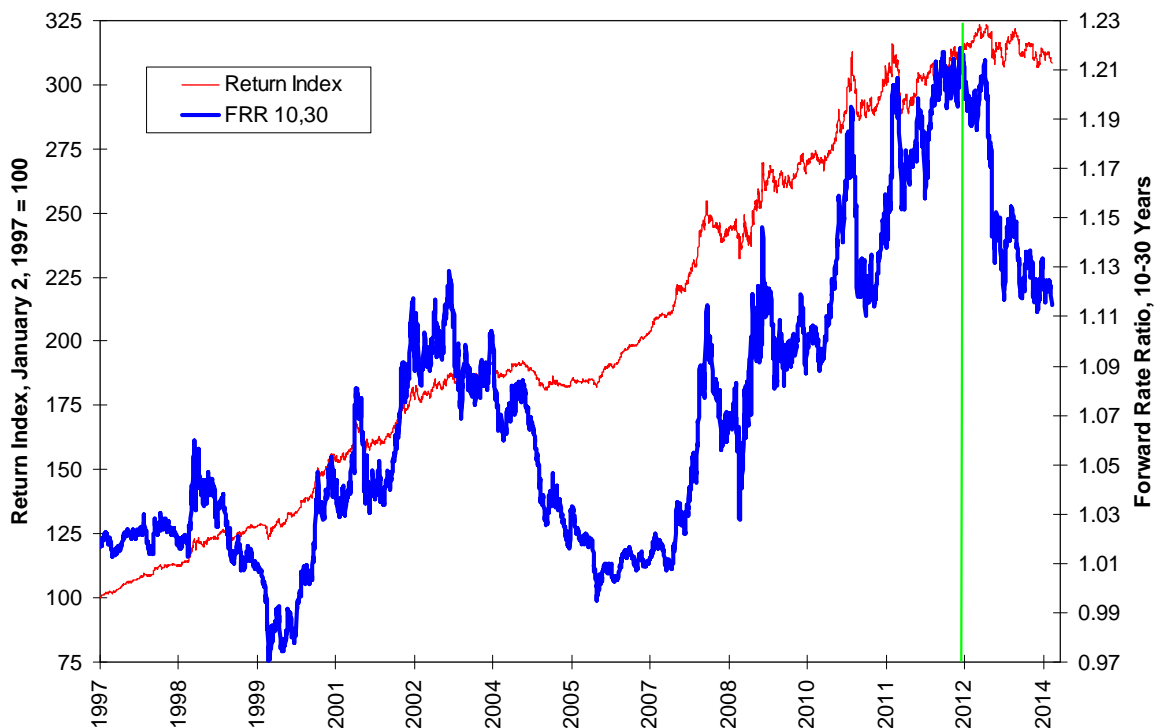


Will The Yield Curve Keep Flattening At The Long End?

It may seem like a bit of distraction in a market driven by news out of Ukraine, Gaza, Portuguese banks and Argentine deadbeats, but the long end of the Treasury yield curve deserves our full and complete attention. Go ahead, try and give it your full and incomplete attention.

The long end as measured by the forward rate ratio between ten and thirty years ($FRR_{10,30}$) has been flattening consistently since the end of November 2011, marked with a green vertical line below. This is the rate at which we can lock in borrowing for twenty years starting ten years from now, divided by the thirty-year rate itself. The more this ratio exceeds 1.00, the flatter the yield curve is.

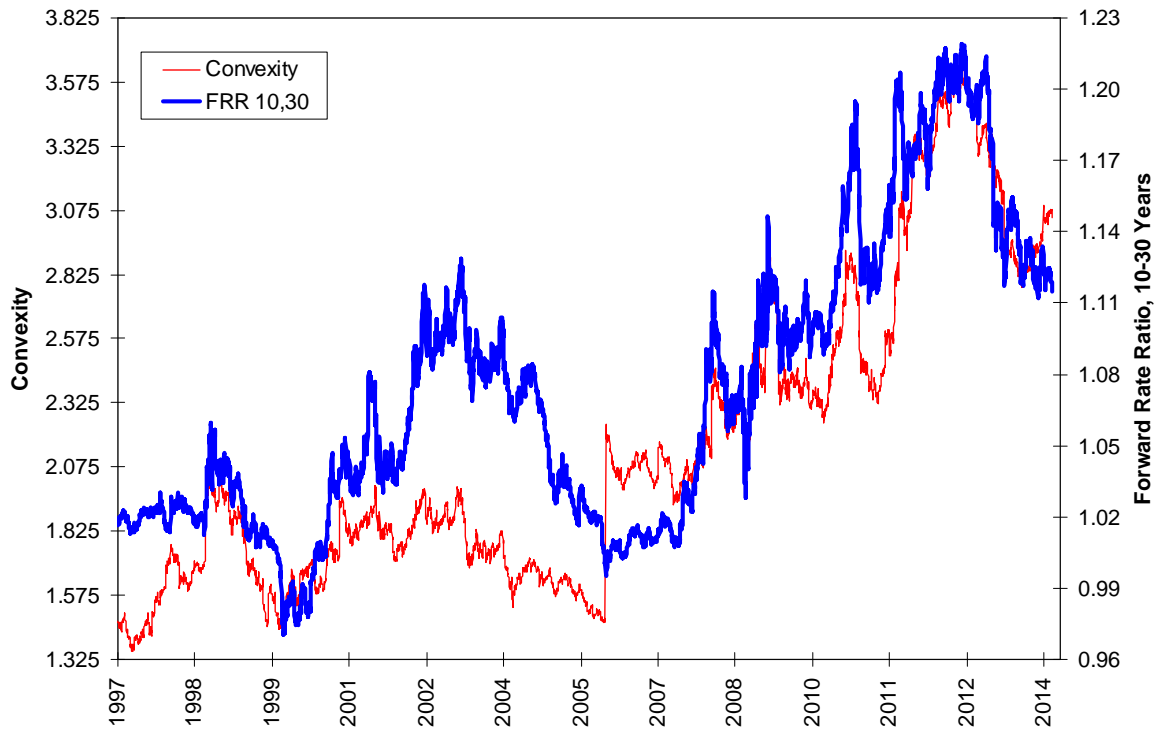
Return On Ten-Thirty Year Treasury Trade As Function Of Yield Curve



