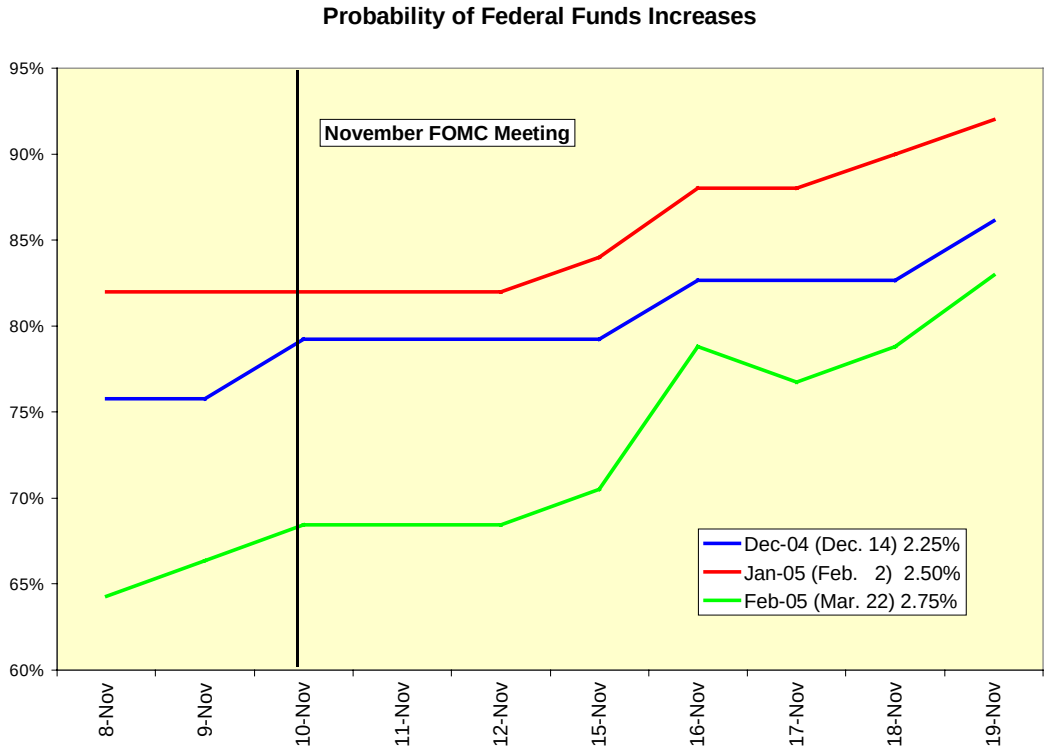
A Bond Loss Named Desire

Tennessee Williams was far better at searching the recesses of human failure than at divining the next move in interest rates, so he would have had a different take on Alan Greenspan's admonition last Friday that "anyone who has not appropriately hedged this position by now obviously is desirous of losing money." Cinematic history certainly would have been different had Marlon Brando's fictional Stanley Kowalski appended "shorten our duration!" to his famous bellowing of "Stella!" in the 1951 classic *A Streetcar Named Desire.*

Why Chairman Greenspan might feel ignored is unclear. The federal funds futures market has been pricing in not one, not two, but three separate rate hikes at the next three FOMC meetings. The chart below depicts the odds for rate hikes to specific levels for each of the next three futures contracts; the operative meeting dates are included.



While we can argue whether these futures contracts are accurate predictors this far in advance, we should not argue whether all financial markets are incorporating these assessments into their pricing structures. Those who bet against the efficiencies of arbitrage have more than a desire to lose money, they have an actual plan for doing so.

Tennessee Williams also would have understood the inherent frustrations produced by markets; indeed, the aphorism "markets produce the greatest pain for the greatest number" could have flowed from his pen. In terms of the bond market, consider the following statement:

Any credible forecast of interest rates is inherently self-defeating.

Paradoxically, the forecast must be credible to produce this self-defeating outcome; let's stipulate that Alan Greenspan is a credible forecaster if for no other reason than he can create market conditions while the rest of us merely pontificate. Traders will, wisely or note, act upon his words. In the present context, lenders will consider themselves wise to withhold funds from the market today in order to realize tomorrow's higher rates, while borrowers will rush to lock in funds today from the same noble motivation.

The end result of this game - and I use "game" in its classic economic sense - is an immediate surge in interest rates today as higher short-term borrowing demands intersect lower short-term funds supplies. The higher rates today

squelch overall economic growth and produce lower credit demands in the future. The credible forecast for higher rates in the future will produce higher rates today and lower the probability that today's forecast will prove correct.

This, incidentally, is why Wall Street gurus, both anointed and self-proclaimed, get shot off their horses with such regularity. My post from March 11th of this year, a time when various economists were falling all over themselves to proclaim low interest rates forever, is but one of thousands of examples of this action.

