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## COMMENTARY

Market Opinions And Topics Of Interest  
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### The Trade No One Recommended? Part 2 – Why Has Spread Product Performed Poorly?

In part 1 of this commentary, we showed that the Merrill Treasury Master has outperformed all other major fixed-income Merrill Master Indices: year-to-date; over the last 12 months; and over the last 3 years.

Listing these three time periods is important because spread product has consistently under-performed for this length of time. Many of the reasons that are typically offered for this poor relative performance of spread product only address the last few months. (Treasury buybacks, potential GSE regulation, issuance, poor stock market performance, etc.). We believe any discussion of the poor performance of spread product should offer reasons that have been valid since early 1997.

#### Swap Spreads

Charts 1 and 2 show a long-term look at swap spreads. We show both the 2-year swap market (since it is more liquid) and the 10-year swap market (which is more popular). Both of these swap spreads began a trend toward widening about 3 1/2 years ago. This widening began as spread products began to underperform Treasuries. This is not a coincidence.

To understand why this is not a coincidence, we need to look at the factors that drive swap spreads. We believe there are two major factors: (1) the movement and direction of interest rates and (2) the fear of systemic or credit risk that might call into question one's ability to get paid on a swap contract.

**Swap spreads are nothing more than an exchange of cash flows** (fixed versus floating). This means the perceived direction and movement of interest rates **should be** the dominating influence on swap spreads.

Chart 3 shows a rolling 1-year correlation between 2-Year Treasury Note and 2-year swap spreads.

Notice that for most of the 1990s, swap spreads and interest rates were highly correlated to each other. This means that swap spreads and interest rates move in the same direction and to roughly the same degree. **It is common for higher interest rates and higher swaps to occur at the same time.**

The exception to this relationship has been when "credit concerns" dominated the trading in swap spreads. Such occurrences include: the recession of 1990/1991; the Asian Financial Crisis; and the period that encompassed the LTCM bailout and Russia's debt moratorium in 1997/1998. These episodes are listed on Chart 3.

In each of these cases, yields fell and spreads widened thereby producing a large negative correlation. So, while credit concerns do impact swap spreads, it is the exception rather than the rule. The "normal" trading pattern of swap spreads should be highly influenced by the movement and direction of interest rates.

Starting about three years ago, the correlation between interest rates and swap spreads started to weaken. Despite the roaring economy, the correlation between these two series has yet to return to the levels seen in the mid-1990s. Why?

Since we believe that swap spreads are driven either by the movement and direction of interest rates or systemic risk, it has to be one of these factors that is causing the lack of correlation. If it were the movement and direction of interest rates, then we would be saying that interest rates are irrelevant to swap spreads. This is definitely not the case.

This leaves systemic or credit risk. We believe there has been an overriding fear of "systemic problems" over the last three years. From the Asian financial crisis to LTCM to increasing corporate default rates to sky high equity valuations, we believe that the lack of correlation between swap spreads and interest

rates has been an over-riding fear of increased risk in the financial system. We believe this sense of increased credit risk has been the catalyst for higher swap spreads and the widening of all spread products. This in turn has led to the outperformance of Treasuries over all other major fixed-income sectors.

### **Conclusion**

Understanding what is driving swap spreads is critical in gauging the health of the fixed-income markets. Since swap spreads have at their essence just two driving factors, they can help us isolate whether it is the movement and direction of interest rates or systemic risk that is affecting the bond market. How can we tell which of these factors is dominant? By looking at swap spreads correlation to interest rates.

For the last few years, swap spreads have exhibited little correlation to the movement and direction of interest rates. We believe this means that swap spreads are pricing in more and more systemic risk.

This increased systemic risk is behind the widening of all spread products over the last few years and the main reason that Treasuries, the highest credit quality major fixed-income sector, have been the best performing part of the fixed-income market.

Going forward from here, we suggest watching the correlation between swap spreads and interest rates. When the correlation between these series returns to normal levels, it might suggest that systemic risk is lessening. Interest rate risk (the movement and direction of interest rates) should then be the dominant factor in setting swap spreads. When this occurs, the premium in all spread products due to systemic risk should contract, and spread product will be a better relative performer. Until then, Treasuries should continue to be the best performing sector.

What is going to get the marketplace to believe that systemic risk is lessening? At this point, it is not the "usual suspects" such as a strong economy, rising stock market or a vigilant Fed. We have had all these and swap spreads continue to rise while showing little correlation to interest rates.

Unfortunately, we believe the return to normalcy might not occur until the bottom of the next recession. Only then will the marketplace have the confidence that systemic risk is not a major factor. This would allow the "systemic risk premium" priced into swap spreads and spread products to contract.

If we are correct in this assessment, it means that more pain is in store for holders of spread products.