November 2011 was when central banks expanded their global currency swap lines, alleviated a dollar shortage for European banks and triggered a rally in global equities. The MSCI World index has returned 55.6% in USD terms since then. The return on the duration-neutral bullish flattener, borrowing the ten-year and lending the thirty-year, did not fare as well over this period; it returned only 5.75%. The current duration ratio would involve borrowing 2.2 ten-year notes and lending one thirty-year bond.

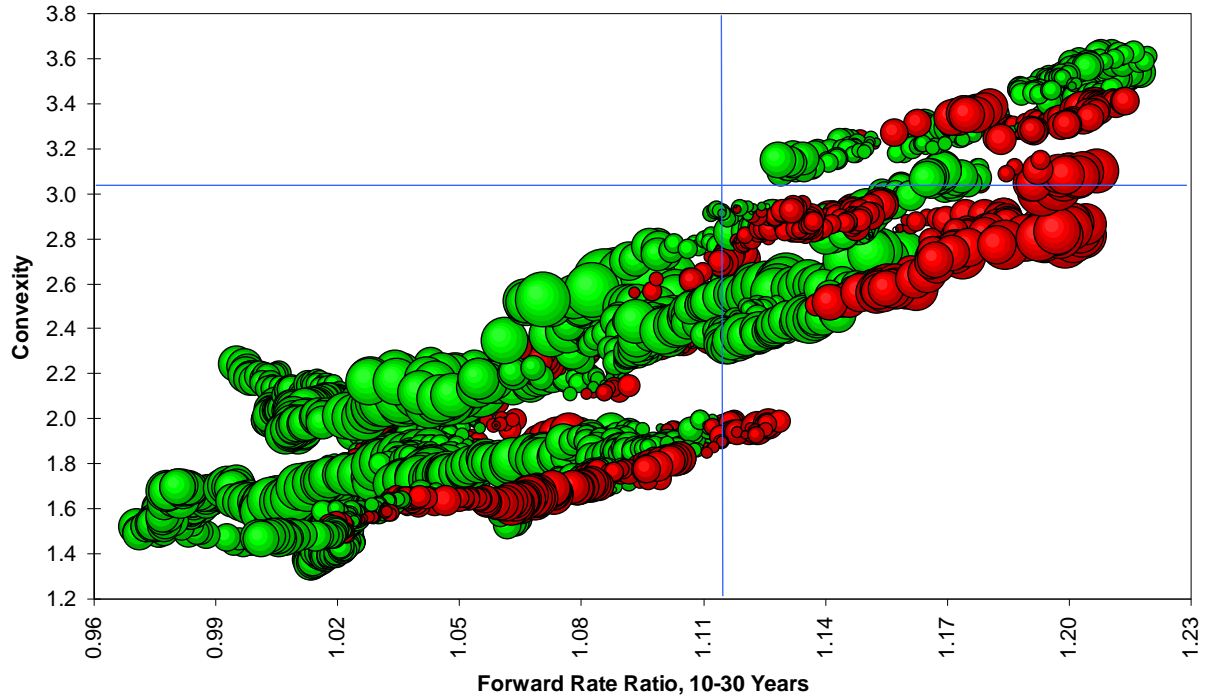
What are the current prospects for this trade? First, the net convexity gain on the trade is increasing once again. Convexity is the rate at which a bond's duration changes with respect to changes in interest rates. This is valuable to bond traders as a longer duration in a falling yield environment increases the rate of price appreciation. However, higher convexity also increases a bond's interest rate risk, something we need to consider when real rates remain negative out to seven years. We saw last week just how twitchy the Treasury market could be when the GDP report came in stronger than expected.

Convexity Of Ten-Thirty Year Treasury Trade Versus Yield Curve



If we sum this all up and map prospective returns on the duration-neutral bullish flattener as a function of net convexity gains and the $FRR_{10,30}$, we find ourselves in terra incognita, wherever that is. Positive prospective returns on the flattener are marked with green bubbles, negative returns with red bubbles; the diameter of the bubbles corresponds to the absolute magnitude of the return. I marked the current environment with a bombsight. It has been drifting slowly to the northwest corner of the map and is out of range of more than sixteen years of historical observation.

Three Month-Ahead Return On Ten-Thirty Year Trade As Function Of Yield Curve And Convexity



The good news, however, is there is nothing to suggest we are heading toward negative returns on the flattener. So long as the yield curve itself flattens and as net convexity gains are rising, we should remain in the flattening environment that has accompanied rising financial markets since November 2011.