

Barclays Capital Trading and Distribution Commentary

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Notes on US Interest Rate Derivatives

Mark Twain: "I didn't have time to write a short letter, so I wrote a long one instead."

That will be the theme of this week's newsletter, as I write this one fairly rushed between two trips. Hopefully, it conveys some of my thinking without confusion and errors.

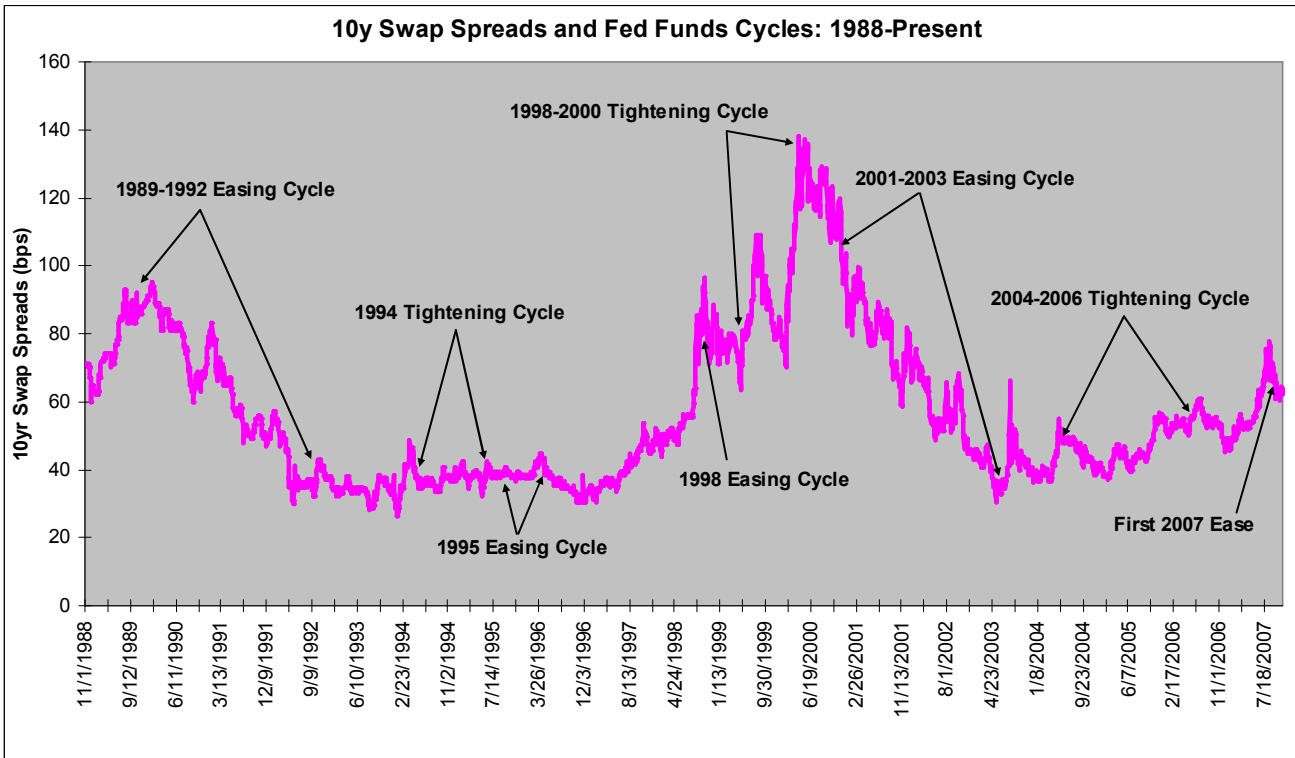
The market continues to search for direction, concerned about the credit markets, uncertain about the economy and the Fed. Vols pushed up again. The curve continues its steepening path. Much of the credit market continues to widen. Swap spreads remain stagnant, however, helped by hopes of further Fed eases.

