Occupy Wall Street and Liberate The Yield Curve

The Rise In Volatility Says The Yield Curve Needs A Bearish Steepening

If you find yourself at a too-tedious confab and would like nothing better than a few hors d'oeuvres and something with which to wash them down, there is no better way to clear a path to your goal than a discussion of factors affecting the yield curve: The sea of humanity will part before you as if you were Moses.

If you find yourself at a serious financial gathering filled with professionals and would like nothing better than to make an actual contribution to the discussion, there is no better way to become a magnet to the sea of human iron filings than a discussion of the yield curve: Amateurs talk trend; pros talk logistics.

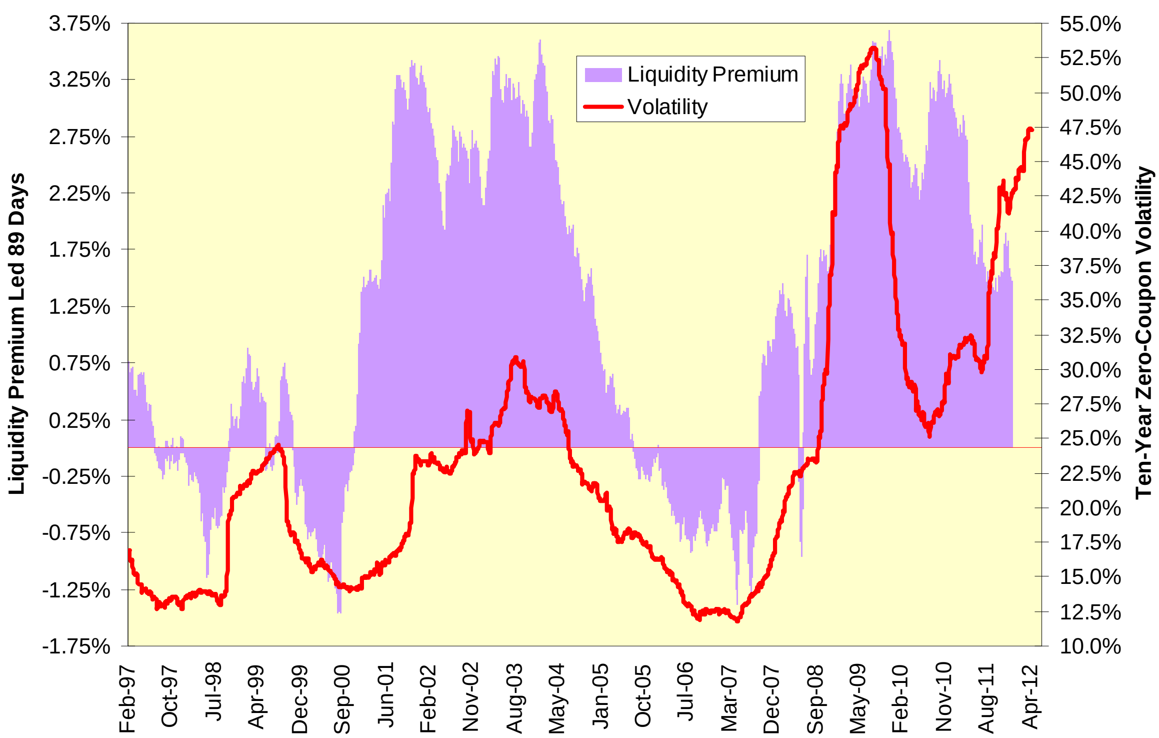
The Liquidity Premium

Let's define the liquidity premium as the spread between ten-year Treasuries and three-month LIBOR. The dominant thinking about this spread for years was it was driven by expected inflation. This was Fisher's Law, named after the Yale professor who developed it, forecast a permanently high plateau for stocks just before the 1929 crash and was clocked therein.

Fisher, of all the bad luck, lived and died before the introduction of TIPS in 1997. This saved him from the embarrassment of discovering, as other theorists who have spent the better part of entire afternoons dreaming this stuff up, Fisher's Law just does not work in practice.

