

A Short Above Zero

“The waiting is the hardest part.” – Tom Petty

Should we be sad or appalled at how appropriate parallels between the U.S. and Japan remain nearly twenty years after the Japanese markets peaked and nine and one-half years after the U.S. bull market ended? The answer here is the same answer given one year ago in another, separate glance at the U.S.-Japanese analog (see “A Tale Of Two Tragedies,” September 2008), and that is our attitude should be one of resigned acceptance. The funny thing about tragic inevitability is its, well, inevitability.

Japan moved to a policy of zero interest rates in February 1999; when that failed, they moved to a policy of quantitative easing, or shoving excess (and by definition unwanted) reserves into the banking system in March 2001. Those unwanted reserves fueled an extension and expansion of the yen carry trade, the borrowing of cheap yen to invest in search of higher returns elsewhere.

All these credit-easing moves did for Japan is send Japanese savings around to world for the benefit of others. It did little to restore Japanese economic might and nothing to restore the once-mighty Japanese stock market. The same can be said for a parallel orgy of Japanese fiscal stimulus; by the end of the first quarter of 2009, Japan’s public debt equaled 167% of its GDP.

The reasons for these twin failures of policy stimulus are simple: Fiscal stimulus may be wholly justified in Keynesian logic as an offset to increased saving by consumers and lowered investment by businesses (see “Wall Street Armageddon: Now What?” January 2009), but it tends to fall apart when you realize the money being spent by governments is either taxed away or borrowed from the private sector and spent on projects selected politically, not economically. If you do not believe this, would you be willing to hire Uncle Sam as an investment manager?

Second, monetary stimulus is designed to work by shifting demand forward in time. This it can do very well if consumption and investment demands are high; it is “pushing on a string” if such demands are low. If we throw in an impaired financial system and noncredit-worthy borrowers, we find low interest rates act to punish risk-averse investors (savers, really) without providing relief to credit-starved borrowers. And as government debts and borrowing demands grow, the government can claim an ever-greater share of available investment funds at ever-lower relative interest rates and winds up disintermediating capital markets. This phenomenon became quite visible in late 2008 both in the London interbank and U.S. commercial paper markets.

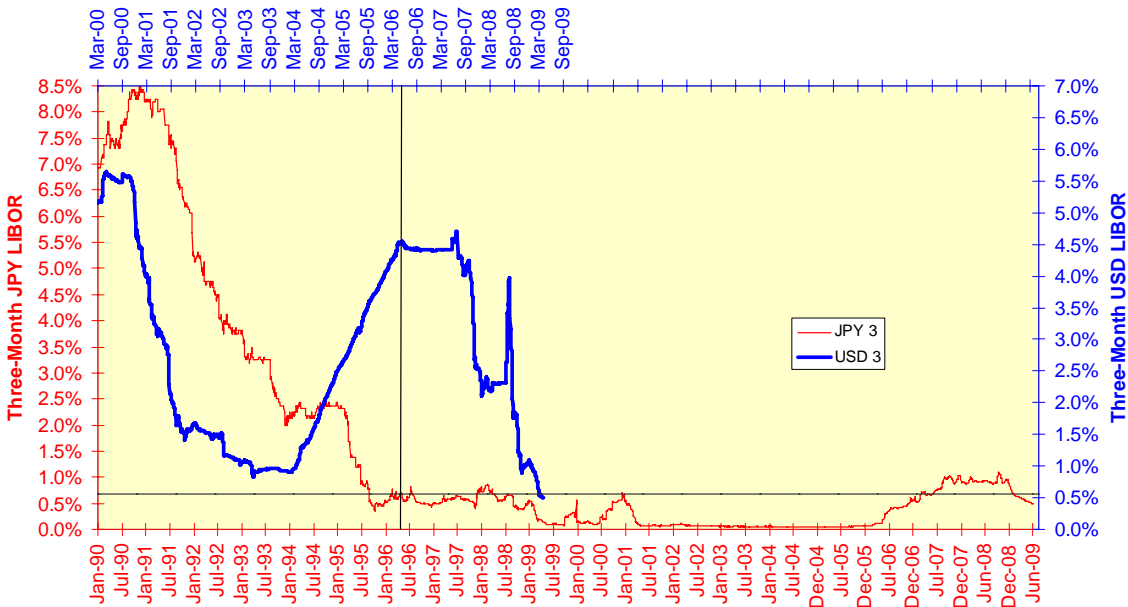
The problem with public finance is it is run by governments and politicians whose first and often only impulse is to be seen “doing something” to redress the present situation. Short-term thinking dominates long-term planning, with predictable results. Each step, no matter how well-intentioned, often is little more than a paving stone on the road to economic hell. Ask our friends in Tokyo.

