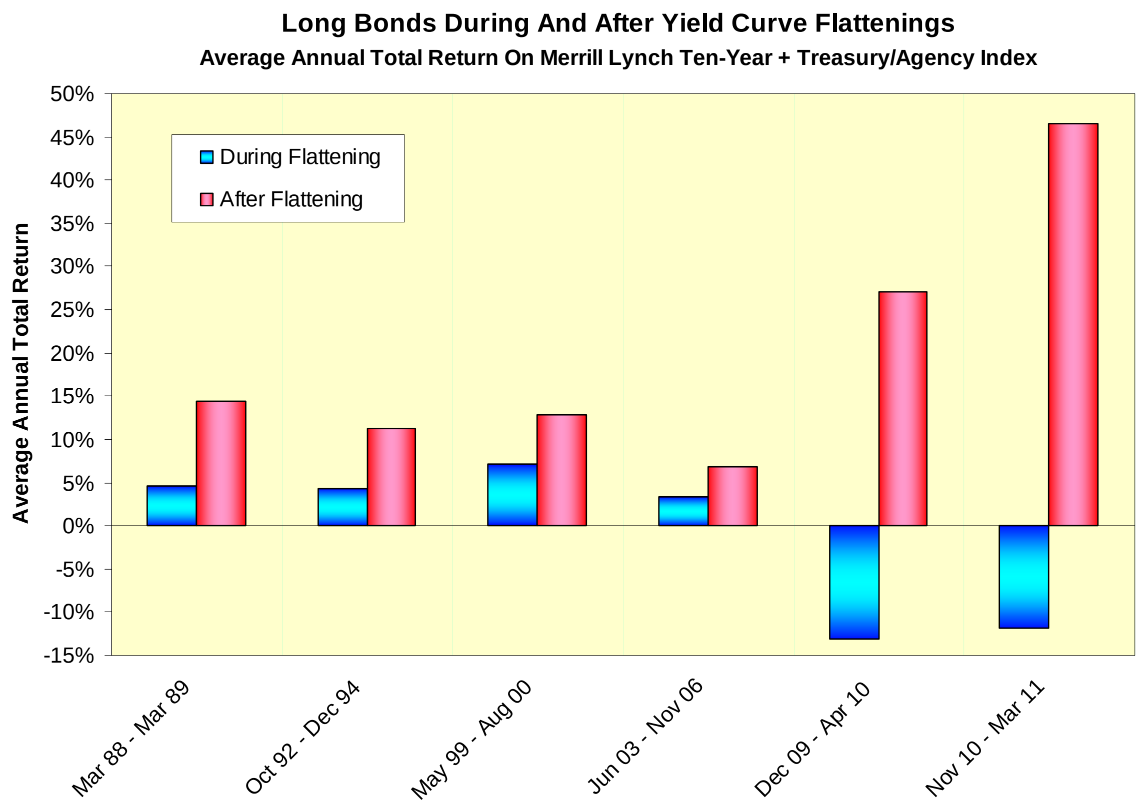
Yield Curve Trades During The Twist

Let's not mince words: If any of the massive fiscal and monetary interventions undertaken since the start of the financial crisis worked we would not be talking about doing more of the same. The mission would have been accomplished by now. Imagine, then, my surprise upon hearing some of the FOMC's doves are talking about buying more securities; great, just what we need these days, another reward for holders of paper assets while the real economy treads water on its good days.