Chart 1

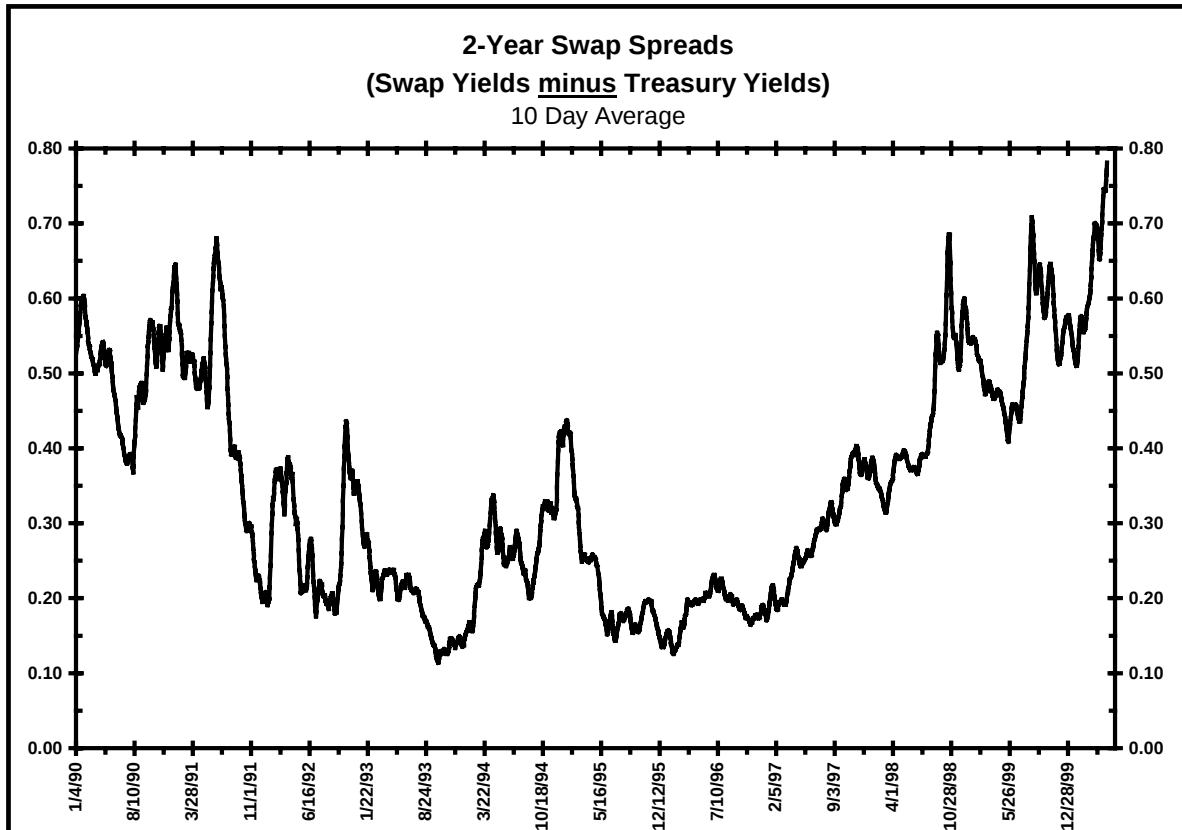


Chart 2

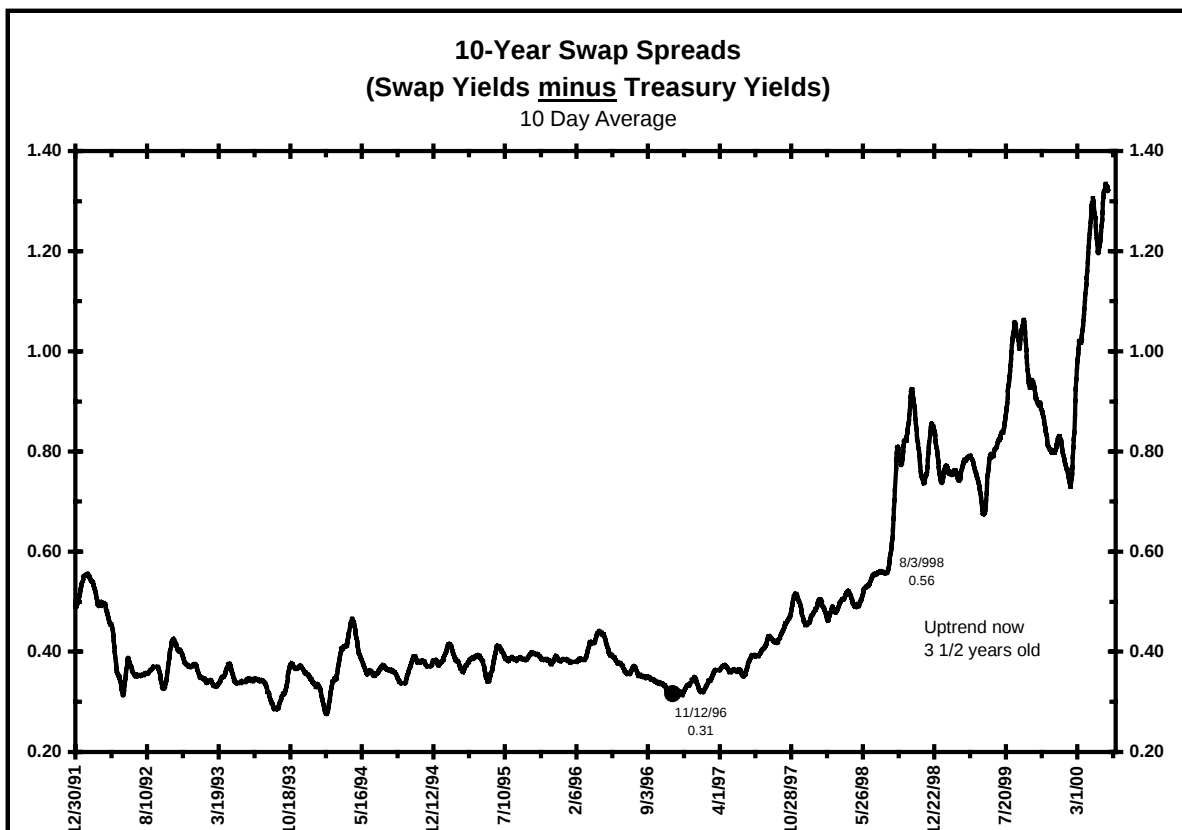


Chart 3

