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A Commentary by Harley Bassman:

THE CONVEXITY MAVEN

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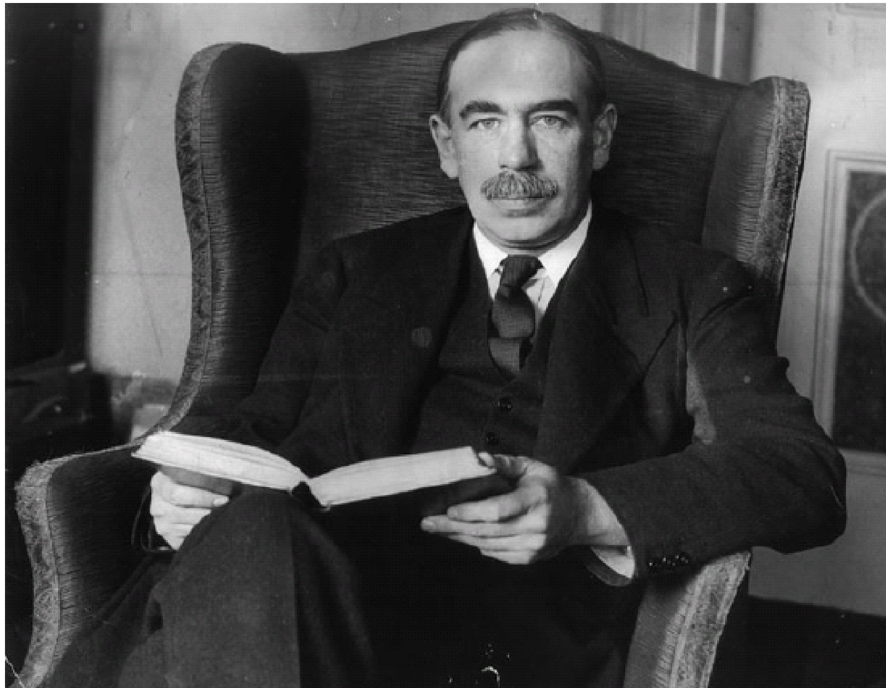
Value Concepts from the Credit Suisse Trading Desk
February 27, 2012

"When the Facts Change, I Change My Mind, What Do You Do, Sir ?"

Unconfirmed attribution to John Maynard Keynes



In as much as the Monetary Policies of "Helicopter Economics" and "Financial Repression" are distasteful, ultimately, the FED has concluded (and I agree) that "Plan B" would be worse. The over-leveraging of private balance sheets required the Government to step in and transfer some of the risk, at least on a short-term basis, to the public sector. Thus, the creation of an alphabet soup (TARP, TALF,

etc.) of Government policies. Similarly, as the risk of a deflationary spiral brought on by a classic Liquidity Trap loomed, the FED cut their main interest rate to nearly zero. So the primary question is: How long will the FED maintain its Zero Interest Rate Policy (ZIRP)? And secondarily, what is the "right price" for Interest Rates and Implied Volatility under current conditions?

Let's review the logic of the FED from 20,000 feet.

Classic Monetarist theory states: **M*V = P*Q = GDP**

In plain English, Money times Velocity equals Price times Quantity equals GDP. To pump up the "M", the FED has been running the printing presses at full speed for some time, yet this has been ineffective since Velocity has ground to a halt. As such, the FED has taken extraordinary measures to create Velocity. First they implemented ZIRP to force cash out of money market accounts and into the economy. When excessive investor fear thwarted this effort, team FED purchased nearly two Trillion in MBS and Treasury bonds to engineer an "asset substitution" via Large Scale Asset Purchases (aka, QE). No such luck. Like the phoenix from the ashes, they revived a 1960s policy dubbed Operation Twist (thank you Chubby Checker). The idea here was to "roll" shorter-term assets into longer-term ones on the FED's balance sheet. The resulting flattening of the Yield Curve would, theoretically, force investors into risky assets and create Velocity in the private sector. Once again, no takers as investors held on to their "riskless" assets.