What, then, does drive the liquidity premium? My own empirical work shows a combination of fixed-income volatility, currency volatility and in the old days when the mortgage market was active, prepayment risk is involved. Right now fixed-income volatility is the dominant factor; the higher the volatility, the greater the dispersion of bond returns. Investors need protection from volatility in the form of higher long-term rates.

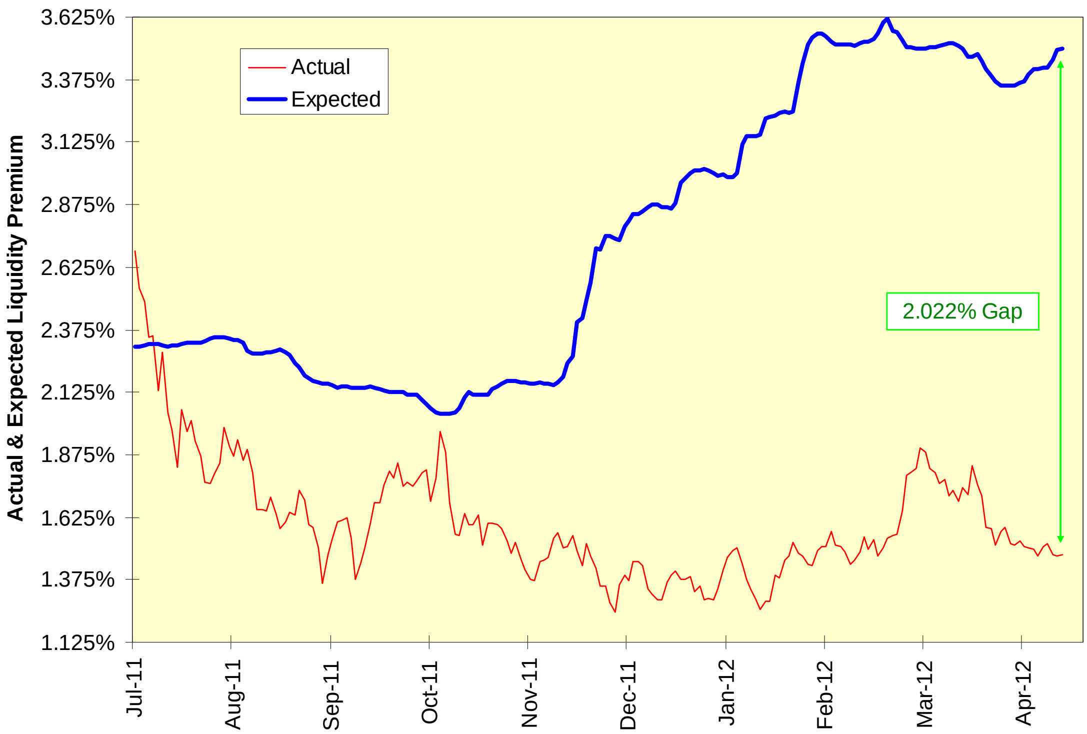
Volatility And The Yield Curve



Yield Curve Suppression

Once Operation Twist was anticipated last July, volatility rose and the yield curve flattened bullishly. If we use the relationship in the chart above and calculate the expected level of the liquidity premium, we find the expected value is more than 200 basis points over the actual value. Restated, the Federal Reserve has squished the yield curve lower and everyone recognizes the situation is unstable. This is why the artificial suppression of long-term interest rates has been so ineffective at macroeconomic stimulus: Anyone who bases a long-term investment decision on an artificial number is going to join Irving Fisher in the "getting clocked" department.

Liquidity Premium Suppression In The Operation Twist Era



While the Nobel Prize committees in other endeavors have been observed handing out trophies for no apparent reason in recent years, the Economics award given by the Swedish Riksbank still is rewarded on merit. Winners such as Milton Friedman, Edmund Phelps and Thomas Sargent all have demonstrated how people incorporate expectations into their decision-making. This is one more example of that principle in action.