Long-Term Decline In Short-Term Rates

One financial writer we know was on a dinner cruise on Lake Michigan in June 1996 when the company chairman sidled up to him and said, “You should write something on Japanese interest rates. They can’t stay here forever.”

Quite true: Three-month yen LIBOR was at .5547% back then; both the time and the rate are marked with black cross-hairs in Chart 1. Please note that with only a brief and small exception in the first half of 1998, these Japanese rates did not rise over that level for good (for now, at least) until December 2006, ten and one-half years later.

Chart 1: Dollar LIBOR On Its Long, Strange Trip



The history of three-month yen LIBOR, scaled in red for both yield and time in Chart 1, begins on December 29, 1989, the all-time high for the Nikkei 225. If we add the history of three-month dollar LIBOR from the March 24, 2000 local peak in the U.S. market, scaled in blue for both yield and time in Chart 1, we see how U.S. short-term interest rates resumed a convergence path toward their Japanese counterparts in August 2007 after an April 2004–August 2006 detour higher.

Moreover, with the October 2008 credit crunch and its effects on the LIBOR markets excepted, the second decline in U.S. short-term interest since 2000 occurred at a far faster rate than Japanese rates did other than a brief period in 1995. Few, if any, observers ever thought such a decline in U.S. rates would have been possible.

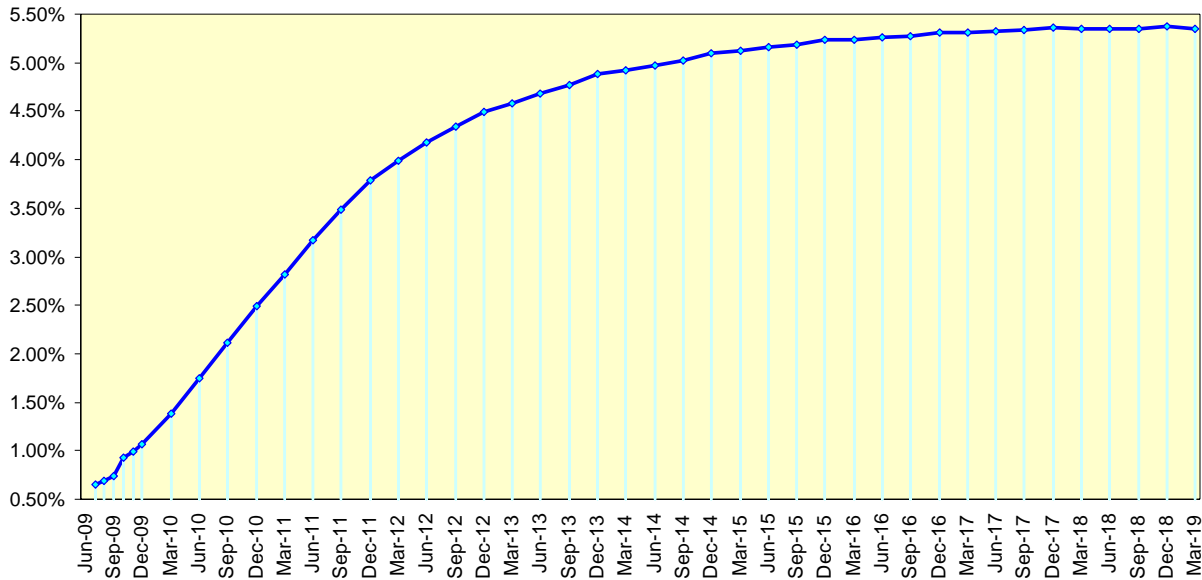
We should pause here to mention the dollar carry trade, a counterpart to the yen carry trade, had operated in 2006–2007 as funds flowed from the U.S. into emerging markets and into commodity-linked investments. The dollar carry trade ceased to operate in late 2008 as the rest of the world entered into an economic downturn at least as violent as the American one. Restated, while Japanese monetary excess did some good somewhere in the world, the cumulative effect of American and other quantitative easing moves globally were non-existent until March 2009 and debatable thereafter.

