

Barclays Capital Trading and Distribution Commentary

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Weeks of May 12, 2008 – May 16, 2008

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Notes on US Interest Rate Derivatives

Market continues to take its lead from the SPX market. With stocks continuing higher, we saw higher rates, led by the front end. We saw lower long-dated vols and lower swap spreads.

Despite the improvement in market tone recently, I sense a growing global concern about building inflationary pressures. Our global head of asset allocation, Tim Bond, put out a great piece on this over the past week, which I am attaching in the email.

Broader Market

Inflation

Let's begin with Tim's piece. Tim notes several things that are worth reflecting up:

- Import prices (for the US) are rising and this is having a meaningful effect on inflation in the US.
- Rising prices is not just a problem for the US, but is a global factor already evident in China, Asia in general, the UK, India, etc.
- Interestingly, we have seen a surge in people's expectations for much higher inflation in the US, UK, and JPY, indicative of declining confidence in the central bank.
- In China, we have seen the rise in inflationary pressures extend to wages. It seems this may be an issue for the key developing countries as a whole.

Overall, Tim's argument is that the environment for investment assets is "Getting Nasty", and that we are potentially heading to an environment diametrically opposed to the 1990s-2000s. It is well worth a read.

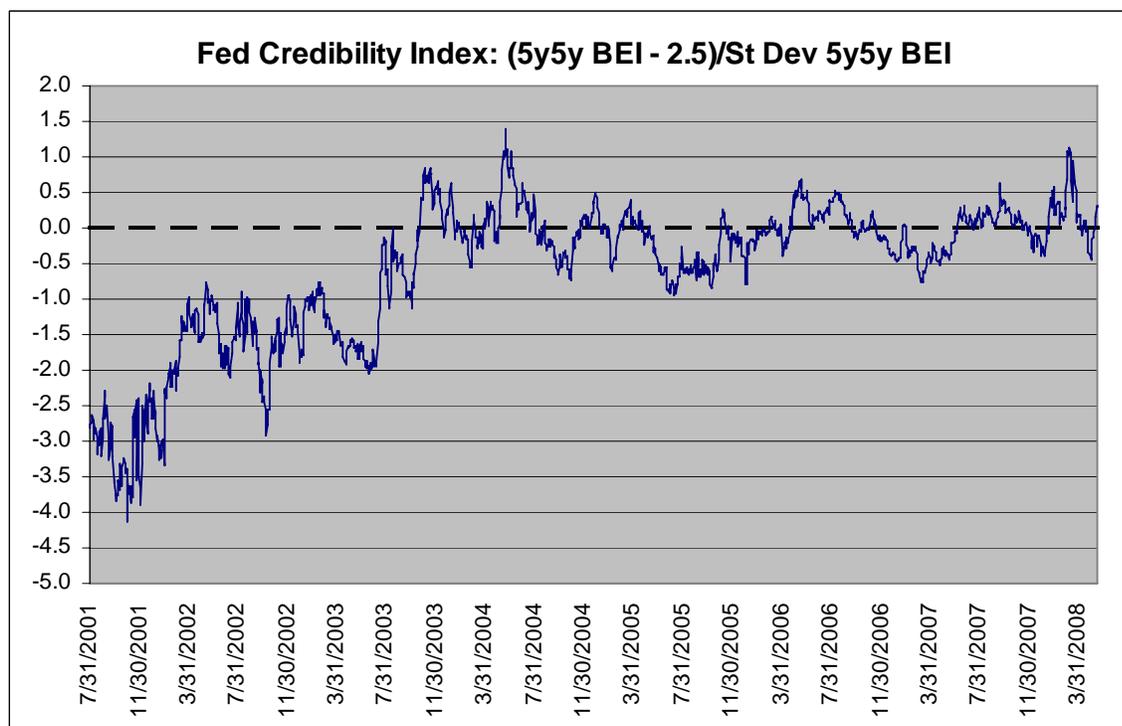
Yes, I know, people have expressed inflation concerns for years on some or many of these issues in the past. Why should I particularly care now? I suggest two reasons. One, Tim's piece shows that the inflationary pressures may be intensifying. Thus, there are many signs that the day of reckoning is near. Two, I am going to argue that fixed income investors, particularly those at the long end of the curve, may be suffering a false sense of complacency.

