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COMMENTARY

Market Opinions And Topics Of Interest
March 1, 2001

Here Comes The Convexity Trade Again!

*"Prepayments on mortgage bonds, which crimp investors' returns, surged in February **at the fastest pace ever** [our emphasis] as homeowners took advantage of falling mortgage rates to refinance their loans."*
Bloomberg, March 1, 2001

In our January 29, 2001 Commentary, we explained "The Convexity Trade" and why it might be one of the most important influences on the bond market today. This trade appears to be "re-asserting" itself as 5-year and 10-year Treasury rates are at their lowest yields in the last 2 years.

As the quote above and Chart 1 show, mortgage rates are on the verge of breaking through to new lows. Should this happen, we can expect a rush to re-finance mortgages. This will shorten the duration of the mortgage index even more. Already this week, we have seen the effective duration of the Merrill Mortgage Index fall from 3.201 on February 23 to 2.799 on February 28.

As Chart 2 shows, the drop in yields this week alone has pushed the amount of "10-year equivalents" up by \$12 billion. As Chart 3 shows, since Fannie Mae and Freddie Mac own over half the mortgage Index, they also could be looking to replace \$6 billion in lost duration.

Conclusion

The most important aspect of the convexity trade is that it cannot create a new trend in interest rates; it can only exaggerate the current trend.

Should interest rates continue to break to new lows, the convexity trade will become an even bigger influence and help continue the trend toward lower rates. Stay tuned.

From Our January 29, 2001 Commentary:
What is the Convexity Trade?

In the bond market, there is a rather arcane trade tied to the fortunes of the mortgage market loosely called "the convexity trade."

The convexity trade gets its name from a defining characteristic of the mortgage market – "negative convexity." This means that as overall market yields fall, the duration of the mortgage index falls (shortens) as well. Duration measures how sensitive price movements are to changes in interest rates. The fact that mortgage prices become less sensitive to falling interest rates (rising prices) is not a good thing for the owners of mortgage securities. This is why they are said to be "negatively convexed." Conversely, when yields rise (falling prices) mortgage prices become more sensitive to changes in yields -- also not a good thing.

This negative convexity is mainly due to mortgage refinancing. When yields fall, homeowner's rush to refinance their mortgages. Since mortgage securities "pass-through" refinancing to their investors, this has the affect of speeding up mortgage prepayments, thus shortening duration and causing prices to rise less as rates fall. In extreme cases, an investor who bought a mortgage security believing he would get interest payments over **many** years might wind up with significantly fewer payments than anticipated, and receive his money back in a **few** years. If this investor paid a price significantly over par (100) for this security (he would do this believing this security would pay interest for many years), a loss can occur. This is why mortgage investors more often run into problems when rates fall as opposed to when they rise.

So what is the convexity trade? As mortgage yields fall, duration shortens or is "lost." This is of particular concern to professional bond managers who manage a bond portfolio with a large portion in mortgage securities targeted to a specific duration (such as an insurance company that tries to match their bond portfolio's duration to their liabilities'.

duration). When yields fall and duration is lost, many of these managers will seek to replace the lost duration by purchasing other fixed-income assets such as Treasuries (which have "positive convexity") or interest rate swaps.

The convexity trade, by itself, cannot create a new trend in yields. It will only exaggerate an existing trend. This trade is neither bullish nor bearish, but the increased amount of trading is causing exaggerated moves and more volatility..