Top-Picking

Most market commentators fall into the category of bloviating blowhards committed only to finding reasons why they are right and not giving any thought as to how they could be wrong. This attitude explains why the most sophisticated traders in our lifetime have had the most spectacular flameouts. Let’s reverse their execrable thought process. Instead of insisting U.S. short-term interest rates have to go down to Japanese-like lows, let’s return to that chairman’s thoughts of long ago and suggest how we can go short the Eurodollar *for no other reason than it has risen too sharply for our tastes*.

Let’s take a look in Chart 2 at a forward curve of Eurodollar futures’ implied yields from June 15, 2009. The yield curve rises steadily from the serial month of July, jumps from September to December 2009 in anticipation of a possible tightening of monetary policy, and rises in an almost linear fashion for three more years.

Chart 2: Eurodollar Forward Curve
June 15, 2009



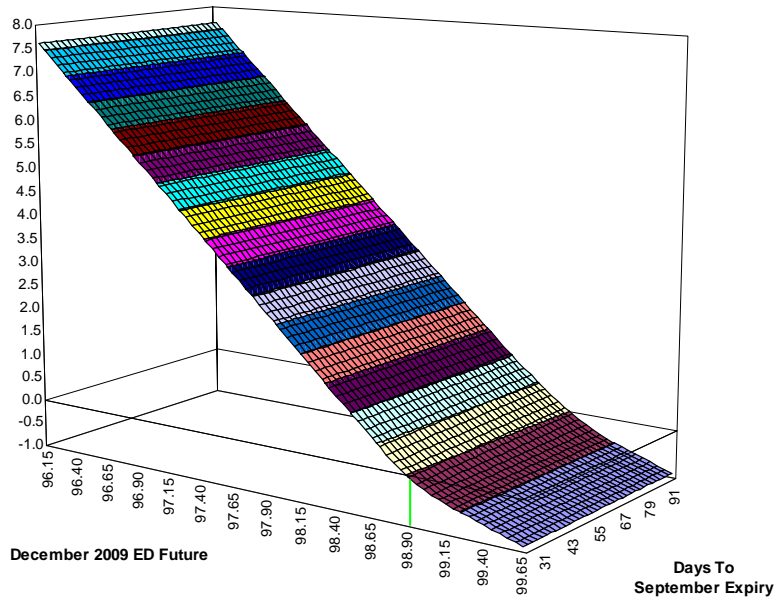
Barring a significant change in monetary policy from this starting point, we should expect any long position in a Eurodollar future to “ride down the curve” as it approaches expiration. Another way of stating this is to say any long futures position should gain in price as it will be priced off ever-lower yields as its maturity shortens.

How can someone structure a Eurodollar trade to take advantage of this phenomenon? The answer for December 2009 Eurodollar futures generated from the author’s Dynamic Option Selection System (DOSS) program would acquire the same delta as 100 short futures with the following calendar straddle:

Buy 182 September 99.25 calls at 0.115
Sell 182 December futures at 98.93.

The incremental financial profile of the trade relative to the base case of selling 100 December futures with the September-December spread held constant is shown in Chart 3. The December futures price on June 15, 2009 of 98.93 is marked with a bright green line. The incremental profit profile is leveraged to the downside; that is, it will benefit from unexpected yield increases. The incremental loss to the upside is capped by the presence of the September call options.

Chart 3: Incremental Financial Gain On Split-Strike Synthetic Future



Keep On Trying

An acquaintance from the late 1980s said he always kept a bull spread position on in crude oil because, “it’s going to happen.” This strategic positioning for low-probability / high-impact events can be an exhausting and ultimately expensive trade. Nassim Taleb of “Black Swan” and “Fooled By Randomness” fame saw his Empirica Capital hedge fund dwindle on such positions. The oil trader was proven right by the August 1990 Iraqi invasion of Kuwait, but he then had to wait for more than a decade for another bull run in crude oil. Similar stories could be constructed for stock market crashes and the like.

How long has someone had to wait for short-term Japanese rates to rise? The answer is close to fifteen years, which sounds like a waste of one’s life and a tax on mental capital. This is why compulsive top- and bottom-pickers often sound so shrill in defense of their positions.

The toughest trade in a secular low short-term interest rate environment is staying long, not picking the top. But if you must, use a gamma-positive, defined-risk trade such as the one suggested above. And be ready to wait.