Yield Curve Flattening Trades Could Support Long-Term Bonds

Traders often fancy themselves as some sort of modern Horatio-at-the-bridge, bravely standing alone against the forces of evil or something similar. In reality, discretion is the better part of value in this business and while the meek might not inherit the earth, they probably will enjoy longer lifespans. This is why serial top- and bottom-pickers, those who fight against prevailing trends and will be right only once in the process, tend to be better at producing headlines than profits.

So saying, market prices are set by arbitrage relationships and by buyers and sellers at the margin. Fundamental traders who sell over this fair value or buy below it stand a decent chance of profiting. However, as fair value is a moving target and can change rapidly as new information comes into the market, buying low and selling high remains easier said than done.

Duration And Convexity

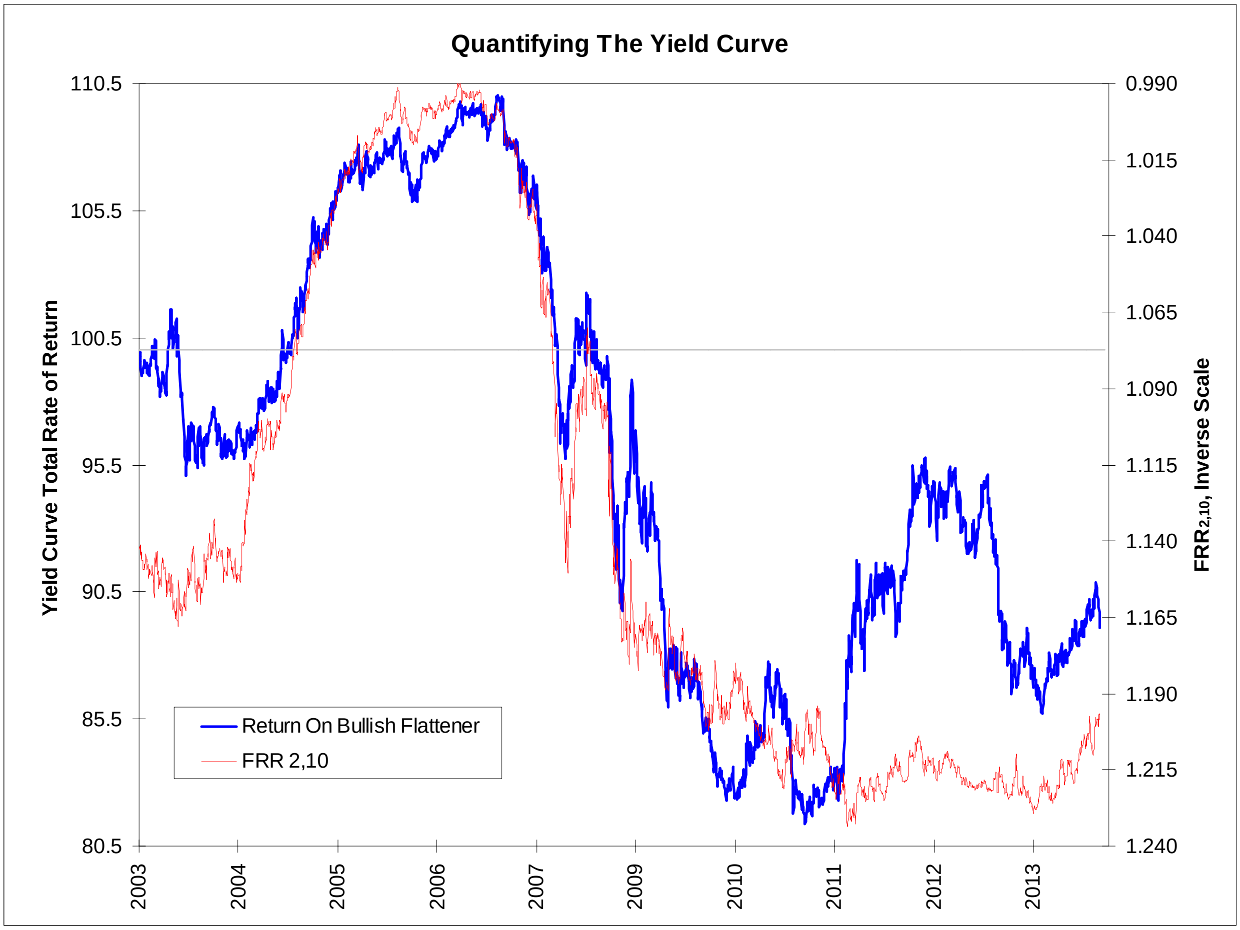
Let’s take a look at a common yield curve trade, the duration-neutral bullish flattener between two and ten years. Duration is the sensitivity of a bond to changes in interest rates. The duration-neutral aspect of the trade is simply a hedge ratio to neutral overall interest rate exposure. Right now, we would need to borrow nine two-year Treasuries and lend two ten-year Treasuries to be duration-neutral.

This trade produces a net convexity or rate at which duration changes as a function of yields. Convexity is valuable: The higher it is, the more the bond gains as rates fall and the less the bond loses as rates rise. For those of you comfortable with option Greeks, think of duration and convexity as you might delta and gamma.

Flatter My Curve To Thee

The Treasury yield curve as measured by the forward rate ratio between two and ten years ($FRR_{2,10}$) has flattened from 1.2293 on November 21, 2013 to 1.1988 last Friday. While two-year Treasury yields increased 29 basis points since November, ten-year yields have declined 17 basis points. The short end of the yield curve continues to price in expectations for higher short-term interest rates while the long end of the yield curve has been pushed lower by regulatory constraints on bank holdings, haven bids, carry trades and stable inflation expectations.

A duration-neutral bullish flattener has returned 2.67% while the $FRR_{2,10}$ has flattened. This is a restoration of the normal pattern; flatteners gained steadily through the 2004-2006 period when the Federal Reserve executed a series of seventeen consecutive increases in the target federal funds rate. The gains on a flattening trade during the heyday of yield-curve twisting in 2011-2012 derived from the artificial gains on ten-year Treasuries during a steep yield curve environment.



Right now, the net convexity gains on the yield curve flattening trade are greater than they were in November 2013, a fundamental factor in favor of the trade. The real yield on ten-year Treasuries of 0.475% is approaching the November 2013 level of 0.564%; it had been as low as 0.146% in mid-August. Real two-year Treasury yields have climbed from -1.689% in March to a level of -0.808% last Friday. A flattening trade thus involves borrowing at a negative real rate to lend at a positive rate. This, combined with the convexity gain and the yield curve's flattening trend, makes the trade attractive still. You will know if this trade is wrong fairly quickly if ten-year Treasury yields break over 2.70%.