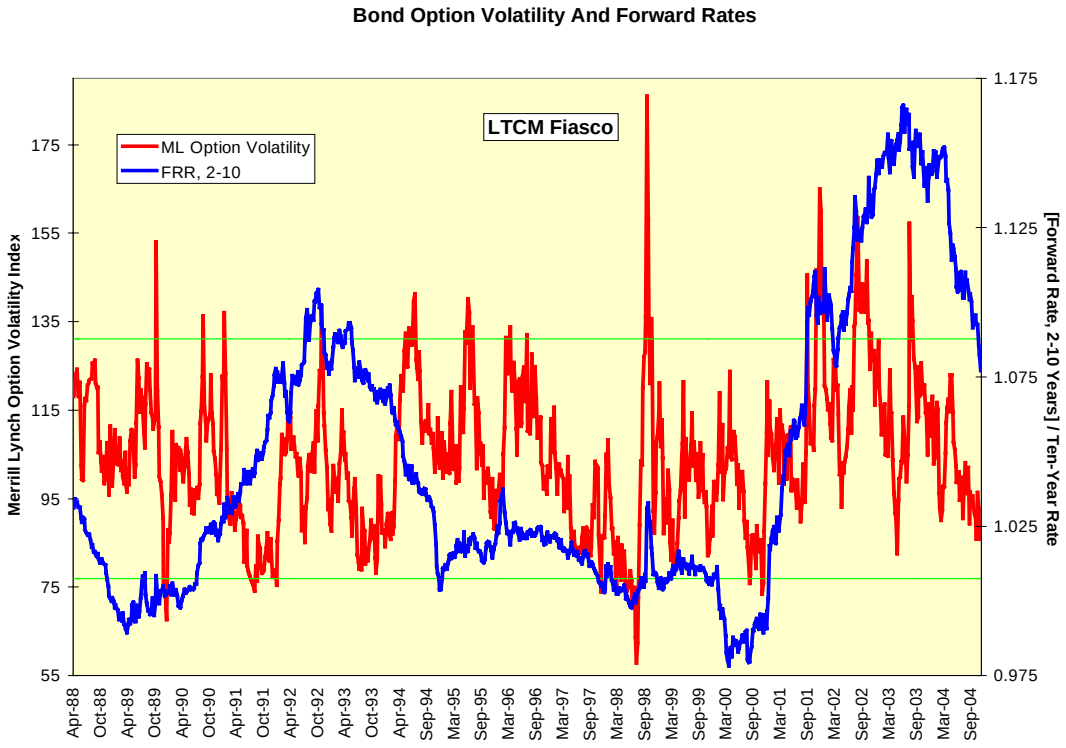
The Nature Of Bond Hedging

Hedging is a form of buying insurance, an act that at its most basic involves accepting a defined loss today to avoid an undefined loss in the future. The time premium component of a long option position is a hedge cost, as is the sale or purchase of any futures contract at a level either less than or greater than its full cost of carry, respectively. I have referenced these insurance components in both the crude oil and other physical commodity markets at various times.

The definition of hedge costs in the bond market is not as well defined as it is in other markets. First, the yield curve can take on any number of shapes at any given level of interest rates. Second, all components of both the yield curve including the risk-free short-term rate, expected inflation and the forward rate structure are influenced instantaneously by the actions of traders. Unlike a physical commodity market where the cost of carry can define a single natural lowest energy state, the bond market can clear the demand for insurance in multiple states.

If this sounds complex, it is. Just accept that insurance changes behavior. Think of how differently you would trade stocks if someone handed you a free put option with each purchase, or how stock option grants change the behavior of corporate managers. Each bond trader seeking to lower position risk changes the risk being insured against and turns the market in aggregate into a gigantic game of whack-a-mole.

We can depict the history of insurance demand in the bond market with the Merrill Lynch Option Volatility index (MOVE). The MOVE is a yield curve-weighted index of 30-day options on 2, 5, 10 and 30-year Treasuries. Its present reading of 86.21 basis points is near the lower end of a historic 90% confidence interval, which by itself would reinforce Greenspan's comment that a little more fear would be nice, thank you very much.



But if we overlay the ratio of forward rates between two and ten years, the rate at which we can lock in borrowing for eight years starting two years from now, to the ten-year rate itself on the MOVE, a pattern emerges. The higher this ratio, the steeper the yield curve and the greater the MOVE. The present drive lower in the MOVE is coinciding with a rapidly flattening yield curve, as evidenced by the declining forward rate ratio.

The rationale behind such a correlation is, mercifully, simple. A flatter yield curve reduces the profit potential in carry trades, those in which investors borrow at the short end of the curve to lend at the long end of the curve. If the Federal Reserve is raising rates *and is expected to continue* raising rates at the short end of the curve, leveraged traders have to start reducing their riskier bond positions. Once they shed these positions, their demand for insurance drops and we see a lower MOVE number.

The end result of the bond market's action should be a lower probability of the insured event, higher yields, materializing. Maybe the fictional Blanche DuBois could live off the kindness of strangers, but bond traders cannot.