Rates

Swap Spreads

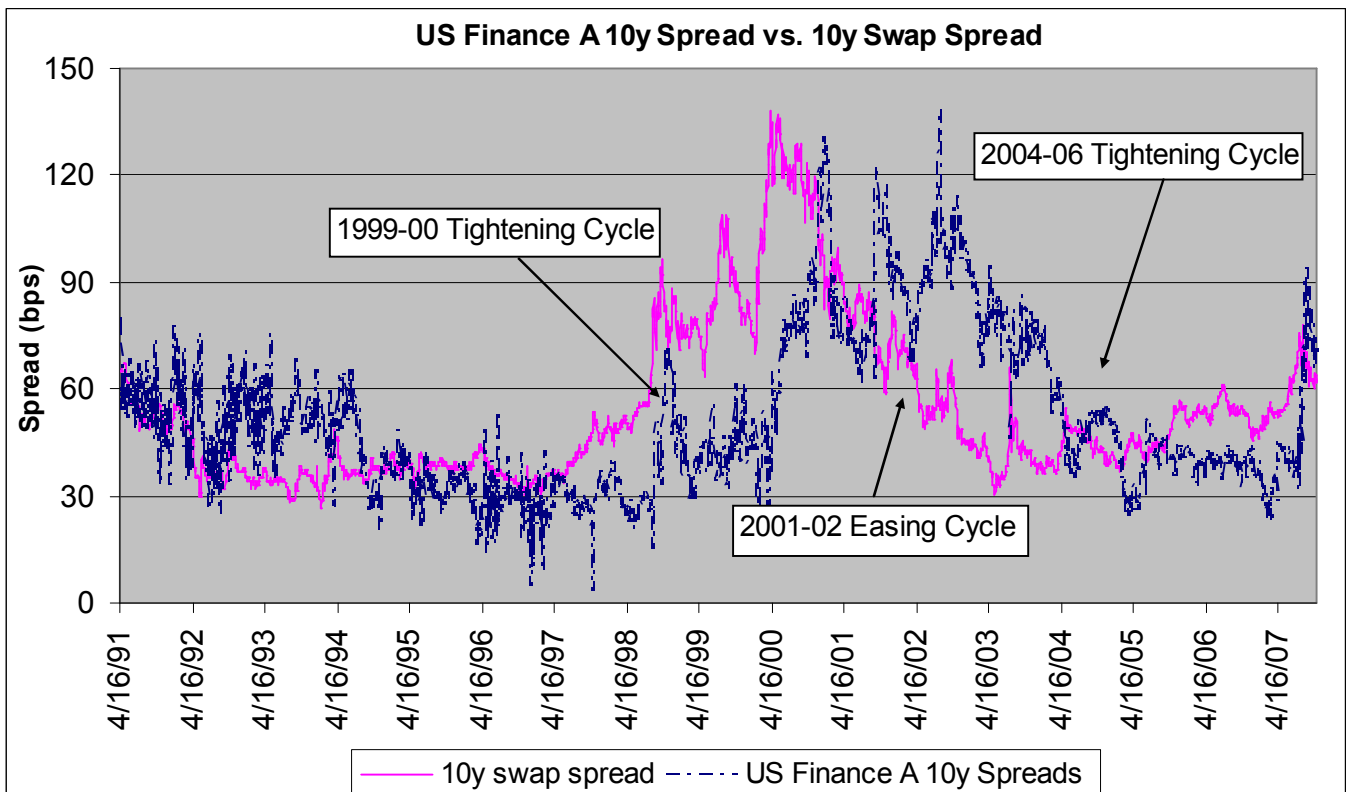
As I have written in the past, swap spreads are in part liquidity instrument and in part credit instrument.

- Liquidity → The swap market serves as a transition tool for those seeking to increase or lower duration. For instance, when the curve becomes very steep (usually during Fed easing periods), corporates use swaps to transition their fixed rate debt to floating rate debt. Likewise, when rates start falling, mortgage accounts receive on swaps to replace lost duration. In contrast, when the Fed starts raising rates, we see the opposite behaviour – corporates using swaps to transition to more fixed rate debt and mortgage hedgers paying fixed to hedge their increasing duration. This behaviour extends beyond these two market segments. Thus, it should be no surprise that, during every tightening cycle of the past two decades, swap spreads went higher or stayed the same. And, during every easing cycle of the past two decades, swap spreads fell or stayed the same. The following chart shows this.