Unless the FED desired to implement the radical, but technically legal, policy of buying Corporate Debt, the only card left to play was to massively reduce Implied Volatility via the issuance of a "Bernanke Put". Similar to the "Greenspan Put" first introduced after the 1987 Stock Market crash (and brought out for an encore after the 2001 market swoon), the Bernanke Put took the form of a promise to keep Interest Rates low for and "extended period" of time.

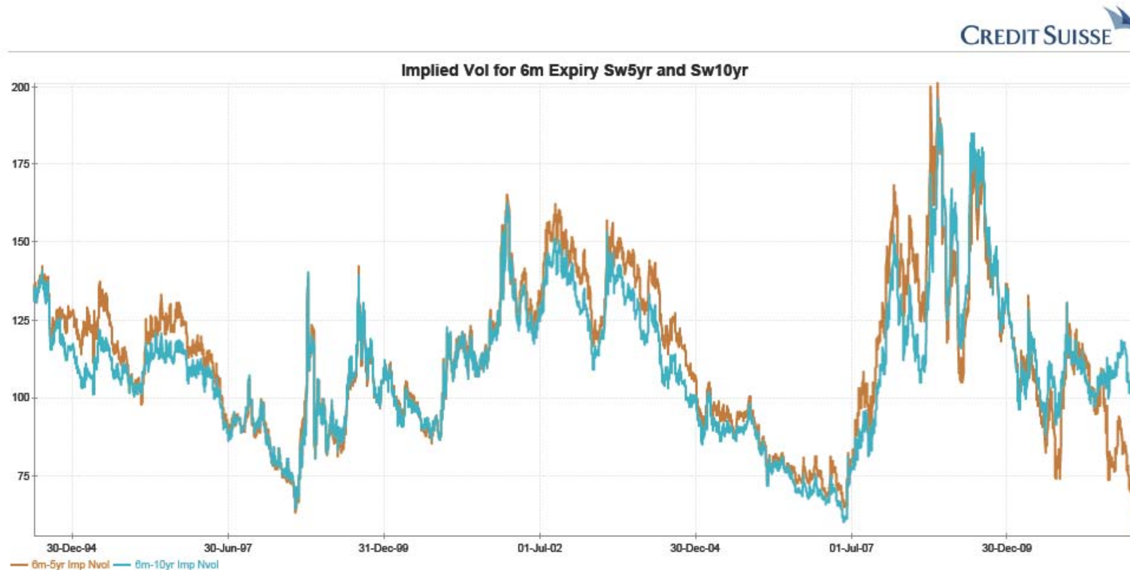
Bernanke unveiled his eponymous option early last summer when he offered to keep Rates low until mid-2013. While Rates did decline, the asset substitution he desired back-fired as the Stock market dipped to local lows. Frustrated, the FED dropped the hammer on the market last month when they offered to keep Rates low until the end of 2014. Additionally, they instituted a policy of full transparency on their future activities so as to provide an early warning signal for that distant date when Rates would eventually increase. This had the desired effect of both compressing Credit Spreads and sending the Stock market on a one-way train north, presently approaching a post-crash high near 13,000.

