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COMMENTARY

Market Opinions And Topics Of Interest
February 11, 2000

Our Take on the Bond Market in 2000
Part 1: Why the yield curve is inverted

The last few weeks in the bond market have been among the most confusing periods we have seen in some time. For the last several days, we have been sitting in front of our computer attempting to write our take on what is happening in the bond market. As always, our goal is not to state the obvious (the Treasury announced a reduction in supply and a buyback…), but to dig deeper.

What Do <u>Leveraged</u> Traders really bet on?

Has anyone noticed that the 30-year bond **<u>rally</u>** of the last few weeks has caused pain and grief in the **leveraged** community (dealers and hedge funds)? The last bond rally of this size was in the fall of 1998, and it also caused pain and grief. So, why is it that the leveraged community only experiences pain and grief when bonds rally? Where was the pain and grief when bond prices were getting killed between October 1998 and January 2000?

In answering this question, we need to recognize what kinds of bets most leveraged bond traders actually make.

Despite the implication in the financial press, few leveraged bond traders make bets on the direction of interest rates anymore. What they do is bet on the direction of spreads (i.e., "convergence trade"); the shape of the yield curve (flattening or steepening); or what parts of the fixed-income market will outperform a benchmark index ("sector bets"). While these types of "swap bets" (both long and short bonds at the same time) have been around forever, we believe it was the 1994 "bond market debacle" that pushed leveraged bond professionals almost exclusively into making these kinds of bets.

This is why the absolute movement of yields (October 1998 to January 2000) did not produce pain and grief like that seen when the yield curve twisted and spreads shifted in the last few weeks. To be sure, the level and direction of interest rates are of major concern to **unleveraged** bond professionals (mutual funds and pension managers) and everybody outside the bond market.

This is important to recognize because the vast majority of non-leveraged traders (including economists and equity managers) look at the absolute movement and direction of interest rates to make statements about inflation and the state of the economy. What they **<u>assume</u>** is that this influential group of bond traders, the leveraged community (see chart 1 for a sense of how big they are), are trading based on their belief about the direction and level of interest rates. Since they are not, their actions can often go at odds to the fundamentals that drive the level and direction of interest rates. We believe the current situation is one of these times.

What Bet Went Wrong?

So, if leveraged bond professionals are not betting on the absolute level and direction of interest rates, what are they betting on?

This question is very difficult to answer as little data exists to confirm *Wall Street* chatter. However, if we assume that the dealer community and the hedge fund community are often in the same types of trades (a reasonable assumption based on the experience of the last few years), then we can do a little extrapolation.

Chart 2 shows the results of a survey by IFR (formerly Technical Data) where bond portfolio managers have structured their portfolios in a "barbelled" fashion looking for a flatter yield curve. Since one of the roles of a primary dealer is to accommodate their customers, we believe it is reasonable to assume that their inventory has a complimentary bet. That is, the dealers have a curve steepening trade on.

Chart 3 shows one of the more popular watched yield curve sectors, the 30-year minus 10-year spread. Notice that this spread, like many other spreads, has been flattening for almost 18 months. So, why did the dealers feel comfortable in keeping a structure that profited from a steeper yield?

How many more Fed tightenings were coming?

Recall that throughout 1999, the Fed tightening campaign was met with denial and calls that the Fed was about to be finished raising rates. Consider:

- When the Fed first moved to a tightening bias in May 1999 (and immediately announced it for the first time) it was dismissed because "in the recent past, the Fed has had lots of tightening biases and did not necessarily move at the next meeting." The Fed did move rates at the next meeting (June 30).
- When the Fed raised rates on June 30, the belief was "one and done, just like March 1997." After all, inflation was not a problem and the Fed moved to a neutral bias (even though they moved to a neutral bias after every tightening in the 1990s.). This implied an easier monetary policy going forward. Despite this argument, the Fed hiked rates at its next FOMC meeting on August 24.
- After the August 24 FOMC meeting, it was once again believed that the Fed was done. This time the argument was that the Fed took back 50 bps of its 75 bps easing from late 1998. Coupled with wider credit spreads, the Fed had removed its easy monetary policy of late 1998 and thus did not need to tighten anymore. The Fed raised rates again on November 16.
- After the Fed raised rates on November 16, the belief was the Fed took back the full 75 bps of its late 1998 easing (forget the wider spread angle). Again the Fed was believed to be done tightening. Despite this rationalization, the Fed raised rates for a fourth time last week, on February 2.