Chart 1

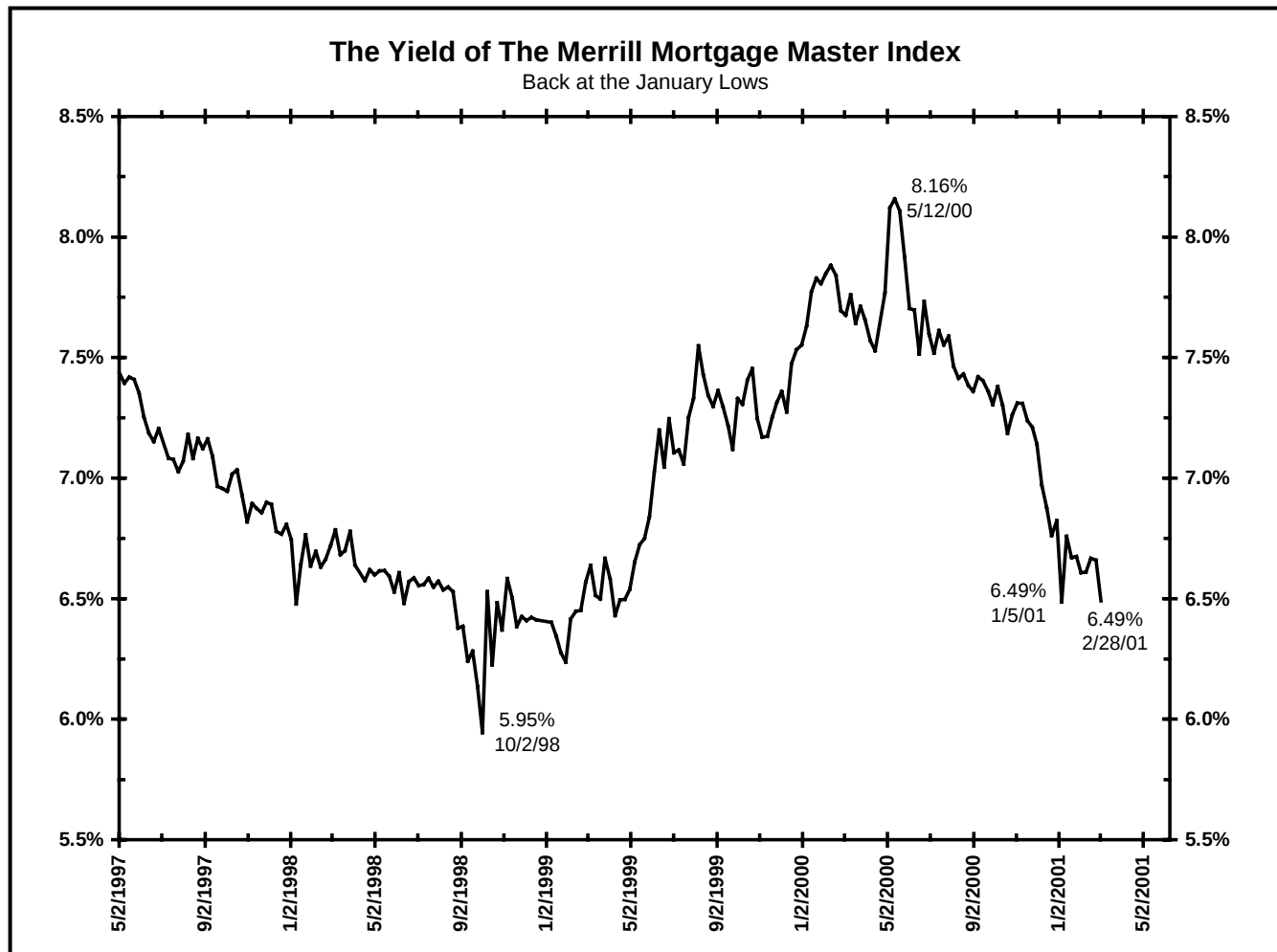


Chart 2

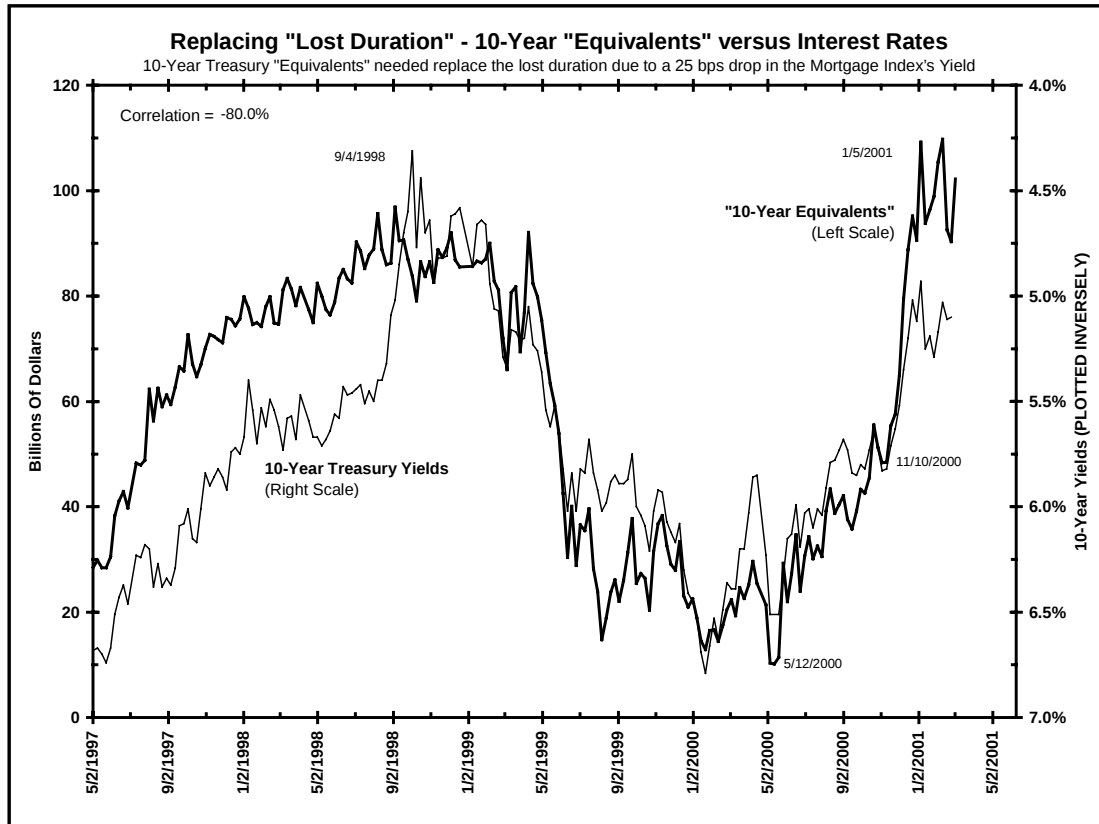