Toward this end, I'd note that in early 2007 many people had dismissed those concerned about the credit environment as "chicken littles." After all, people had expressed those concerns for quite some time and nothing had happened yet. Absent a recession, it was argued, credit spreads should be fine. Well, GDP growth was fine (>2%), as it was in 1998 when we had similar credit issues, and yet we had a market tsunami. Indeed, we had the greatest credit problems in housing, despite rates being very low and despite the unemployment rate remaining at 5% or below. I would argue that market complacency is a key contributing factor to really "nasty" market moves.

President Kennedy wrote his senior thesis on Britain and World War II. The thesis was eventually made into a book, called *Why England Slept*. In that thesis/book, he argued that England slept while the danger of Germany rose right in front of everyone's eyes because that is the nature of humans. People have a tendency to sleep, he argued, until some crisis arises to rudely awaken them.

We see this consistently in the markets – amazingly so. We saw it in equities and then in credit. And I think Tim is quite right to sound the alarm system on inflation. Bondholders, in particular long-term bondholders, seem to be sleeping while the enemy is gaining terrible strength.

Earlier this year, I created a “Fed Credibility Index” to track the market’s concern about the Fed’s inflation fighting abilities. In this chart, we look at the market price for the 5-year into 5-year breakeven inflation rate (i.e., the market price for inflation as expressed by TIPS/Treasuries). The Fed is known to track this as a measure of structural inflation. We deduct this from 2.5%, which I believe is consistent with what the Fed would like to achieve by this measure. I then divide this difference by the historical standard deviation of the 5-year into 5-year breakeven. Dividing by the standard deviation attempts to normalize the difference for the typical market noise – that is, it allows us to distinguish a truly big move from merely noise. The next chart shows this index. . (Note: the 5-year into 5-year index I am using differs from that the actual one the Fed is believed to use. Theirs is based upon off-the-runs and is thus biased higher. Nonetheless, the two methods generally track.)



Source: Barclays Internal Data, Barclays Calculations

What this chart tells me is that the market, in aggregate, is very comfortable with the Fed and its ability to contain inflation. The inflation concern is a concern for more limited audiences and not the market as a whole. Indeed, the chart shows that the market’s only concern over the past 7 years has been deflation. And that concern was addressed through forceful Fed actions. While it is indeed possible that the Fed could turn quickly and address the building inflation issues, the risks do seem skewed one way. And if these risks break out, owning long-term bonds at historically low nominal rates and without an extraordinarily steep curve may prove as imprudent as taking large credit risk at the beginning of 2007.

(Historical note: Like many things with President Kennedy, the book I allude to is shrouded in controversy. It is rumored to have been written by someone else, with the gifted speechwriter Ted Sorensen often mentioned. Sorensen was the author of many of JFK’s most famous speeches, including the inaugural. He is also a part of the current Obama team. If you read his speeches, they are most noteworthy for their cadence and alliterations – “pay any price, bear any burden” and “ask not what your country can do for you, ask what you can do for your country.” For anyone who has read *Why England Slept*, it is hardly a masterpiece of rhetoric. It reads like it was written by a young, analytical college student – not a master scribe. So perhaps it was penned by someone else, but I strongly doubt it was Sorensen.)

LIBOR

Over the past week, we received two important – and in my view contradictory – pieces of information regarding LIBOR. On the one hand, we had the British Banking Association announce that it will make some adjustments to

the index at the end of the month. The market has perceived this to be an upwards pressure on LIBOR, on the belief that banks are artificially repressing the LIBOR setting. Immediately upon hearing this news, short-dated Eurodollar contracts sold off, consistent with this perception. I'd note that it is possible the BBA adjustments lead to a lower LIBOR setting – for instance, perhaps some minimum rating on banks is set.

Two, we had Chairman Bernanke state that there was still funding duress in the system, and he implied that the Fed stood ready to take further liquidity actions. This was particularly telling because we already had seen a meaningful technical improvement in the fixed income markets and in the liquidity markets, and there were already quite a number of innovative efforts under way. To me, it indicated that the Fed is focused upon getting the money markets back to a normal condition. They are not merely intent, it seems, to soften extreme conditions. They want to get conditions back to a steady-state normality. Perhaps I am reading too much into his comments, but that is the distinct impression I have.

