A Matter Of Small Interest

"Experience is what you got when you didn't want to get it." – Ken Harrelson

Perhaps it is a good thing on more than one level I did not live through the Great Depression. Not only was the time dreadful, but the experience was so searing for those who did they framed all subsequent events in their life through that lens. Only fifty years after World War II did they discover their experiences earned them the sobriquet, "The Greatest Generation."

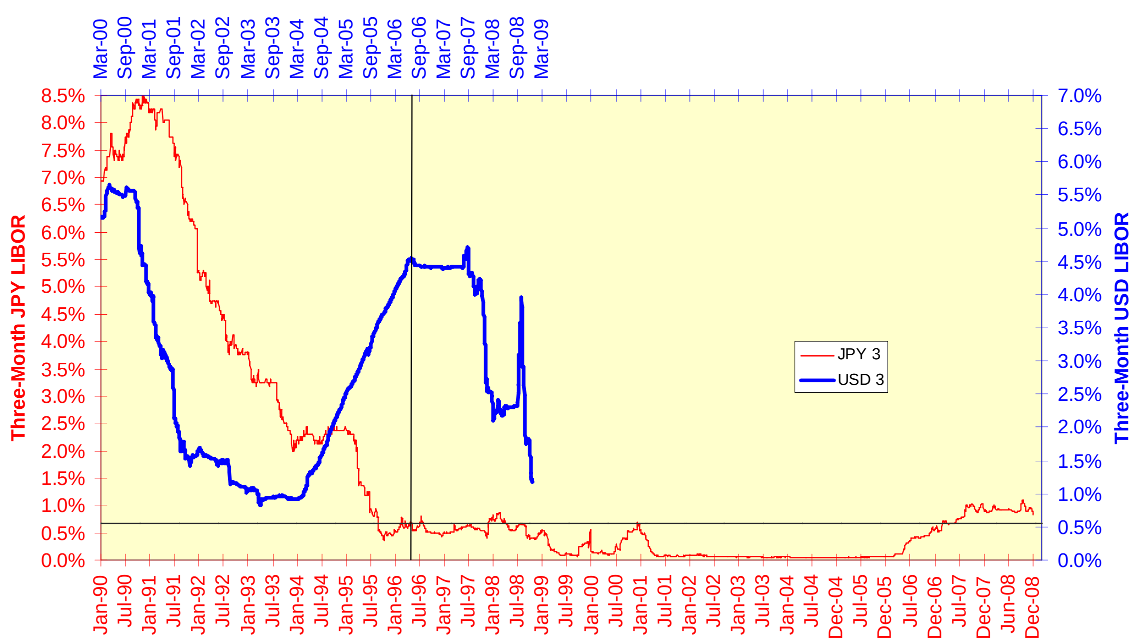
However, I combined secondhand accounts of the Great Depression with my own experiences of the Great Inflation of the 1970s, the 1987 crash, the 1990s deflationary recession in Japan and the two booms and busts we have had here over the past fifteen years to create my own lens, displayed most recently last October.

The Long Decline

But experience can arrive in humorous packages as well. I was on a dinner cruise on Lake Michigan in June 1996 when the company chairman sidled up to me 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 on the chart below. 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.

Dollar LIBOR Has Room To Decline



I began that Japanese history, scaled in red for both yield and time, 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, we see a sobering pattern, one first noted here in October 2002. U.S. interest rates, long-term as well as short-term, are following a Japanese path lower.

With the rather abrupt reversal higher in USD LIBOR in October 2008 excepted, U.S. short-term interest rates are declining for the second time since 2000 at a rate faster than Japanese rates did. Moreover, while U.S. Treasury bill rates are artificially low on various flight-to-quality and end-of-year considerations, USD LIBOR is still higher than levels reached in late 2003 and early 2004. Quite simply, U.S. short-term interest rates outside of the Treasury market can decline further.

If anyone thinks these low nominal interest rates are going to be a fleeting phenomenon, please look at the Japanese example. We are in time where Japan was in October 1998, more than ten years ago. Their policies of zero interest rates, quantitative easing and massive public works spending failed to reignite Japan to its glory days of the 1970s and 1980s. Why do we think it will be different here given what we have seen to-date?

