The Risks Of Fleeing To Safety

Last week's trapdoor opening underneath Freddie Mac should be taken as no less than a warning shot into the forehead. I have said several times over the last few years that Fannie and Freddie are the next great financial accident waiting to happen. Whenever you allow anyone to trade with an implied put option courtesy of Uncle Sam, bad things happen, as witnessed in the savings & loan bailout of the late 1980s and early 1990s.

A second lesson all of us should have learned is that just because someone is big and rich does not mean they are smart; moreover, there is nothing more dangerous than traders who are too smart for their own good playing in the derivative sandbox. Once upon a time the Japanese were considered the role model for a new and wondrous brand of state-sponsored business-as-war capitalism; who makes that analogy anymore? And after the assorted crash landings of Enron, Bankers Trust, Long Term Capital Management, etc., is anyone still impressed with financial razzle-dazzle?

The risks, for now, are concentrated in mortgage-related securities. The spreads on corporate debt, until now one of the driving forces behind the recent rally in equities, could be affected as well.

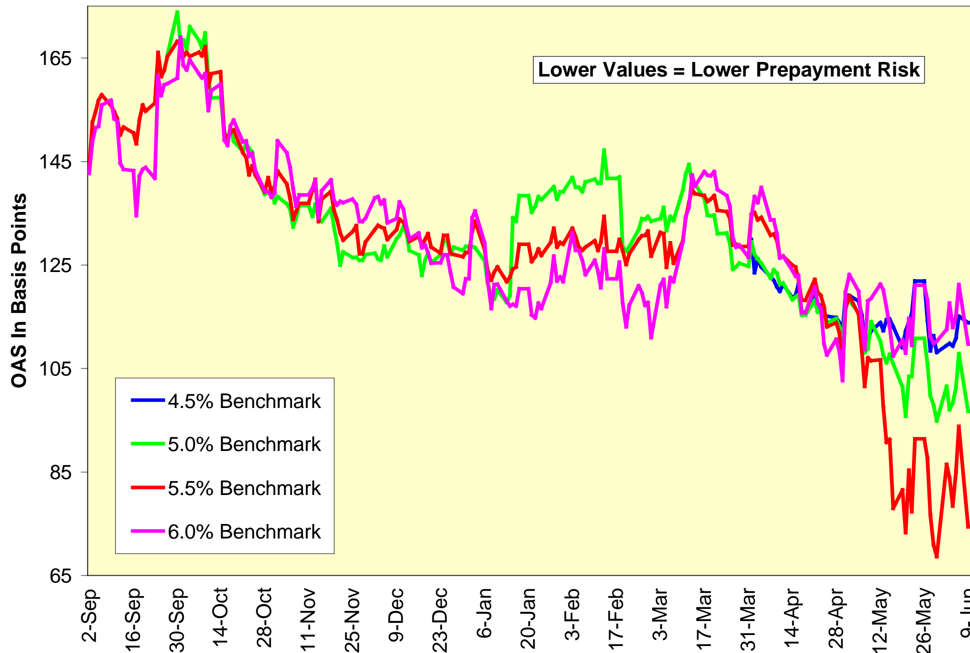
Less Than Zero

A negative-sum game is one wherein each player tries to maximize their own welfare and in so doing minimizes the welfare of the group as a whole. Think of everyone trying to be the first one out of a burning building or everyone trying to be the first one to sell a breathlessly overvalued market. When traders fled into Treasuries last week to avoid mortgage-related risks, they inadvertently put greater pressure on Fannie and Freddie. As explained here last year, both firms are short a call option on bond prices and both of who need a positively sloped yield curve. The plunge in yields last week raises the likelihood of additional prepayments in the two firms' mortgage portfolios, which will lead them to buy more bonds and contribute to another bullish flattening of the yield curve in a vicious cycle.

The road to hell is paved with short options: The best traders control the decision points on where and when to close a position, and anyone short an option has ceded that critical right.

Interestingly enough, the market for to-be-announced mortgage securities is not yet panicking about another massive round of refinancing. In fact, the option-adjusted spreads for TBA mortgage securities have been moving lower as so many people have refinanced recently that the betting is that they will not again soon.