Source: Bloomberg

- Credit → Like credit spreads, swap spreads are indeed a measure of market risk premium as well. They measure the expected long term spreads between LIBOR (bank short term rates) and Treasury repo (Treasury short term rates). Thus, it should be no surprise that they follow the path of credit spreads for big structural moves. The following chart shows this.



Source: Bloomberg

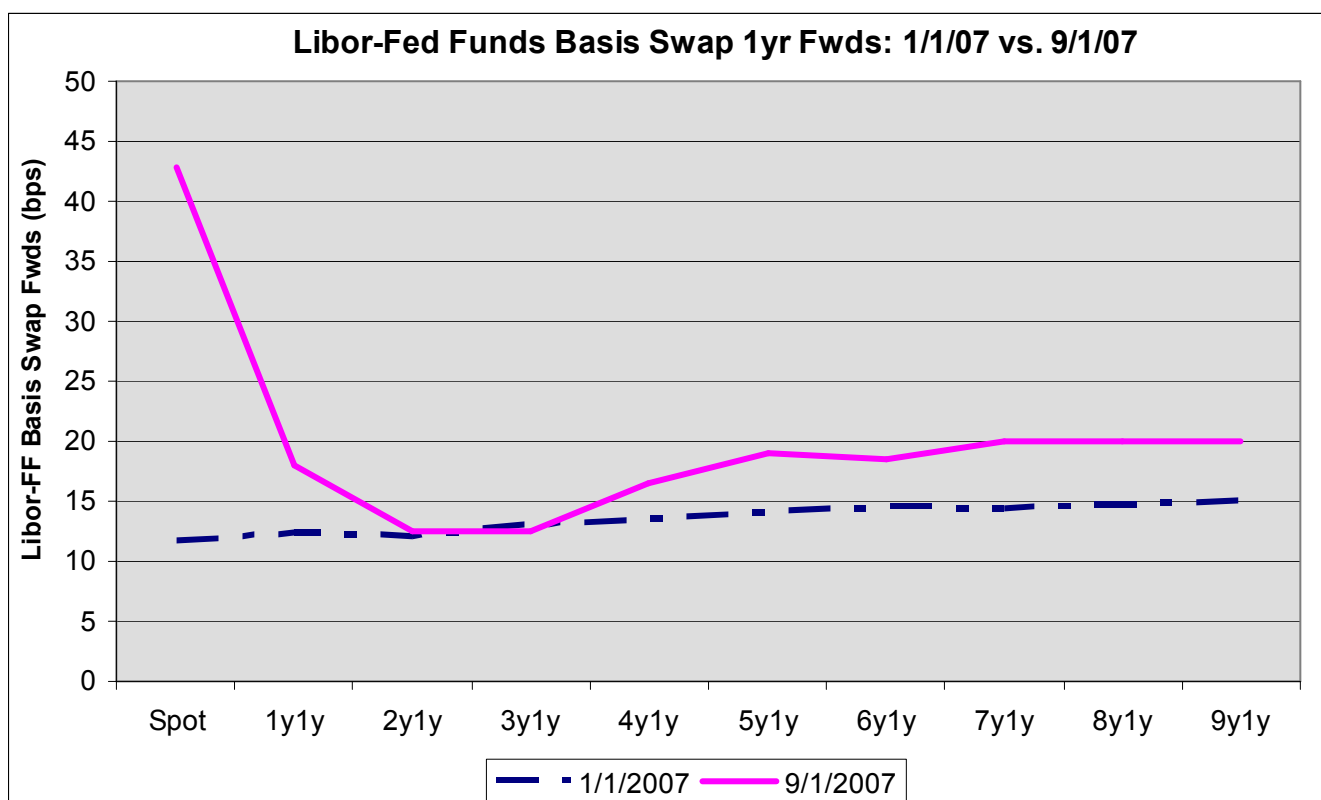
Currently, in my view, swap spreads are being tugged back and forth between these two factors. It is no surprise that, coincident with the September 50 bps ease, swap spreads narrowed. Nor should it be a surprise that swap spreads blew out, earlier in the summer, in sympathy with the credit markets. So long as the Fed continues easing,

there will be some downward pressure on swap spreads. However, so long as the credit markets struggle, it will be hard for them to narrow too much.