But this does beg the question: **Is it possible we have a "Fibbin' FED" ?**

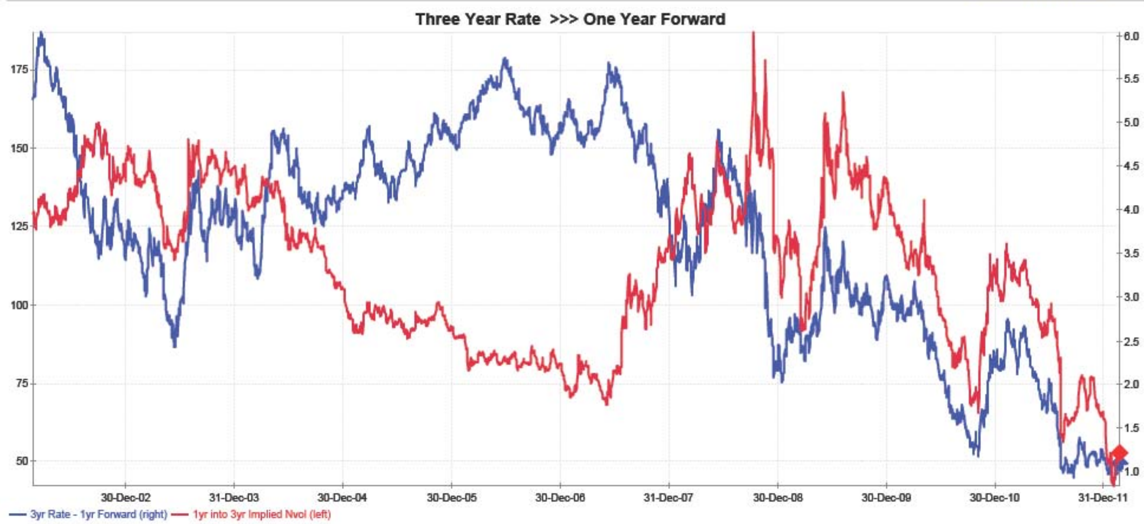
Seemingly, the market has taken the FED fully at their word as near-dated forward rates have declined sharply and "upper left" Implied Volatility has been crunched. Moreover, short-tail versus long-tail Implied Ratios have inverted to their lowest levels in our data history.

Below, the –green line- is the constant 12th Eurodollar contract while the –orange line- is the EDZ4 (December 2014) contract, both listed on the CME. (They merged at the beginning of this year.) Notice how they recently pressed above 99.00 (or 1.00%). That leaves the "bulls" almost no room for error.

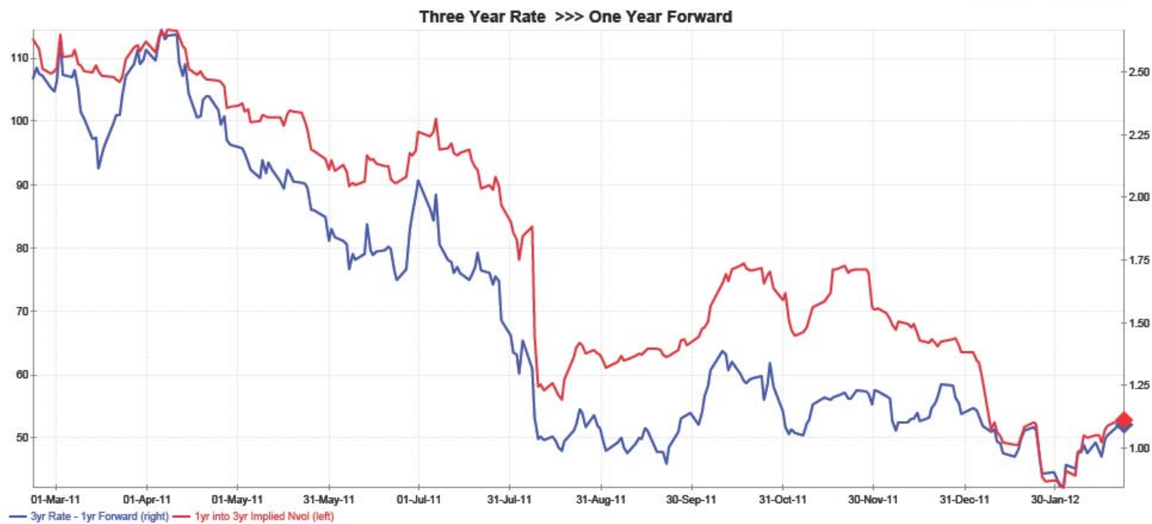
The –rust line- below is the Implied Normal Volatility for a 6m into 5yr swaption while the -turquoise line- represents the 6m into 10yr. It is rare for five-year tail Volatility to ever be lower than ten-year tail Volatility, yet presently the former is priced to greater than a 25% discount. This indicates the market's complete faith in the FED's control of the front-end of the market.



Finally, in both the next charts the –blue line- is the Sw3yr Rate, one-year forward while the –red line- is the Implied Normal Volatility for the same. The first chart shows a decade of values while the second chart focuses only upon this last year.



While both the Rate and the Implied Volatility have bounced slightly off the recent lows, both are still near their forever nadirs.