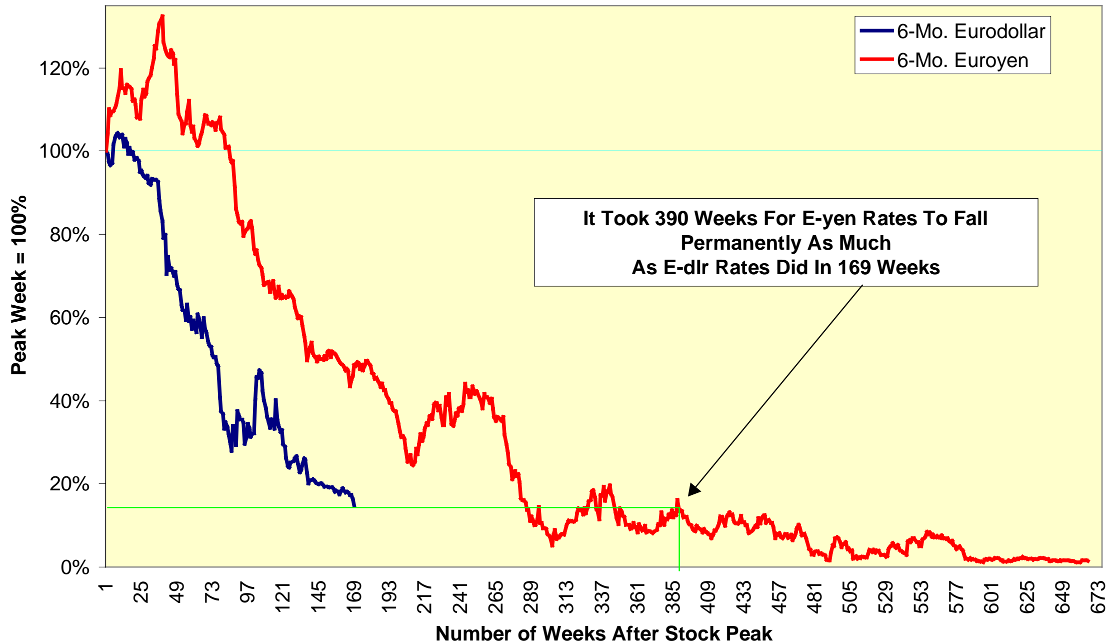
Prepayment Risk Still Falling

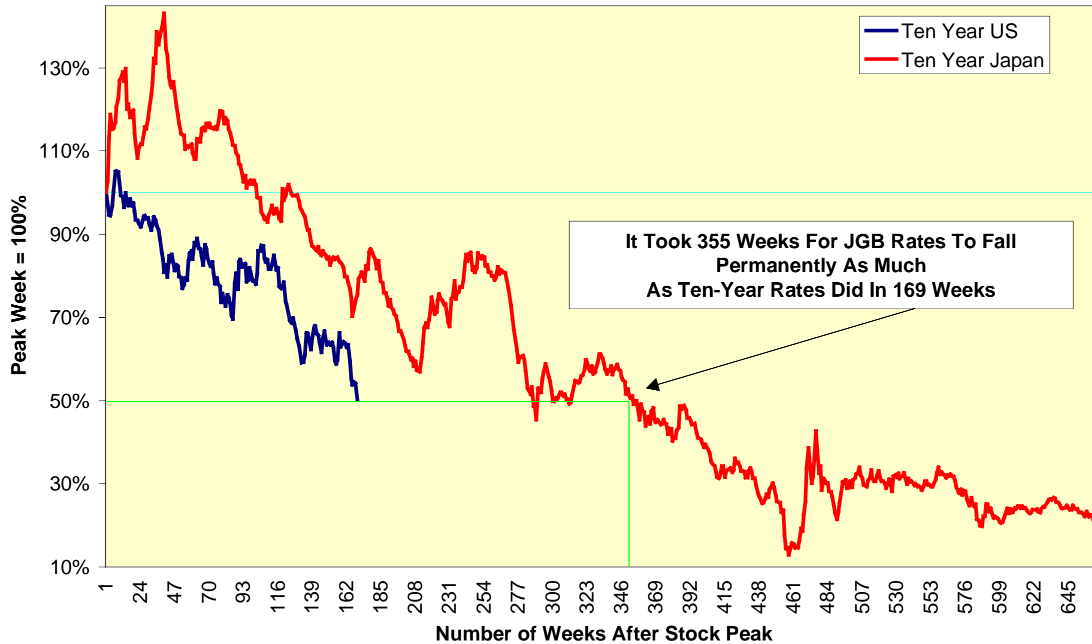


Rising Sun, Falling Rates

Betting on an end to the bond rally seems logical; the risk/reward of lending money at present yields does not seem appealing. But the toughest trade often is the best trade, and if we take a look at some updates of charts presented here last October, we can see just how much further and faster interest rates have fallen in the post-bubble U.S. than they did in post-bubble Japan. The comparison holds for both 6-month swap rates and ten-year government bonds.