Fed Funds vs. LIBOR

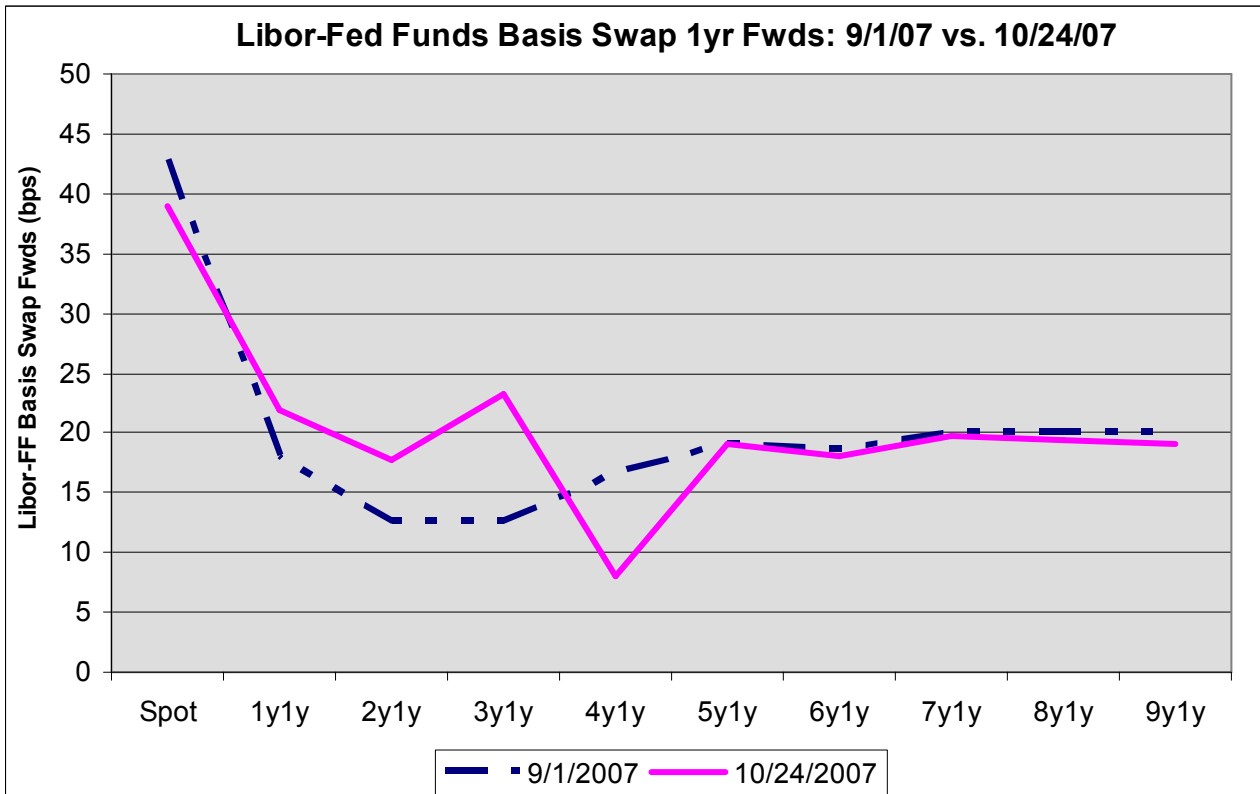
The short term credit markets have been particularly fascinating this year. One metric for short-term funding problems is the basis swap between LIBOR and Fed Funds.