This brings us full circle back to our initial, <u>and certainly tongue-in-cheek comment</u>, **can we be faced with a "Fibbin' FED" ?**

Let us state clearly for the record, we have the utmost respect for Ben Bernanke and the FED. Moreover, we also believe they are acting sincerely in the best

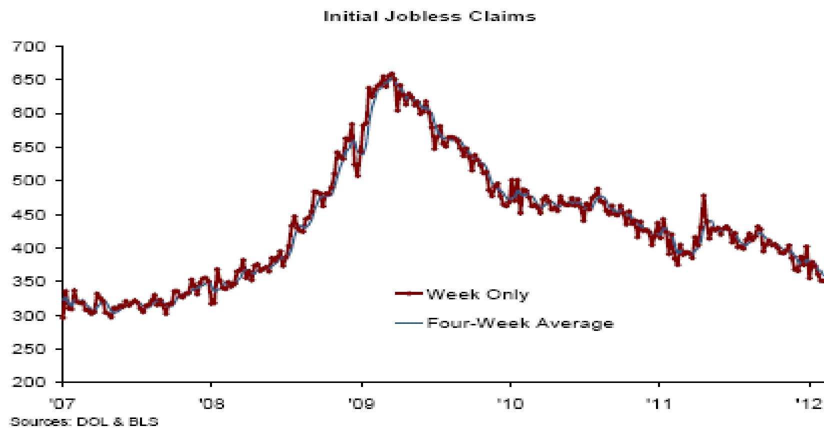
interest of the country. They also recognize that with little hope of any Fiscal Policy assistance, they know that the entire responsibility falls upon them to best utilize all the Monetary Policy tools at their disposal.

So let's summarize the FED's master plan:

1) Cut short-term rates to re-capitalize the banks;
2) Flatten the Curve to encourage asset substitution;
3) Collapse Implied and Realized Volatility to reduce anxiety;
4) Compress Credit Spreads to reduce Private funding costs;
5) Raise Equity prices to increase the Wealth Effect.
6) The circulation of Capital elevates Velocity leading to GDP expansion.

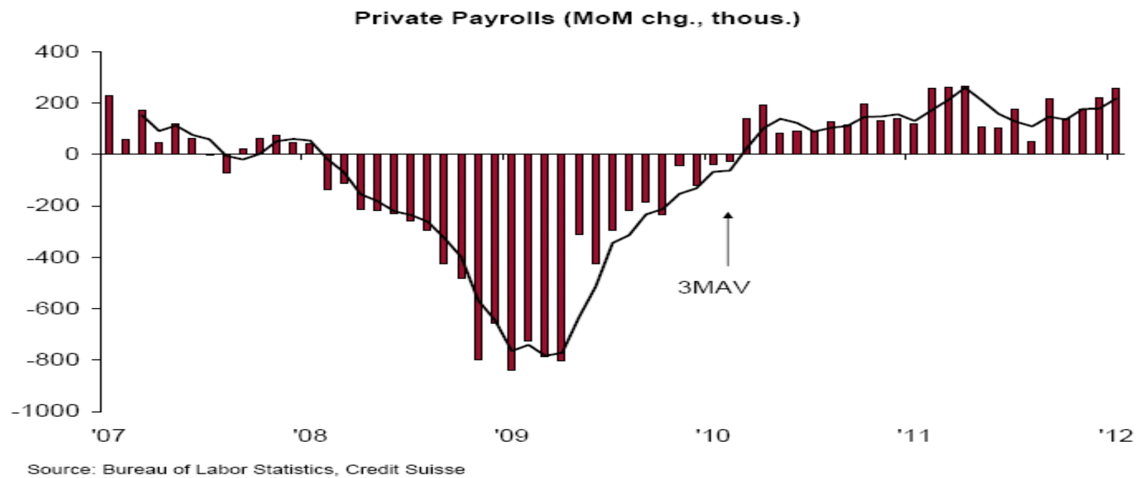
To be effective, the market must believe the FED is sincere in reducing "Risk Vectors" such as to encourage "Animal Spirits". Hence the FED's "promise" to keep Rates exceptionally low for an extended period of time; a promise they fully intend to keep, so long as the data is weaker than potential.

