistent web that will age as well as fresh lettuce.

Buying Protection Against Higher Rates
Let's return to an analysis from last August based on swaption volatilities. A swap spread is the price someone with a floating-rate loan is willing to pay to fix that rate, a lower swap spread denotes willingness to stay floating in the belief rates are headed lower still. A swaption is an option to enter the fixed-rate payment leg of that swap. Higher swaption volatility reflects a stronger belief rates are going to rise by the time the option expires; lower volatility indicates a greater willingness to stay floating.

What does the snapshot look like at present? If we map the swaption volatilities for swaps starting three months from now, the period just after QE2 is set to ride off into the sunset, we see volatilities for both one- and two-year swaptions remain subdued.



If we repeat the exercise for swaptions on swaps starting one year from now, the answer looks very different. Not only have the swaption volatilities for one- and two-year swaps been rising since mid-March when various Federal Reserve officials started campaigning against the Federal Reserve's money-printing policies, (sort of like politicians seeking national office by running against "Washington," no?) they have reached the levels of five- and seven-year swaptions. The market definitely is willing to pay protection for higher rates starting sometime in the last half of this year or in early 2012.



How To Execute

Left unsaid in all of this is how the Federal Reserve will execute its exit strategy; no one ever has tried to reduce a $2.7 trillion balance sheet down toward the $900 billion or so level prevailing before the financial crisis. If the Federal Reserve simply tries to raise the target funds rate without reducing the balance sheet, you could see a massive and inflationary drop in the demand for cash balances and a jump in commercial bank lending.

However, if the Federal Reserve starts to sell assets in the open market, the question will arise, “To whom?” They are now the largest holder of Treasury securities; Japan and China are right behind, and the common thread for all three holders is they do not have a profit-and-loss statement in the true sense of the phrase. No one else is in position to buy what they have to sell and certainly not at the absurdly low yields prevailing in a rising-inflation environment.

This is why I think the present Federal Reserve crowd will end QE2 and then wait in hope they will not have to face the day of reckoning on balance sheet reduction. A delay will mean the market will have anticipated incorrectly, but so what? The market has a margin for error; the Federal Reserve does not, and any mistake on their part post-QE2 could lead to a real abruption in interest rates.