

Shedding Treasury Market Insurance

It Makes No Sense To Leverage A Negative Real Return Asset

One of my favorite teaching approaches involved identifying who was borrowing and who was lending; another involved identifying the purchase of insurance. In the former, a borrower should expect to pay money solely as a function of time; in the latter, an insurance buyer accepts a known loss in hopes of avoiding a larger unknown loss.

I have stressed several times since August 2011 how Treasuries (IEF, TLT and others) have been comically devoid of investment value (see [Operation Twist Does Nothing for the Real Economy](#) or [Treasuries Approaching Zero-Coupon Status](#)). However, I understood the insurance principle involved: Investors, especially those fleeing the sovereign debt-wrecks of Europe or still not ready to return to stocks, were willing to accept negative real returns now in hopes of avoiding larger losses later. I also have railed against the distortions produced in the market by all of the central bank manipulation of interest rates (see [TIPS Market: How Distorted Inflation Breakeven Signals Put Investments at Risk](#)).

Pushed To The Limit

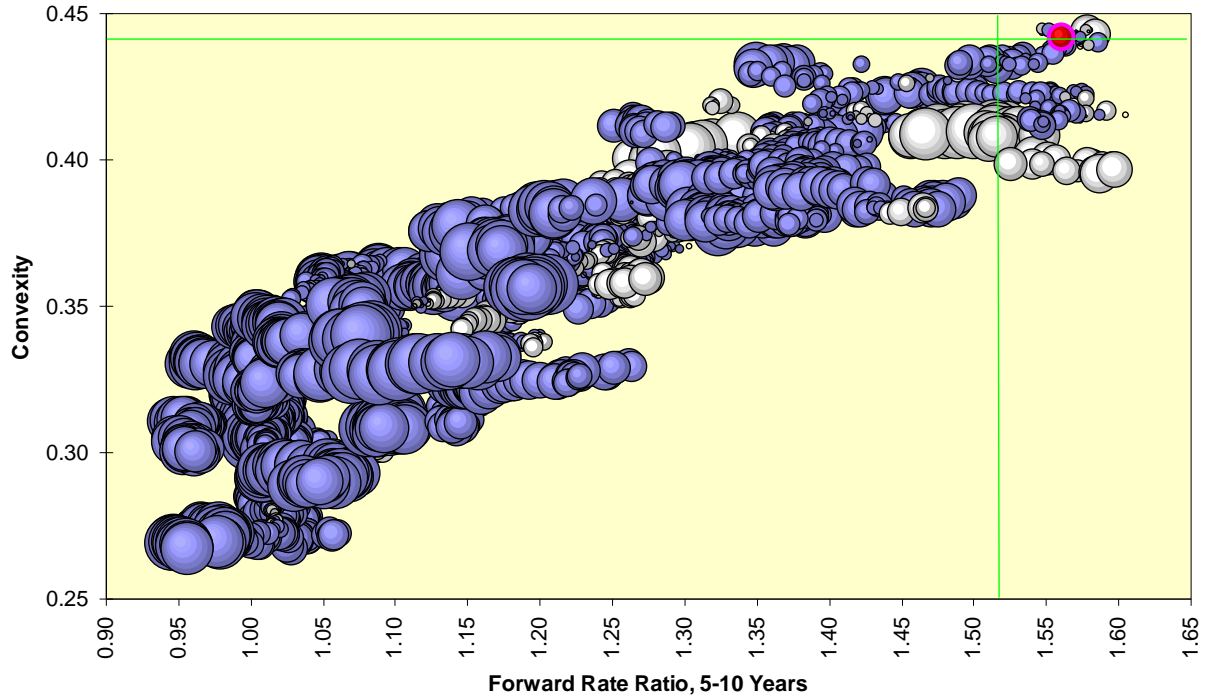
Let's return to the duration-neutral bullish flattener as a governor of where long-term rates can go. This trade involves borrowing at the short-end of the yield curve and lending at the longer end in a ratio based on the duration, or expected interest rate risk, of the two bonds.

One of the reasons behind doing this trade is a gain in convexity, or how much duration changes as a function of interest rate risk; option traders may find it useful to think of this as a bond's gamma and duration as a bond's delta. As interest rates were pushed lower, the net convexity of the bullish flattening trade pushed out to the highest in the 1997-onwards history, and the slope of the yield curve pushed out to record steepness by January 2012. Whenever two different rubber bands are stretched by the same force, something is about to give.

Let's map the three month-ahead returns on the trade of borrowing the five-year and lending the ten-year as a function of the $FRR_{5,10}$ and the trade's net convexity. That FRR is the rate at which we can lock in borrowing for five years starting five years from now divided by the ten-year rate itself. The higher the number, the steeper the yield curve is.

The blue bubbles represent gains on the trade; white bubbles represent losses. The last datum used, from December 15, 2011, is highlighted in red and the current environment is marked with a green bombsight.

Three Month-Ahead Return On Five-Ten Year Trade As Function Of Yield Curve And Convexity



The map was pushed all the way into the extreme northeast corner and is retreating. Please note how the blue bubbles got smaller and started to turn white as we headed to the northeast; as the net convexity of this trade is likely to decrease with any rise in interest rates, we will be headed into a cluster of white bubbles.

All of this is a fancy way of saying the Treasury market got pushed to and through full valuation. It is wrung-out, spent, ridden-hard-and-put-away-wet. It is no more. It, like *Monty Python's* Norwegian blue parrot, sings in the choir eternal. The previously fearful buyers are looking to shed their insurance; why would you want to buy it?