Swaption Market Still Looking At March Taper At Earliest

You really do not want to be famous for famous last words unless they are dripping with irony or some other attribute best left to literature majors to classify; take Pancho Villa's departing, "Don't let it end like this. Tell them I said something." I presume he pressed "2" to say this in Spanish, though, and it may have come across differently to those who were there at the time.

I will settle for, 'He got away with writing about swaptions. How, I do not know" as my epitaph.

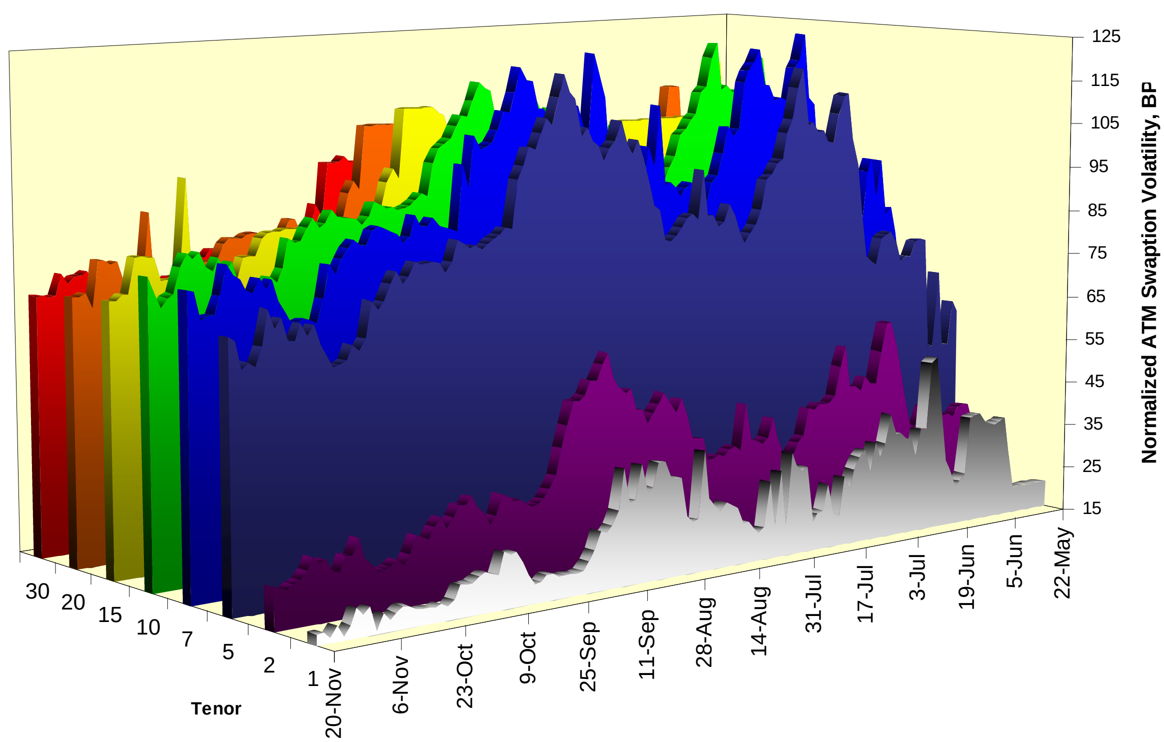
Complacency

The swap spread market is an excellent device for measuring anxiety in the fixed-income market. These spreads rise when floating-rate payors seek to fix their payments in defense against anticipated interest rate increases. A swaption is an option to enter the fixed-rate payment leg of the swap; its volatility thus rises in anticipation of higher rates.

This starts to put financial crises into perspective, doesn't it?

If we go back to May 22, 2013, when the Federal Reserve crowd started teasing everyone about tapering its bond purchases – and what could be more draconian than only printing up $75 billion per month instead of $85 billion? – we see a rise and fall in swaption volatilities corresponding to tapering sentiment. Each ridge in the chart below corresponds to a swap tenor starting three months from the current date.

Three-Month Forward Start Swaption Volatility



Please note how volatilities for one- and two-year swaptions declined and continue to decline after the September postponement of tapering. If we add three months to the current date, those forward-starts correspond to the March 2014 FOMC meeting. In addition, if we add one or two years to March 2014, we cover all of 2014 and 2015 as a low-rate period.

Restated, the market is complacent about rates. However, in the world of P's and Q's not corresponding to pints and quarts, we have price and quantity. Rates are the price of money; quantity is the flow of excess funds coming off of the Federal Reserve's printing presses. A reduced flow, or tapering of purchases, will signal markets very strongly short-term rates will have to follow along and move higher at some point.

When that moment arrives, the very steep yield curve will start to flatten by virtue of higher short-term rates and reduce the carry from free money going into all manner of risky assets including stocks, emerging markets and commercial real estate. The May-June selloff this year was a small-scale dress rehearsal of what we will see when that moment arrives.

For now, though, the swaption market is as complacent as complacent can be. It is funny how fixed-income traders always look askance at the stock market as being populated by wild-eyed optimists; they never look at the credit bubbles and overly positive sentiment building in their bailiwicks. Perhaps this is why financial crises tend to start and spread in fixed-income markets before they annihilate stock markets.