In early January, the rationalizations that the Fed was done tightening dramatically changed. No longer was the belief that the Fed was about to stop. Instead, the Fed was going to get aggressive, "Greenspan style." This meant that the Fed would hike the funds rate 25 bps at every meeting until the economy appreciable slowed.

This change in the forecast for Fed policy can be seen in chart 4. Notice how expectations for more tightening has stayed high (above 50 bps) following the latest Fed hike. This stands in stark contrast to the pattern following the three previous Fed moves where the belief was the Fed might be done (as the expectation dipped below 25 bps and near zero in some cases). For now, the marketplace does not think the Fed is about to stop tightening anytime soon.

We believe the change in perception about Fed intentions was a result of the stock market's huge rally of 1999. In late December/early January, the argument about the wealth effect seems to have been settled (despite some high profile dissenters). The booming stock market was perceived to be the catalyst behind Christmas sales registering growth not seen in 15 years, and two successive quarters of 5+% real GDP growth (Q3 and Q4 1999). If the Fed wanted the economy to slow, it had to raise rates enough to slow the stock market. More than a single 25 bps hike would be needed to accomplish this.

Greenspan himself may have helped fuel this change in perception in his January 13 speech to the New York Economics Club. He suggested that 1% of the recent real GDP growth of 4% over the last few years was due to the wealth effect.

Given this change in perception toward a more aggressive Fed, anyone that had a bet on a yield curve steepening was now doing a radical "re-thinking" of their positions. How is the curve going to steepen if the Fed is going to tighten at every meeting going forward? The answer is the yield curve is not going to steepen. It is going to flatten, since there is little reason for short-term interest rates to fall.

The Wrong Time for A Big Short

Earlier we suggested that most leveraged bond professionals do not bet on the level and direction of interest rates. Let us amend this slightly. There is one group that does bet on the direction of interest rates – large speculators in the futures markets.

As chart 5 shows, these large speculators were net **short** 72,000 bond contracts as of January 25 (the latest data available). This was just a few days after the low trade of the year. So the stage was set for a massive short squeeze in the bond market.

The leveraged community was carrying a large bet on a steepening yield curve. The large speculators were net short a record amount of bond futures. At the same time, the market was beginning to understand that the Fed was adopting a more aggressive stance.

What About Supply and Buybacks?

Notice that so far we have not mentioned the reduction in long-bond supply or the implications of the buyback. We did this intentionally to show that these announcements are more the case of "pouring gasoline on an existing fire" rather than "causing the fire" for the dramatic flattening, and now massive inversion of the yield curve. If all of these "other" factors are behind the twisting of the yield curve, do not expect the yield curve to return to a normal shape should the Treasury change its policy regarding long-bond issuance or buybacks.

In fact, we do not think any change of this kind will matter much. **For the yield curve to "un-invert," short rates need to fall. For short rates to fall, the Fed has to stop tightening. For the Fed to stop tightening, the economy has to slow. For the economy to slow, the stock market has to decline, and stay down**. So, look for the yield curve to remain inverted for some time, or until the stock market declines significantly.

Updating Our Forecast

We have long held the belief that interest rates will have to rise enough to halt the stock market's advance. Earlier this year we suggested it would take yields in excess of 7% to accomplish this. We still believe this to be the case.

