Swap Market Growing Overconfident

Senator Barry Goldwater may have been a Tea Party candidate before anyone knew what a tea party was; his acceptance speech at the 1964 Republican convention included the line, "extremism in the defense of liberty is no vice." You can say the same thing about traders' confidence: If you are not a bit cocky about what you are doing, then why are you doing it?

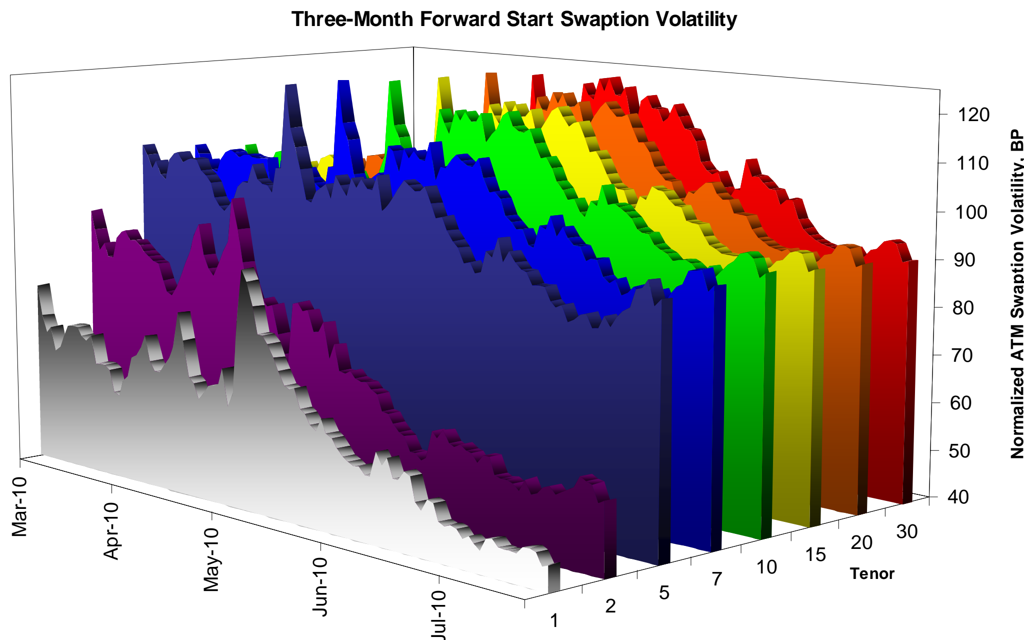
Of course, one of the best ways for an individual or a firm to really get in trouble is to be overconfident about an outlook; that is how too much risk is assumed and we all have seen where that leads. Maybe the best course of action is to be highly confident in your attitudes and yet remain restrained in your behavior. How many of us can thread that needle on a consistent basis?

We noted back in March there were no worries in interest rate swap land. If we fast-forward to our present course where the Federal Reserve is going to keep forcing interest rates lower by maintaining or expanding the size of its balance sheet, that "what, me worry?" attitude turned out to be correct. Is there still a collective belief interest rates have a ways to go before everything is no money down and no payments until 2012 (this is my image of economic management combined with a mattress sale)?

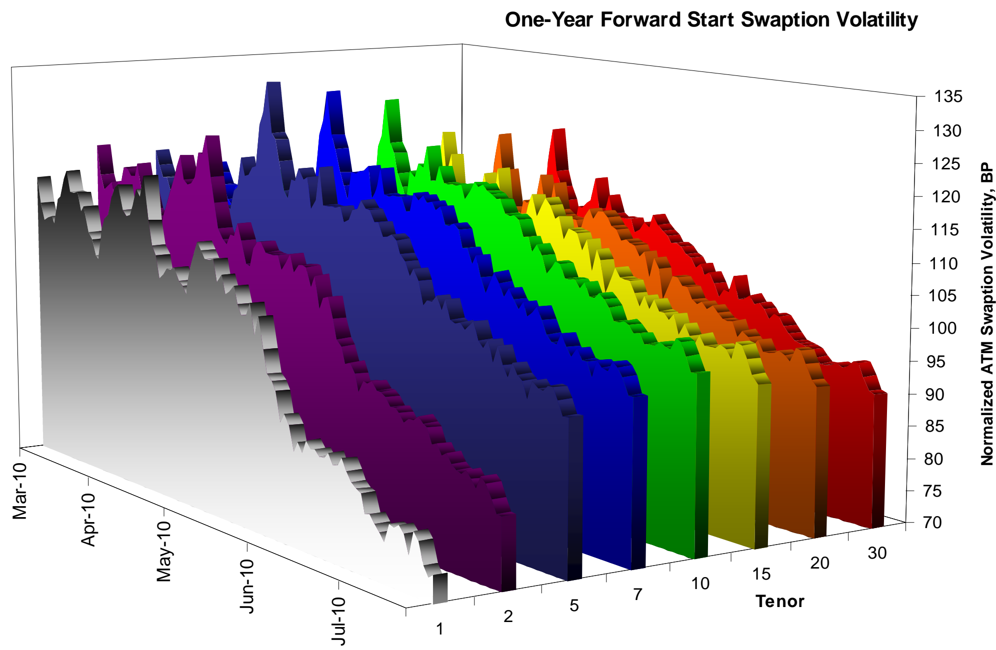
The answer is, "Yes." Let's shift the basis of analysis from the interest rate swaps themselves to options to enter into those swaps, or swaptions. While all of this may sound very esoteric, it is surprisingly simple in practice: As a swap is the price someone with a floating-rate loan is willing to pay to fix that rate, a lower swap spread denotes willingness to stay floating in the belief rates are headed lower still. By extension, lower volatility for options to fix those rates also denotes willingness to stay floating.

Forward, Start!

These swaptions, like equity options, have strike prices and expiration dates. They are forward-starting and settle into a swap of a fixed length of time, or "tenor." The chart below depicts the progression of at-the-money swaption volatility from the interest rate scare in March 2010 onwards for swaps beginning in three months. The most prominent feature here is just how much volatility has come down for the one- and two-year swaps.



We can do the same map for swaps beginning one year from now and see the same time-dependence. The market is unwilling to buy insurance against higher interest rates for two-year swap rates starting one year from now; that takes us out to August 2013.



Now, ask yourself when you are going to get a better deal on an umbrella, when it is dry outside or raining buckets? The market is confident about three years; three years ago this month was when the European Central Bank kicked off the world of extraordinary measures by backstopping BNP-Paribas, when then-St. Louis Federal Reserve president William Poole was taking a hard line on inflation and when, one week later, the Federal Reserve did its first emergency rate cut.

Anyone who knows where we will be in three years is a little too confident. Bullish bond bets such as buying exchange-traded funds like the IEF or TLT or even investment-grade funds like the LQD may make a lot of sense today, but if we have learned anything (hint: We have not) over the past three years is caution in the face of confidence is no vice.