With these two in mind, it is my belief that we are likely headed back to a LIBOR/Fed Funds spreads of 30 bps (give or take 10 bps). This is more consistent with the markets in the 1990s – probably our best benchmark period for normality. As I noted in a prior newsletter, the noise around how LIBOR is defined makes me uneasy about setting a range for LIBOR vs. Fed Funds. It makes my projection less certain.

Why am I so convinced the Fed matters more than the LIBOR redefinition? I think of it simply. If we had this LIBOR discussion about incorrect bank quotes in 2006, when there was an abundance of money in the money markets and very little differentiation in the credit markets, would it have mattered? Maybe, maybe not. Maybe it would have edged things by a small amount (1 bps or so), but it would not have mattered much. Every bank borrowed at tight spreads and the difference in borrowing rates was very modest. However, introduce this debate during a time of turbulence, at a time when some banks have more severe funding situations than others, and it matters. The difference in bank funding rates is largely a result of the environment, a severe one indeed.

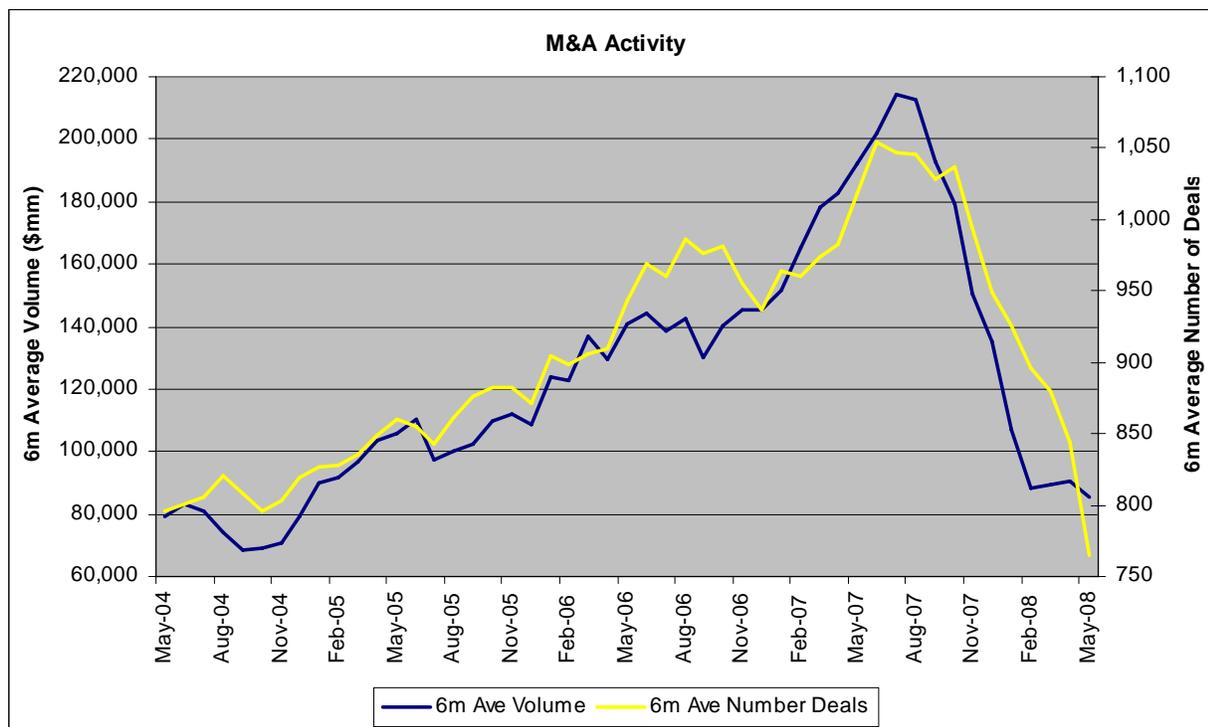
The Fed is trying to reduce the severity of the funding issue. It is becoming much more aggressive and it seems to be having some real traction. To the extent it wins this battle, the debate about differences in short-term lending rates will become less intense simply because I would expect the variance in borrowing rates to narrow.