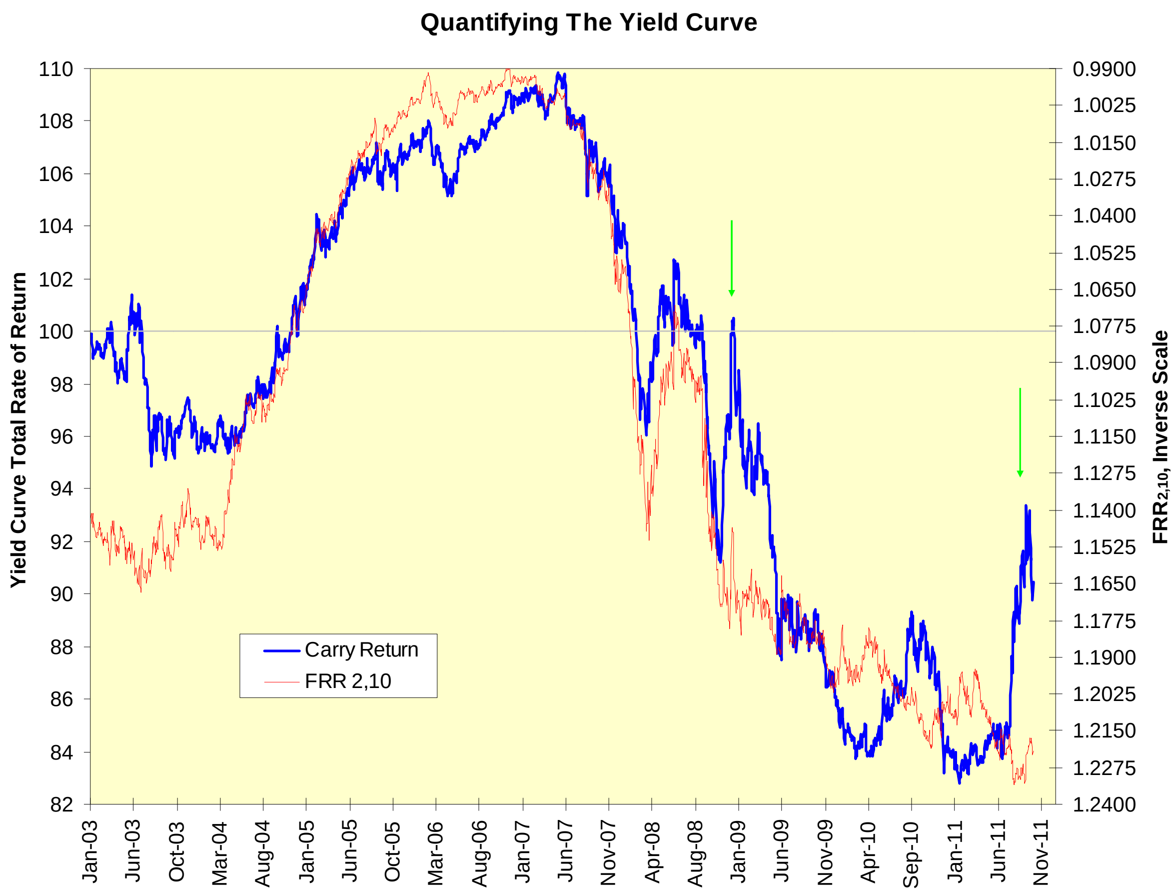
No, as I opined recently, all of this security-buying, financial repression and "twisting" of the yield curve really redounds to the benefit of the U.S. Treasury. However, the phrase, "good enough for government work," can come into play when we start talking about the effects of yield curve manipulations and what happens to bond prices when the Federal Reserve gets involved.

I went back and looked at what happened to the returns on the Merrill Lynch index of ten-year+ Treasuries and Agencies during periods of yield curve flattening and then during the subsequent steepening. All returns displayed below are annualized. The yield curve will be measured by the forward rate ratio between two and ten years ($FRR_{2,10}$); this is the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself.



The first four flattening cycles above show positive returns for long bonds during both the yield curve's flattening and steepening. The last two cycles show negative returns during the flattening phase and massively positive returns during the steepening phase. The December 2009-April 2010 period occurred during the latter months of QE1; the November 2010-March 2011 period occurred during QE2. As we have pushed the FRR2,10 to a record high in August and as the 46.5% return on long bonds between March and August is unlikely to be repeated, we probably are set up for negative returns on the duration-neutral bullish flattening trade of borrowing at the two-year horizon and lending at the ten-year horizon in a 4.5 : 1 ratio.

This happened previously. Between November 20, 2008 and January 2, 2009, a period when the market was guessing what the incoming Obama administration would do and when credit spreads were reaching their peak, a scramble into long Treasuries led to a spike in the yield curve carry trade. A similar spike occurred recently as the yield curve hit its maximum steepness; both periods of high returns on the carry trade are noted with green arrows.



What happened to the carry trade return index after it peaked in January 2009? It declined 14.0% through February 2010. A combination of increased inflation expectations and the anticipation of what would happen at QE1's end led to selling of long bonds. Anyone betting a similar phenomenon will not happen once inflation expectations and actual inflation rise this time and the market starts to anticipate the end of Operation Twist is really looking to pick up nickels in front a steamroller.

The net result of all of this twisting and turning for the real economy will be no gain whatsoever. Of course, that is using past performance to predict future results; we all do this; I admit it.