A Tale of Two Rates





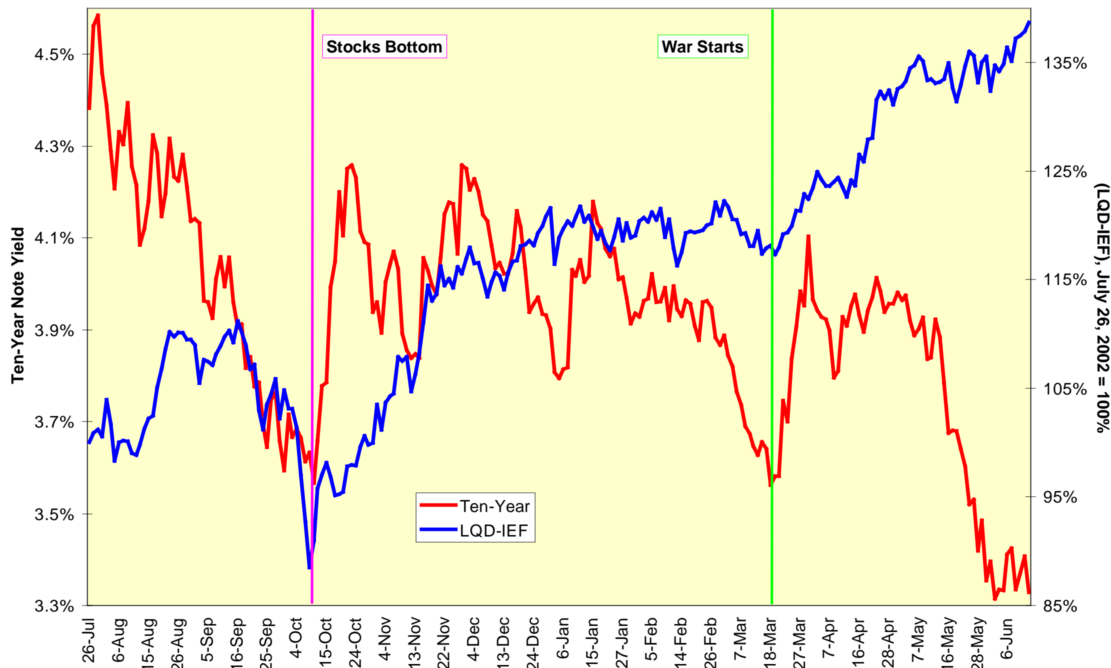
To anyone who states without evidence that "we're not another Japan; it can't happen here," I respond: Prove it. It is happening here, faster and stronger than it did there, and with aggressive statements by the Federal Reserve to remind you it is they, not you, who own the decision points.

We all are short a call option in this grand socioeconomic experiment. As my chemical engineer friends describe thermodynamics, we can't win, we can't break even, and we have to play the game.

Credit Spreads For The Common Man

Exchange-traded funds may not be the greatest thing since sliced bread, but they're well ahead of whatever's in third place. Let's compare two of them, the iShares GS$ Investop corporate bond (LQD) and the iShares Lehman 7-10 year Treasury (IEF) with an eye toward developing a trading strategy.

Since the creation of these ETFs last July, the spread between the two as a function of Treasury yields has gone through two shifts. The first occurred at the October 2002 low for stocks; once equities rebounded, corporate credit spreads started to narrow. The second shift, also in a narrowing direction, occurred at the start of the war in March 2003. Overall, the trade of being long corporates against Treasuries as represented by these two ETFs has been a winner for the corporates.



Some words of caution are in order. It is important to remember how difficult it is to create any sort of bond index. Each and every day the maturity of the underlying bonds is one day less. Combined with the effects of "rolling down" the yield curve and the changing impact of each basis point shift in yield on the bonds' prices, you have a very non-linear package of moving targets.

These effects can be illustrated in a scenario table created by converting the bonds underlying each ETF into a bond portfolio and shifting the yield curve higher and lower by 50 and 100 basis point increments.

Comparative Portfolio Performance: 90 Days Hence

	-100 bp	-50 bp	Flat	+50 bp	+100 bp
			Modified Duration		
LQD	7.09	6.89	6.71	6.54	6.38
IEF	6.73	6.69	6.65	6.61	6.57
			Total Return		
LQD	32.09%	16.37%	2.10%	-10.89%	-22.75%
IEF	29.60%	14.76%	0.97%	-11.85%	-23.77%
			Value of 1 Basis Point		
LQD	$ 9.006	$ 8.453	$ 7.949	$ 7.489	$ 7.068
IEF	$ 6.375	$ 6.126	$ 5.887	$ 5.659	$ 5.440

In both the higher and lower yield cases, the LQD appears to be the superior asset; it both makes more and loses less. This suggests that buying the LQD and selling the IEF will continue to be a winning trade, a successful bet on the closure of credit spreads and on the renewed acceptance of risk on the part of investors.

However, this analysis ignores the hard shifts in risk preferences known to occur at the time of crisis. As we saw during the 1998 Russian/Long Term Capital Management selloff in 1998, the idea of being short Treasuries against long risk can be a bad one. We got a taste of it last week when money rolled out of mortgages and into Treasuries. Should a further shudder hit the market, we will see more of the same.

If you are comfortable being long stock, buying the IEF and selling the LQD moves in the direction of being a hedge against financial distress. If you think more risk is on the horizon and find the idea of being long bonds at these yields unappealing, the long IEF / short LQD trade works again. When should you stay with the trend trade of being long LQD and short IEF? Only if you have not jumped back into stocks yet and think that the bond rally is about over for now.

What about stepping up to the plate and buying agencies against Treasuries? Not yet: That is a trade that you may be able to enter at a much, much better price a few months from now.