Chart 3

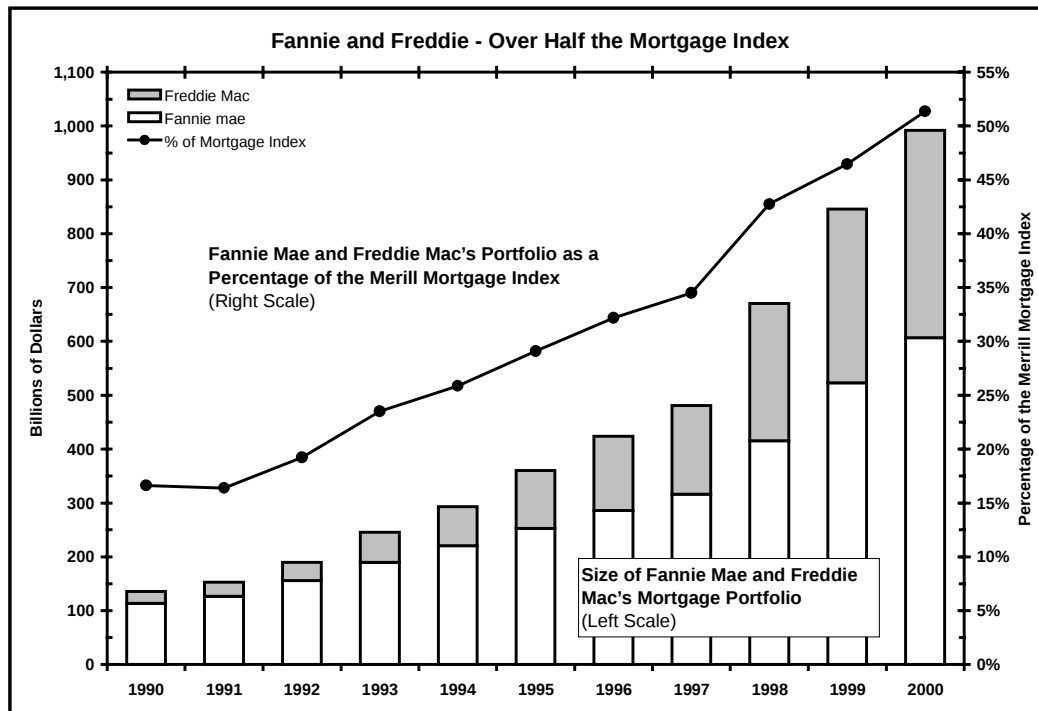
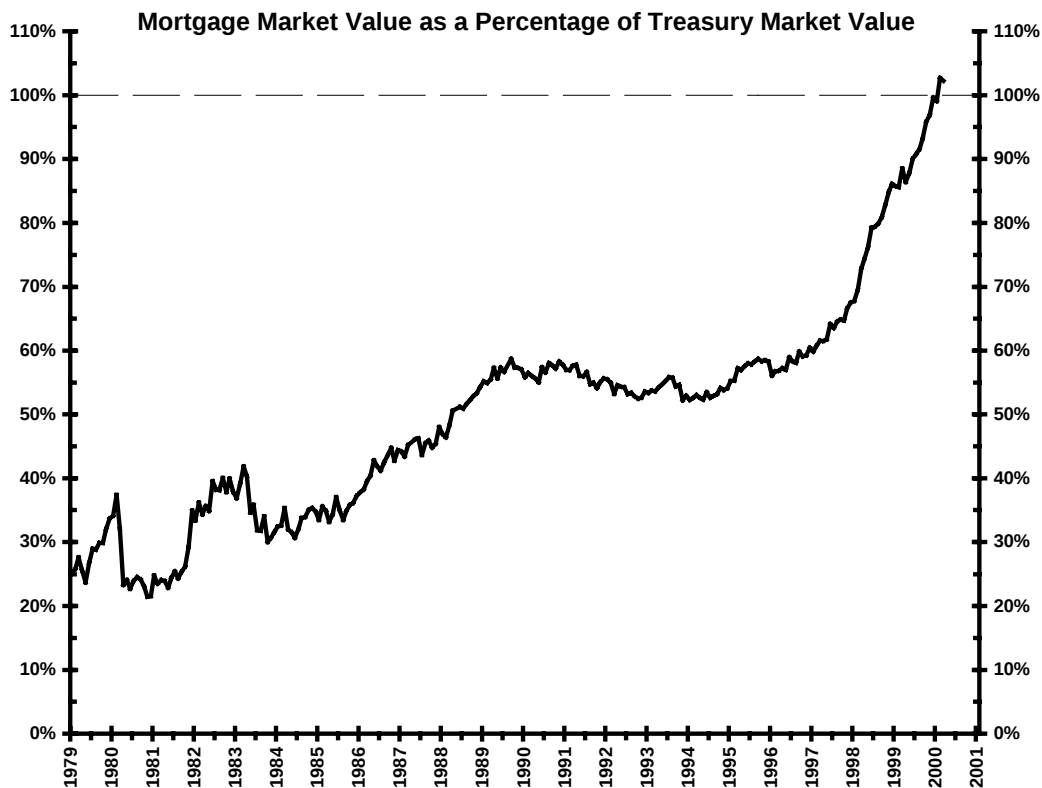