However, this dramatic rise in interest rates will most likely **not** take place in the 30-year bond. It now appears that late January's high of 6.74% could very well have been the high of the year. We say this because we believe it took a massive short position (both among futures traders and leveraged traders betting on a yield curve steepening) to push yields this high. Now that these shorts have been squeezed and badly hurt, we do not expect them to get aggressively short again anytime soon. Without this aggressive shorting, the 30-year should only be able to retrace its drop in yields and not make new yield highs for the year.

Regarding the rest of the yield curve, 7+% yields still look likely to us. Currently the July Fed Fund futures contract suggests a 6.50% fed funds rate by mid-year. If this occurs, two-year yields could approach 7.25% to 7.50%. 10-year yields could also top 7% while long bond yields stay below 6.50%. So, we are looking for the yield curve to invert further.

Should this happen, it will accomplish the goal of slowing the economy. The added wrinkle of an inverted yield curve will **help** the Fed case as it will cause more pain on *Wall Street* than the orderly rise in interest rates did last year.

Once the economy slows enough for the Fed to stop raising interest rates, yields will fall. Only then will the yield curve "un-invert."

In part 2 we will discuss how far the yield curve can invert in the coming week/months.

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Chart 1

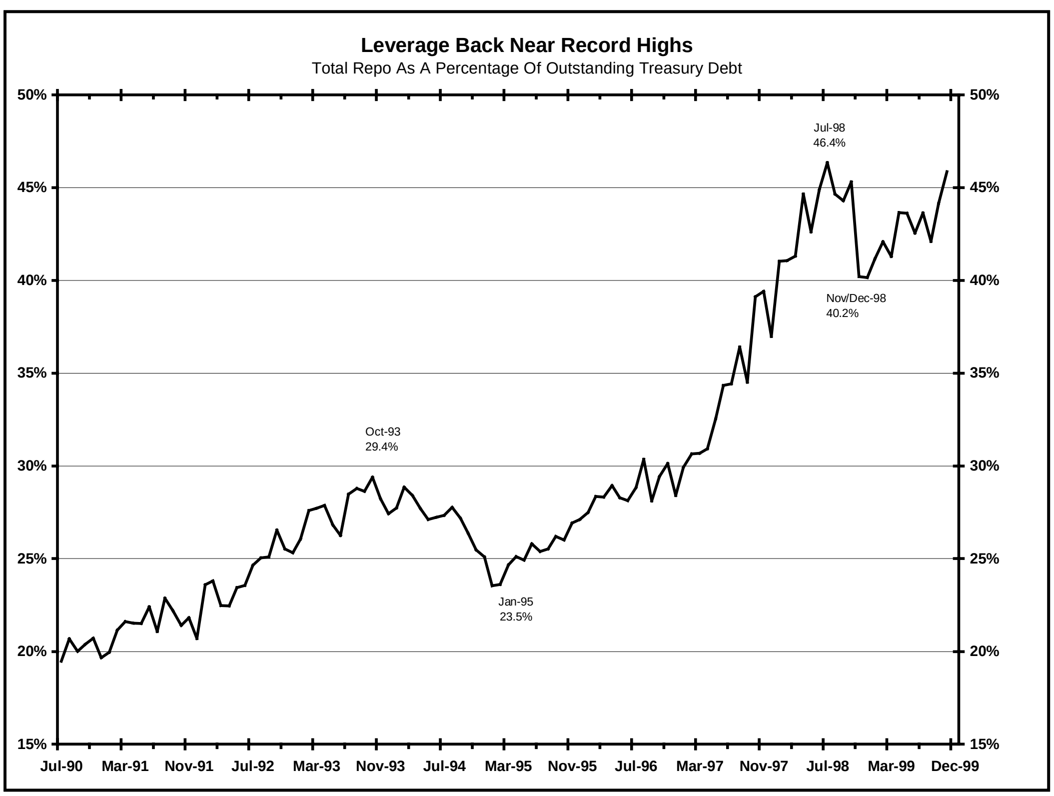


Chart 2

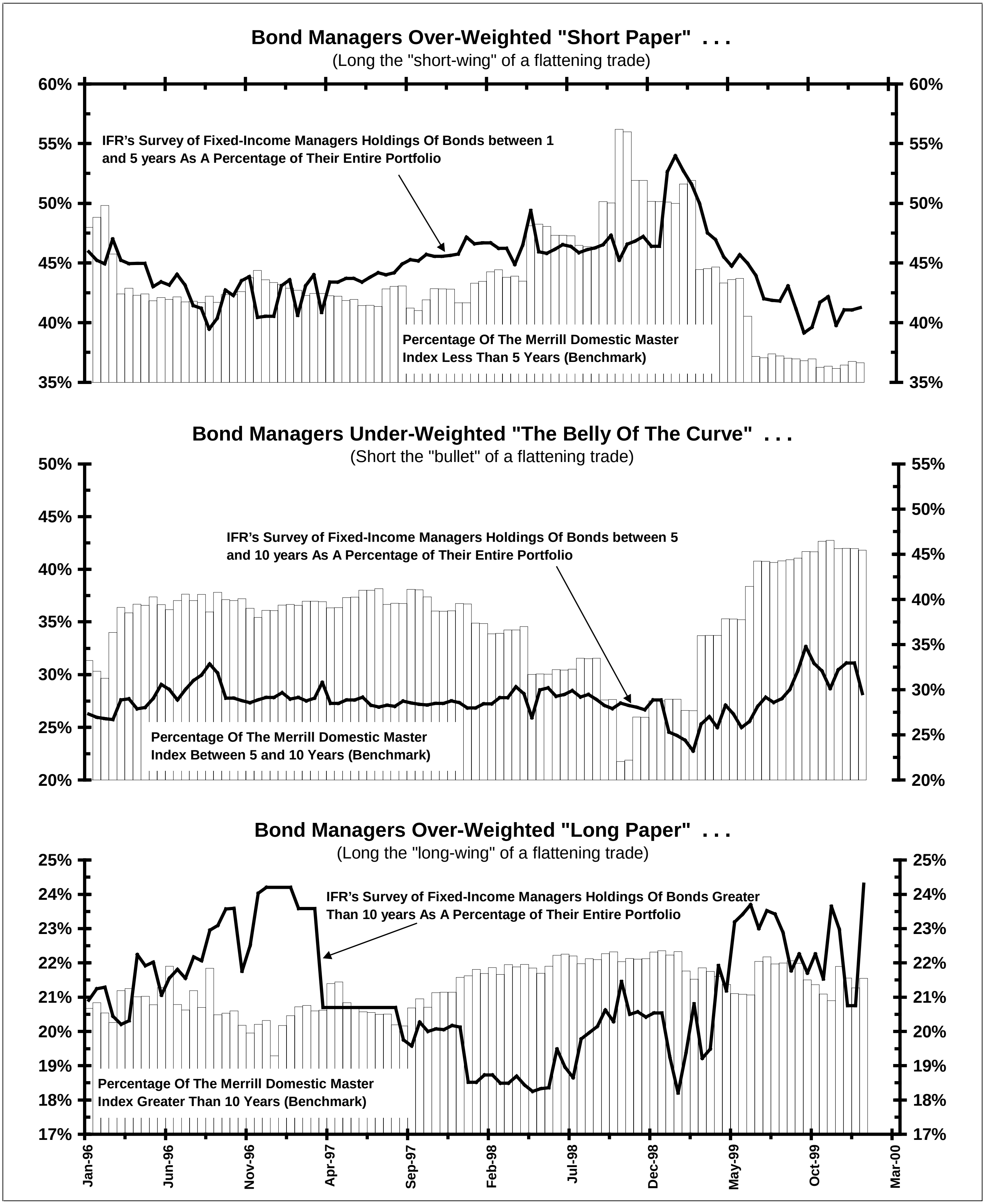

Bond Managers Over-Weighted "Short Paper" . . .
(Long the "short-wing" of a flattening trade)
IFR's Survey of Fixed-Income Managers Holdings Of Bonds between 1 and 5 years As A Percentage of Their Entire Portfolio
Percentage Of The Merrill Domestic Master Index Less Than 5 Years (Benchmark)
60%
55%
50%
45%
40%
35%
Bond Managers Under-Weighted "The Belly Of The Curve" . . .
(Short the "bullet" of a flattening trade)
IFR's Survey of Fixed-Income Managers Holdings Of Bonds between 5 and 10 years As A Percentage of Their Entire Portfolio
Percentage Of The Merrill Domestic Master Index Between 5 and 10 Years (Benchmark)
50%
45%
40%
35%
30%
25%
20%
55%
Bond Managers Over-Weighted "Long Paper" . . .
(Long the "long-wing" of a flattening trade)
IFR's Survey of Fixed-Income Managers Holdings Of Bonds Greater Than 10 years As A Percentage of Their Entire Portfolio
Percentage Of The Merrill Domestic Master Index Greater Than 10 Years (Benchmark)
25%
24%
23%
22%
21%
20%
19%
18%
17%
Jan-96
Jun-96
Nov-96
Apr-97
Sep-97
Feb-98
Jul-98
Dec-98
May-99
Oct-99
Mar-00