But what if what if the recent positive economic data is not a blip? What if jobless claims continue to fall?



.....or housing continues to levitate towards the 800k population growth level ?

........or if Payrolls gain speed and we clock in half a dozen +300k prints?



I can assure you that if *"the facts change, the FED will change their mind".*

Thus, the introduction of the new transparency. Since the FED has seemingly given their word to keep Rates low for the next three years, this will be their fig leaf should they need to shift gears. By publishing their economic forecasts and votes, they can signal the markets and not be accused of being misleading. This provides the FED with the best of both worlds: They can promise to keep Rates low for an extended period while maintaining an escape hatch should their actions prove more effective than anticipated.

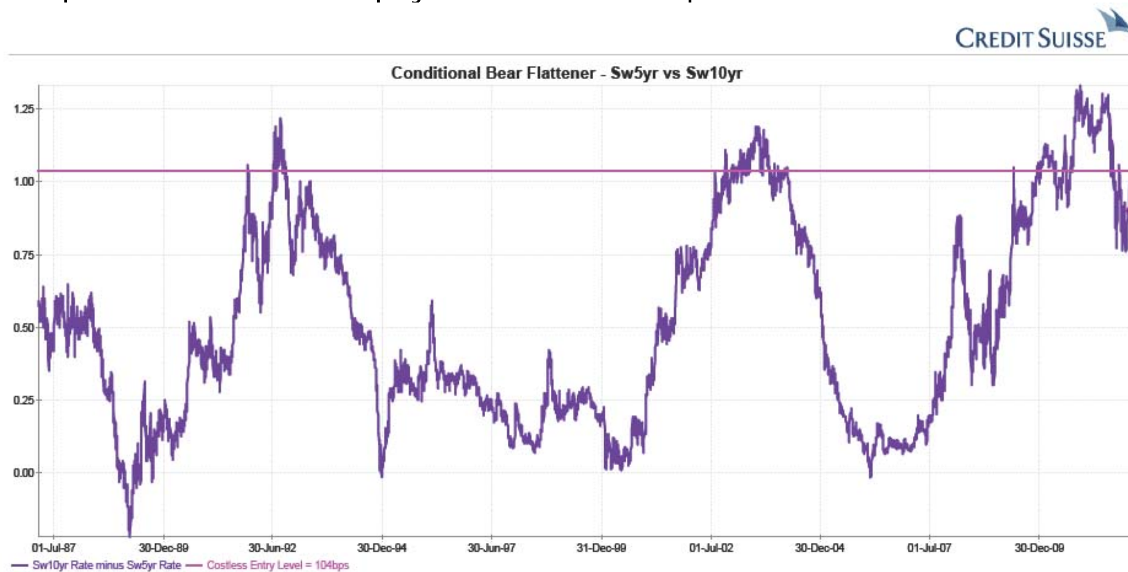
In a nutshell, not much has changed. We have an aggressive FED that will do whatever it takes to re-energize the US economy. The difference is that they are taking FED-Speak to a new level of stridency by offering a long-term commitment to hold rates steady; however, this does not change the fact that policy will tighten if the data demands it. And this is our point, the markets have priced in the risk vectors of Rate and Volatility as if the FED has restricted itself to not alter their Rate policy under any circumstances, and this is clearly false. While the data may presently be poor, and predictions of continued unfavorable data may be reasonable, it is not a certainty. As such, markets should price risk vectors to reflect the chance, however small it may be, that the data improves.

The trades that follow are not expected to terminate "in-the-money", nor even to "cross strike" at some point. They are effectively an observation that the Cost of Insurance against higher rates is too cheap and will become more expensive when the market realizes that ZIRP to the end 2014 is not a certainty. At that point, you can sell the insurance back to the market at a profit to those who took the FED's "promise" at face value.

Our Best Ideas

Buy 190mm 6m into 5yr payers K = 1.56%
Sell 100mm 6m into 10yr payers K = 2.60%
Costless;

Both struck out-of-the-money to a level that might only be reached if the data firms enough to challenge the FED's current economic forecast. Below, the –purple line- is the twenty five-year history of Sw5yr vs. Sw10yr while the –pink line- is the breakeven "conditional" strike level of 104bps (2.60% minus 1.56%). This pair is a "winner" if expiry occurs below the pink line.