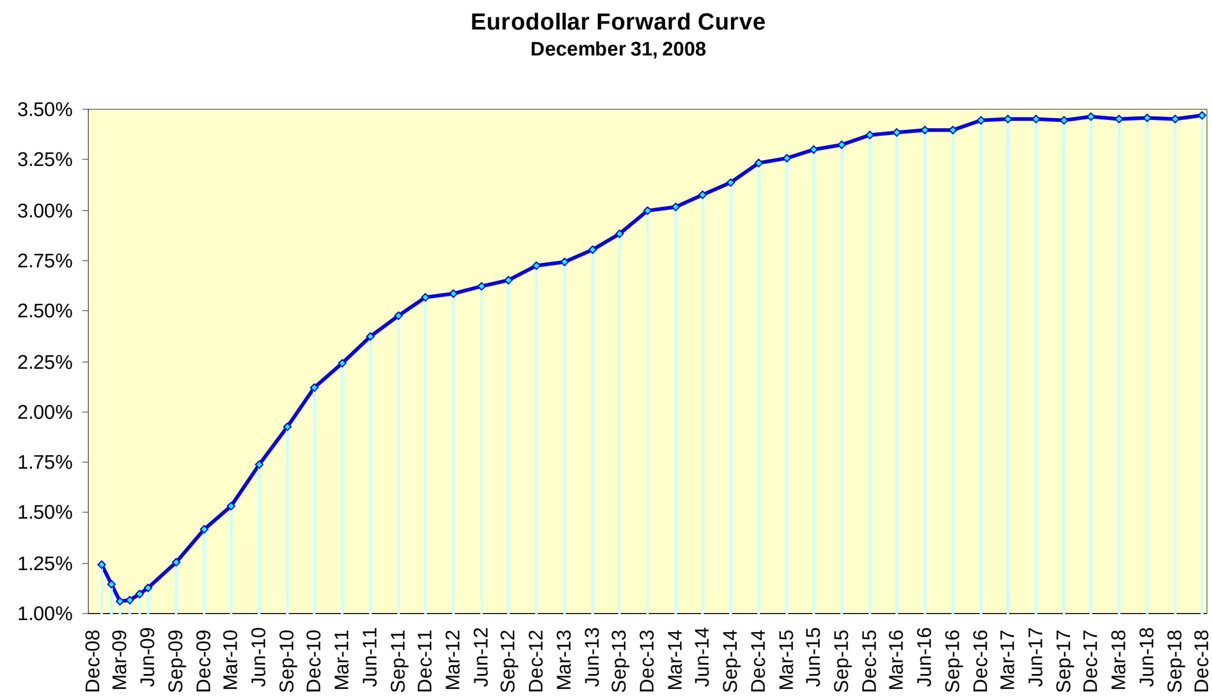
My Pyramid Scheme

While the incoming Obama administration has not sought my advice on fiscal stimulus to the undoubted relief of all parties concerned, let me offer some unsolicited wisdom: Build pyramids. Seriously; we know pyramids are a great tourist attraction in Egypt, we have examples such as Mt. Rushmore in the U.S. and they will be at least as useful and offer fewer opportunities for official misfeasance than the usual road-and-bridge projects.

Top-Picking

Let's return now to the subject at hand, the one that prompted the long-ago "suggestion" by the chairman to write about Japanese interest rates, and that is the impulse too many observers have to sell anything that has gone up or to buy anything that has gone down *just because they have gone up and down, respectively*. This strategy, if it does not embarrass amateurs, should.

Let's take a look at the forward curve of Eurodollar futures' implied yields at year's end. Once the slightly higher serial month yields of January and February are passed, the yield curve hits a nadir in March and rises steadily thereafter.