Chart 3

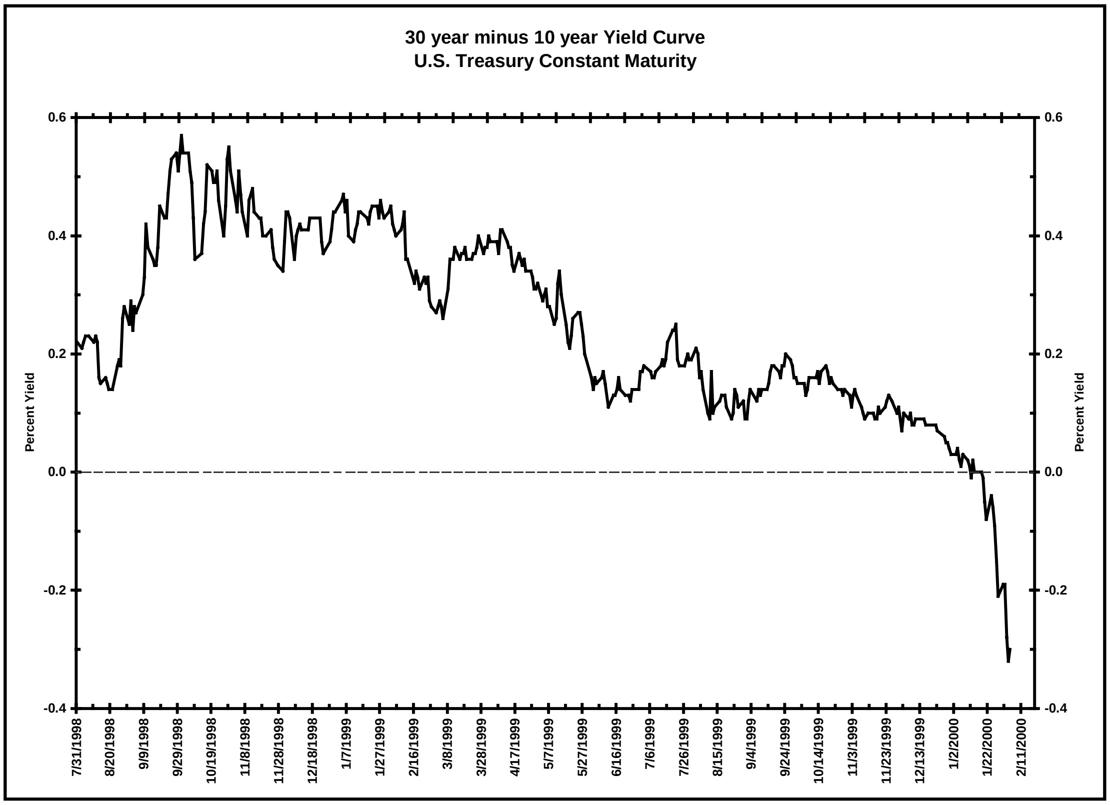


Chart 4

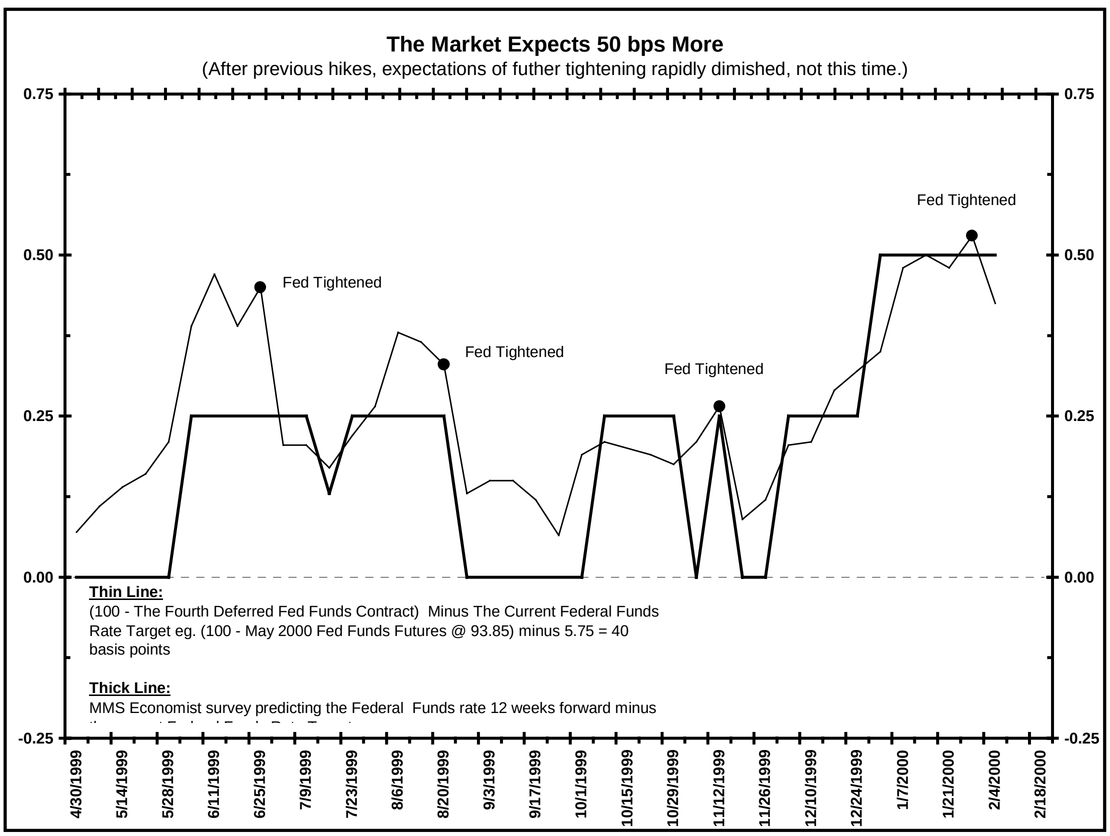
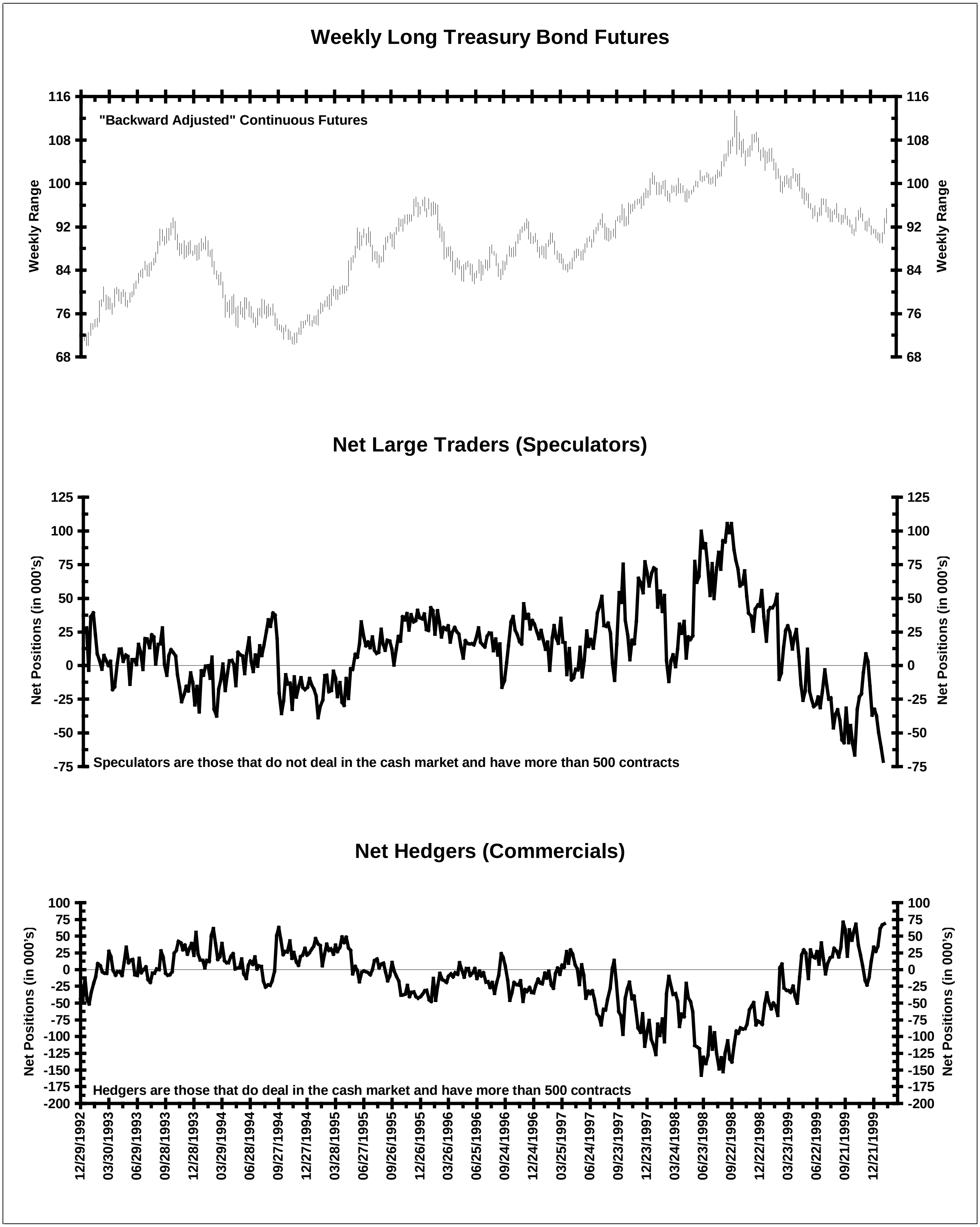


Chart 5



Weekly Long Treasury Bond Futures
"Backward Adjusted" Continuous Futures
Weekly Range
116
108
100
92
84
76
68
Net Large Traders (Speculators)
Net Positions (in 000's)
125
100
75
50
25
0
-25
-50
-75
Speculators are those that do not deal in the cash market and have more than 500 contracts
Net Hedgers (Commercials)
100
75
50
25
0
-25
-50
-75
-100
-125
-150
-175
-200
Hedgers are those that do deal in the cash market and have more than 500 contracts
12/29/1992
03/30/1993
06/29/1993
09/28/1993
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12/27/1994
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