In the next chart, I show how this basis swap moved between the beginning of the year and September 1, 2007. I do so by showing the spread on a “forward basis” to highlight nuances in this market. As I have noted previously, there were two aspects to the shift higher in this spread. First, there was a dramatic increase at the very short term. This reflected the fact that banks have had their liquidity severely tested. Second, there is a fairly quick reversion back to a more normal spread. Basically, by the end of 1-year, the market was saying that the spread would revert back towards 20. Interestingly, in September, the market then discounted the curve between year 2 and 5, relative to the rest of the curve. In doing so, it attracted many hedge funds and other prop accounts into paying this part of the curve.



Source: TTKL on Bloomberg, Barclays Internal Calculations

As a consequence of this arbitrage activity, we saw the curve smooth out. In the next chart, which depicts the Fed Funds LIBOR basis swap for September 1, 2007 and October 24, 2007, we see that, on average (if smoothed), the whole curve – after year one -- has settled at about 20. We also see that the front end softened a touch, helped by the Fed ease.



Source: TTKL on Bloomberg, Barclays Internal Calculations

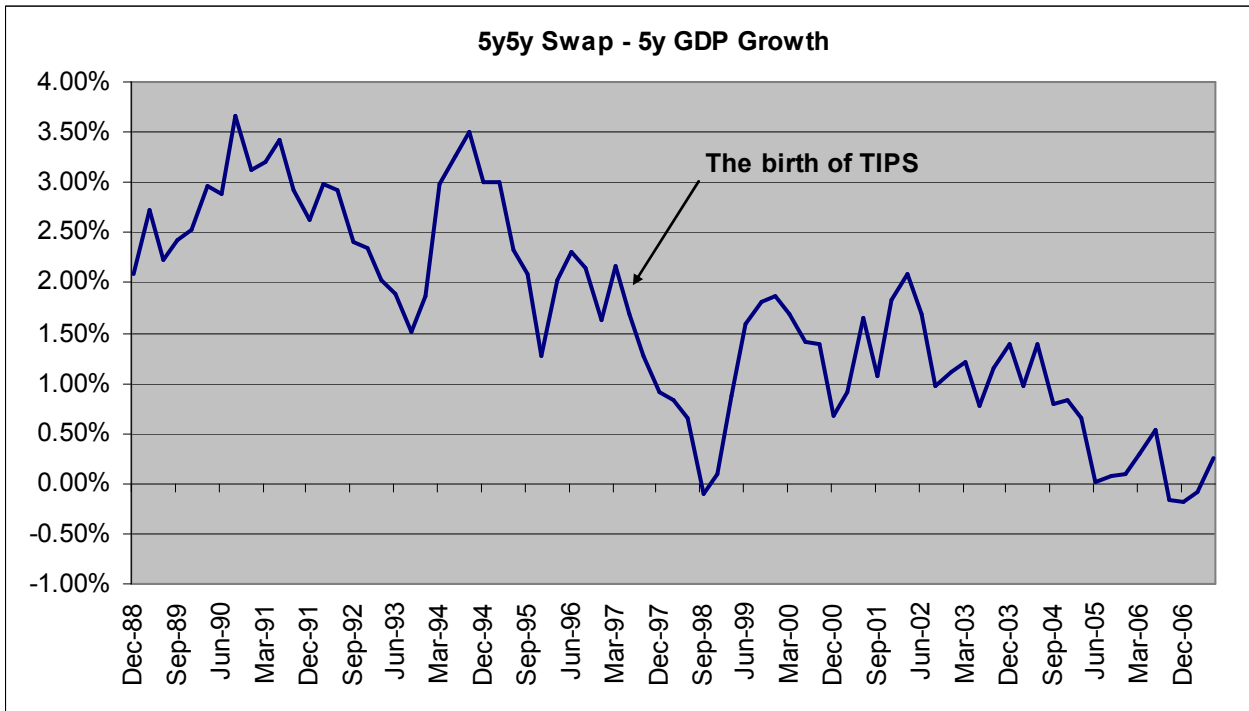
TIPS: Are They Guilty of Reducing Market Risk Premium

Over the past two weeks, the question was raised about whether TIPS have been a benefit to the US government's costs or a detriment. The opposing argument centered on the fact that TIPS, after accounting for headline inflation, have produced a higher cost of funds for the US Treasury than nominal bonds would have.