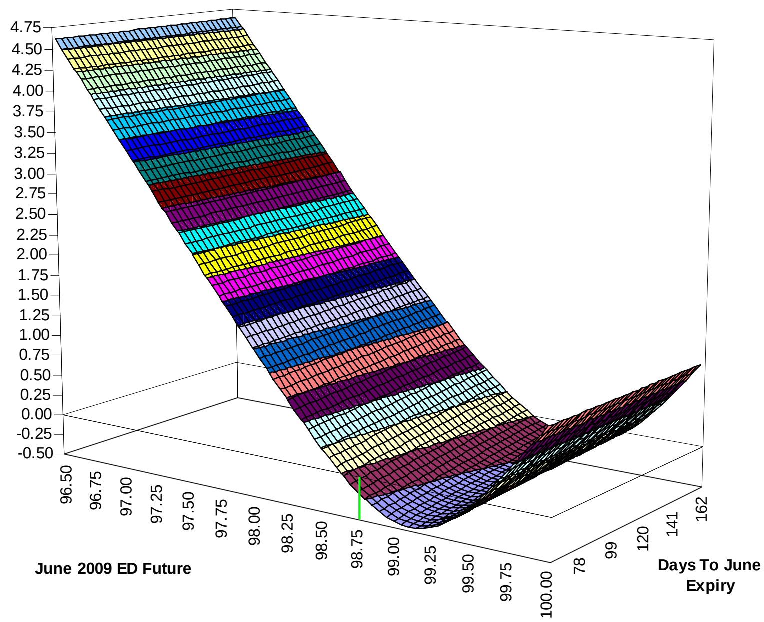
As few if any rational observers expect a change in monetary policy prior to mid-year, we should expect any long position in a Eurodollar future to "ride down the curve" as it approaches expiration. Another way of stating this is to say any long futures position should gain in price as it will be priced off ever-lower yields as its maturity shortens.

How can a compulsive top-picker, someone who just has to be the first kid on his or her block to sell the Eurodollar take advantage of this phenomenon in constructing a limited-risk short position for, say, September 2009 futures? The answer I generated from my Dynamic Option Selection System (DOSS) program would acquire the same delta as 100 short futures with the following calendar straddle:

Buy 227 June 99.00 puts at $0.2925
Buy 227 September 99.00 calls at $0.1725

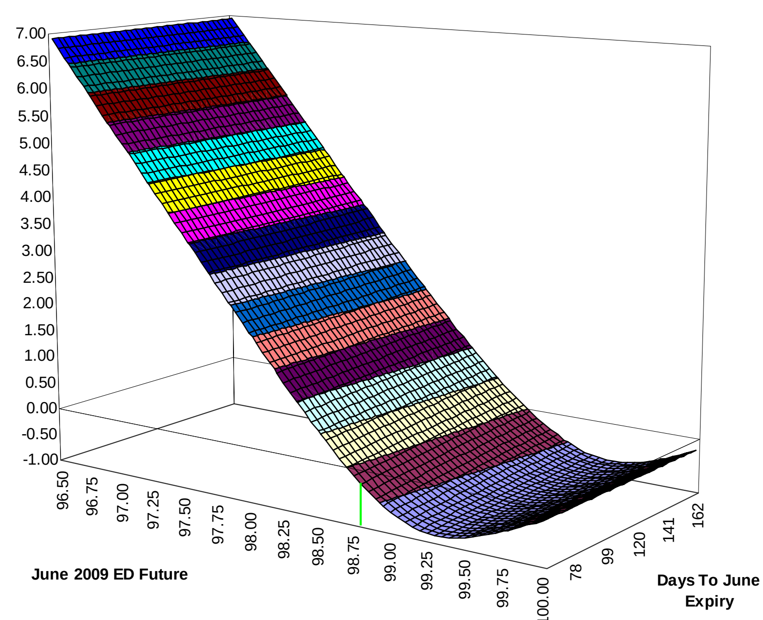
The net financial profile of the trade is across the dimensions of price and time with the September-June spread held constant is shown below. It is highly leveraged to the downside, higher Eurodollar yields, and offers a gain should yields collapse as suggested above. The trade has a finite loss profile maximized as June futures approach 99.10 from their current 98.80.

Net Financial Gain On Calendar Straddle



The incremental financial gain to the base case of selling 100 September futures is depicted below. It, too, resembles a leveraged put option position.

Incremental Financial Gain On Calendar Straddle



The real advantage of a trade such as this comes not in its leveraged position should you be right about yields rising, but rather in the protection to the upside you will achieve should yields fall. That was the case for a long-ago similar trade recommendation on Euroyen futures. The experience was yields can move lower still from impossibly low levels, regardless of top-picking chairmen or your own predilection the risk-reward favors being short Eurodollars at a time such as this.

It was the long positions in the Euroyen that made money for years. Until you acquire the experience, what you got when you did not want to get it, either stay long the Eurodollar or use a protected trade such as this to pick tops.