Buy EDZ4 Mid-Curve puts (Green Dec) K = 98.75 (1.25%) @ 25bps
Expiry = Dec 14, 2012; Spot = 98.81; IVol = 78Nvol

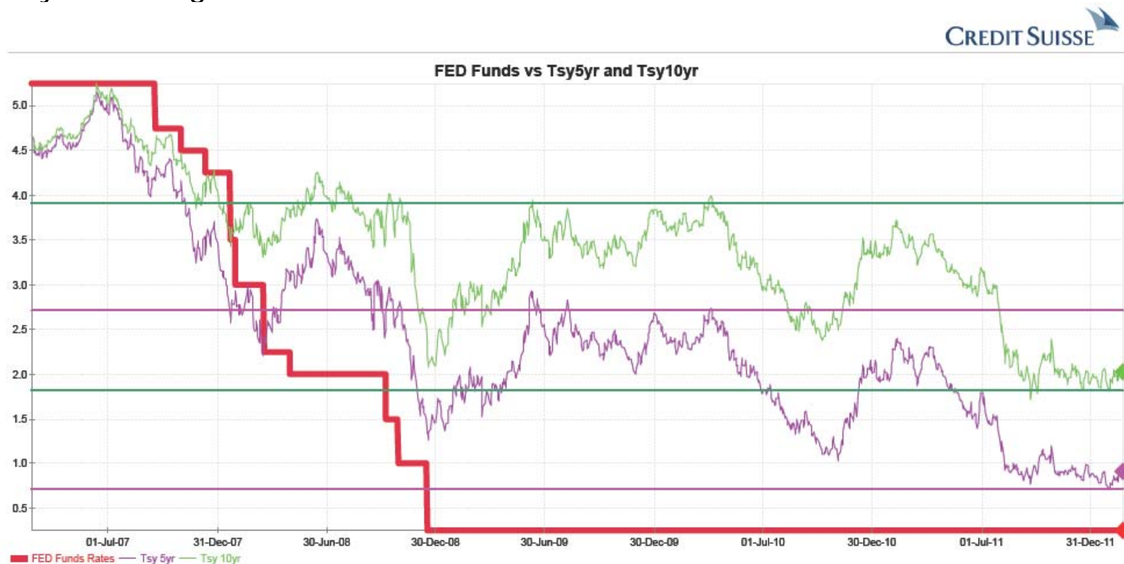
Both the Implied Volatility and the Rate reflect a near certainty of a "FED on Hold" until late 2014. The Actual Volatility has been 82Nv for one month and 84Nvol for three months, above the current IVol. The ImpVol should be at least 10% over the ActVol for this contract to properly value the "tail risk" nature of the contract. If the FED's resolve is questioned at some point this summer, it is the "Greens" and "Blues" that will take the heat.

Buy 1yr into 3yr payer spread: K = 1.25% to 2.00% @ 34bps
Spot = 1.059%, ATM Vol = 57Nvol
……..or
Buy 2yr into 2yr payer spread: K = 1.50% to 2.25% @ 30bps
Spot = 1.259%, ATM Vol = 69Nvol

For both options, the Implied Volatility is about 12% lower than the three month Actual Volatility. Moreover, the absolute Rate is near their historic lows.

Food for Thought:

We have lived in a ZIRP world for over three years. During this time, the Tsy5yr rate has ranged from about 0.75% to 2.75%, a 1.60% average since January 2010; meanwhile, the Tsy10yr has ranged from about 1.85% to 3.95% with a two year average of 2.85%.



Neither the FED nor the private market knows when Velocity will finally increase and accelerate the economy on an upward trajectory. What we do know is the Rate level associated with a FED "promising" to continue ZIRP for three years. We also know the range of Rates associated with no FED "promise", a policy that is dependent upon the data. (Hint – it's about 100bps higher)

Are you sure the FED will keep their "Promise" if the facts change?
I am not !

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February 27, 2012

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