As someone who has been a proponent of TIPS vs. nominals, I would be hard-pressed to refute the argument on these grounds. I have repeatedly argued that the market has underappreciated the level of inflation.

But in reflecting upon the value of TIPS to the issuer (the US government), I think there are many other issues which need to be considered. One of these issues is the fact that TIPS give the investment community and the Treasury far greater clarity into what the market is thinking. Further, for investors, TIPS enable investors to strip apart two separate risks – inflation and real yields – and take the risks that they are more comfortable with. Prior to TIPS, bond investors had to take both risks at once. My argument therefore would be that TIPS lower market risk premium. With TIPS in the market, investors are better informed and own the risks that they are more comfortable with.

Is there merit to my argument? To check my argument's soundness, I attempted to create a crude method of market risk premium. As I have argued in the past, interest rates tend to be strongly correlated with nominal GDP growth. Over long periods of time, GDP growth acts with a gravitational pull on interest rates. When rates are above GDP, it discourages growth, and when below, it encourages borrowing to invest. I therefore used GDP growth as my expected interest rate. Following the arguments of Ben Graham, I used a 5-year average of GDP as a measure of structural GDP (I averaged the prior 5 years). For long-term interest rates, I used the 5-year into 5-year interest rate swap. This should filter out near-term influences and focus on longer term structural rates. The net of the 5-year 5-year swap rate and the GDP is defined as a risk premium. The following chart shows this relationship over time. Note how that almost simultaneous with the TIPS introduction, we moved to a lower risk premium. Could my theory on TIPS be a factor in this?



Source: Bloomberg, Barclays Internal Calculations

Note: I realize that this is not a Nobel Prize type analysis. This is a very crude measure but I do think it gives some flavour of the issue.

The Dollar

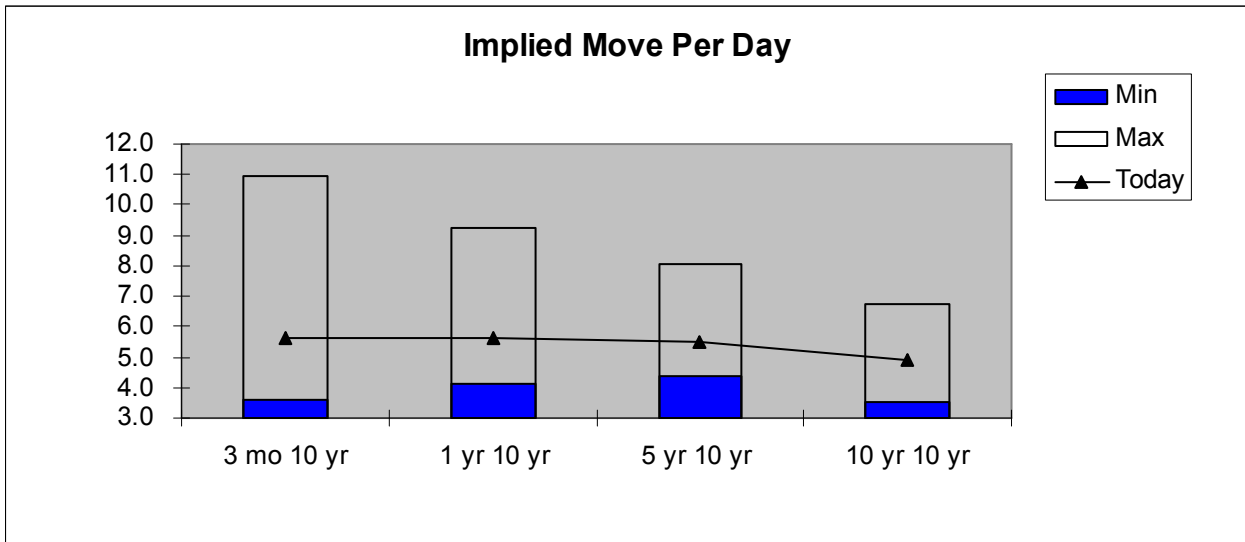
To stay with my simplistic view of the world...one thing that strikes me about the Dollar is that there is an ample supply of them in the world, but the demand (line of investors) is becoming quite limited. Let me give a few examples of what I see as limited demand.