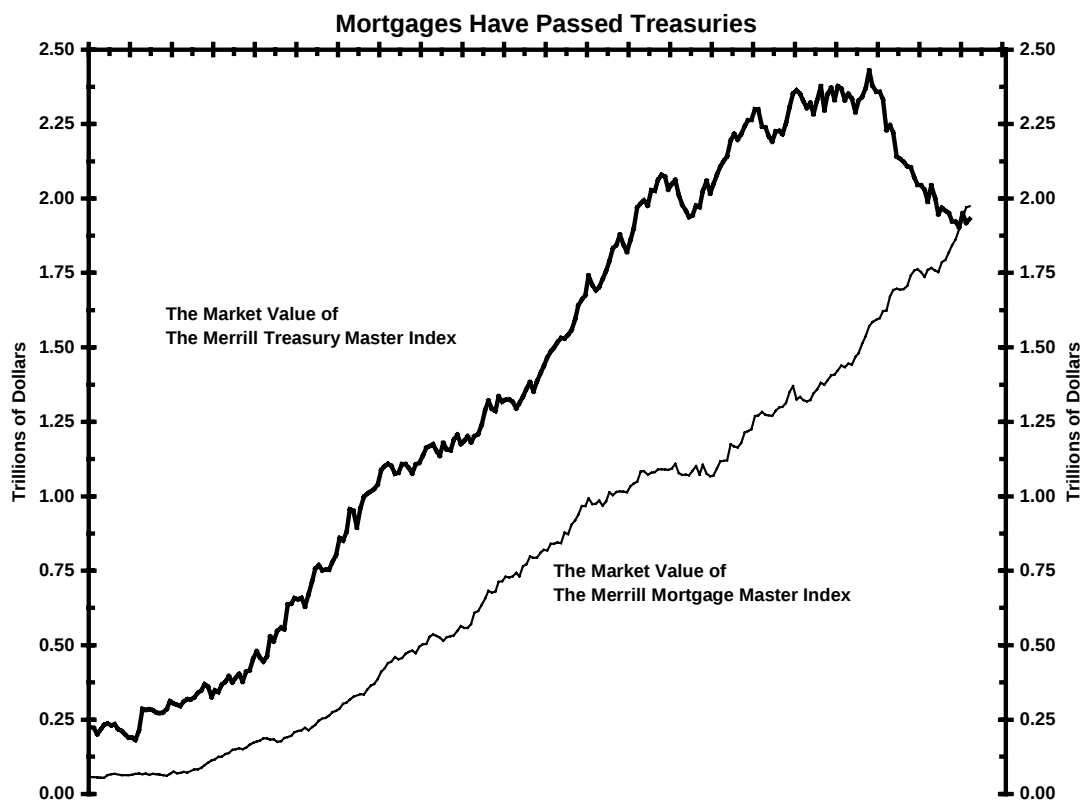


Chart 4



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