- At Jim Grant's investment conference a few weeks ago, speaker after speaker spoke about their investment strategy, and speaker after speaker was allocating capital outside the US. Jeremy Grantham preferred emerging markets. So did Mohamed El-Erian. Sam Zell said that 75% of his investments are now outside the US. There was very little sponsorship of the US in aggregate.
- This past week, the Oracle of Omaha was jetting around Asia, looking for sizeable acquisitions. His most recent acquisition was an Israeli company. At the annual Berkshire meeting, he made quite clear his desire to get more involved overseas.
- At a recent dinner with clients in Europe, I asked the following from each person at the table: if you had \$1 billion and were starting your investments from scratch, what would you invest in? Very little of the ideas came back into dollar-based investments.

Quite simply, the US is not that attractive an investment arena now. However, we need strong investment because we have flooded the world with dollars. I expect the dollar to continue devaluing.

Options

Vols pushed higher again this week.



	3 mo 10 yr	1 yr 10 yr	5 yr 10 yr	10 yr 10 yr
Min	3.58	4.10	4.41	3.54
Max	10.95	9.24	8.05	6.76
Today	5.62	5.64	5.49	4.94
Average	6.57	6.62	6.10	4.96
Change on Week	0.17	0.07	0.06	0.07
Change on Month	(0.51)	(0.30)	(0.05)	(0.02)

Source: Barclays Internal Data, August 12, 1998 – Oct 26, 2007

Looking at Gamma Selling Across Markets

Over the past week, we decided to look at the efficiency of selling gamma in three major markets: 1) interest rates; 2) fx; and 3) equities. For interest rates, we looked at 3-month into 10-year swaptions. For equities, we used the VIX. For fx, we used 3-month options on the \$/yen.

In the following chart, we show the % of premium that the gamma seller achieved 1) on average since 1998 and 2) in 2007. The chart shows the premium achieved as a gain (or loss) as a percentage of the premium sold on the options.

	Premium Captured (as % of Premium Achieved on Sale)		
	10y Swap (1998-07)	USD-YEN (1987-07)	S&P 500 (1990-07)
Max	75%	70%	86%
Min	-62%	-137%	-115%
Avg	21%	4%	39%
2007	16%	-8%	42%

Source: Bloomberg, Barclays Internal Data

What do I take from this?

- SPX vols have the most risk premium in them on average, with interest rate vols second and fx vols third.
- Interestingly, this year's risk premiums for all 3 markets parallel the historical averages.
- The FX market appears to trade in almost risk neutral fashion.
- While equities provide, on average, much greater returns, they also provide the greatest risk (worst, worst case).

SIVS, Ben Graham, Chimpanzees, and Vol

Over the past two weeks, I have spent a decent amount of time investigating SIVs. Once again, I have been surprised at the narrow margin of safety that people have employed in their products. As I have noted in the past, margin of safety provides an important buffer for when you are wrong about your assumptions. The less margin of safety, the less you can be wrong about.

The concerning issue with SIVs is that they can trigger forced sales and that these forced sales can trigger more

forced sales. Indeed, it seems that some of this activity has already filtered into the market. In many ways, this parallels the portfolio insurance product that helped wreak havoc in 1987.

Given the embedding of trigger levels, one would have thought wide margins of safety would be employed, particularly since the underlying product is less liquid.

Once again, I believe the scenario that Jared Diamond outlined in the *Third Chimpanzee* prevailed. That is, those species with the greatest aggressiveness will overtake those more passive. Over time, this creates an environment defined by the most aggressive. In the investment arena, we wound up with a credit market defined/dominated by a leveraged investor thirsty for returns. It was an environment bereft of safety margins. We still have not cleared the aggressive from the environment.

Because of this, and because margins of safety remain low, the market trades with a very high level of tension. This tension arises because any potential error, any potential assumption being violated, can trigger forced sales.

While this tension remains, vols should keep supported, in my view.

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