The first order effect is the environment in my view. That is getting addressed in a major way. The second order effect is the haggling over what LIBOR is.

Equities – “The Audacity of Hope”

A couple of weeks back, I expressed concerns about the SPX market. Of course, since I wrote, the SPX market has trudged higher. But having wrong opinions in the short-term has never bothered me, so I will continue on with this theme.

In 2006 and into 2007, one of the major buyers of equities was private equity shops. Low levels of yields and credit spreads helped fuel this activity. With the widening in credit spreads, particularly in the high yield space, this activity has fallen off a cliff, as the following chart shows.



Source: Bloomberg

Who is the current US equity buyer? It seems to me that the main driver of buying remains the “hopeful” one. That is, it is the pensions with 8% return assumptions that need something with the “hope” of higher returns to meet their lofty expectations. With the short-term funding markets under duress, leveraging credit is no longer a feasible alternative. Yield on non-credit fixed income is miles away from this level. The private equity markets are shut down as well, as the chart shows. This leaves equities as the main alternative for those seeking higher returns. It is their last best hope of achieving the lofty goals set by their investors.

Natural Gas – An Important Correction to My Note Last Week

A client pointed out an important omission in my write-up.

On page 2 in the first full paragraph, I wrote "Barclays energy analyst, George Hopley, estimates that 30%-40% of Nat Gas consumption is for fertilizer."

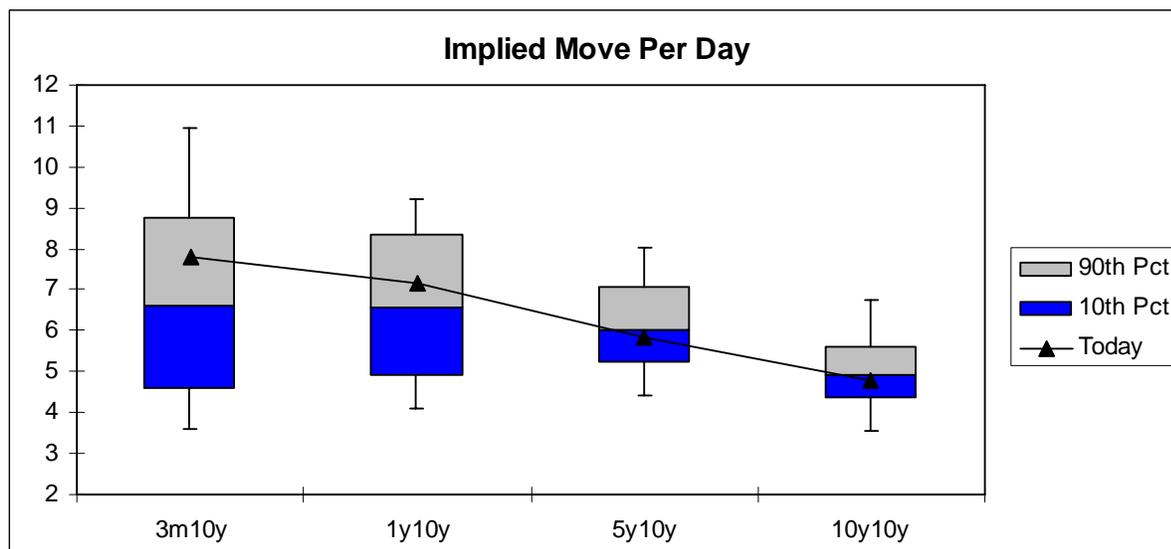
The sentence should have read "Barclays energy analyst, George Hopley, estimates that 30%-40% of **industrial** Nat Gas consumption is for fertilizer."

Industrial consumption of Nat Gas is just about half of the total of all Nat Gas consumption. This means that fertilizer is about 15%-20% of *global* Nat Gas consumption. Fertilizer is a much smaller component of US Nat Gas consumption.

I apologize for the error.

Options

Short-dated vols rose, while long-dated vols fell.



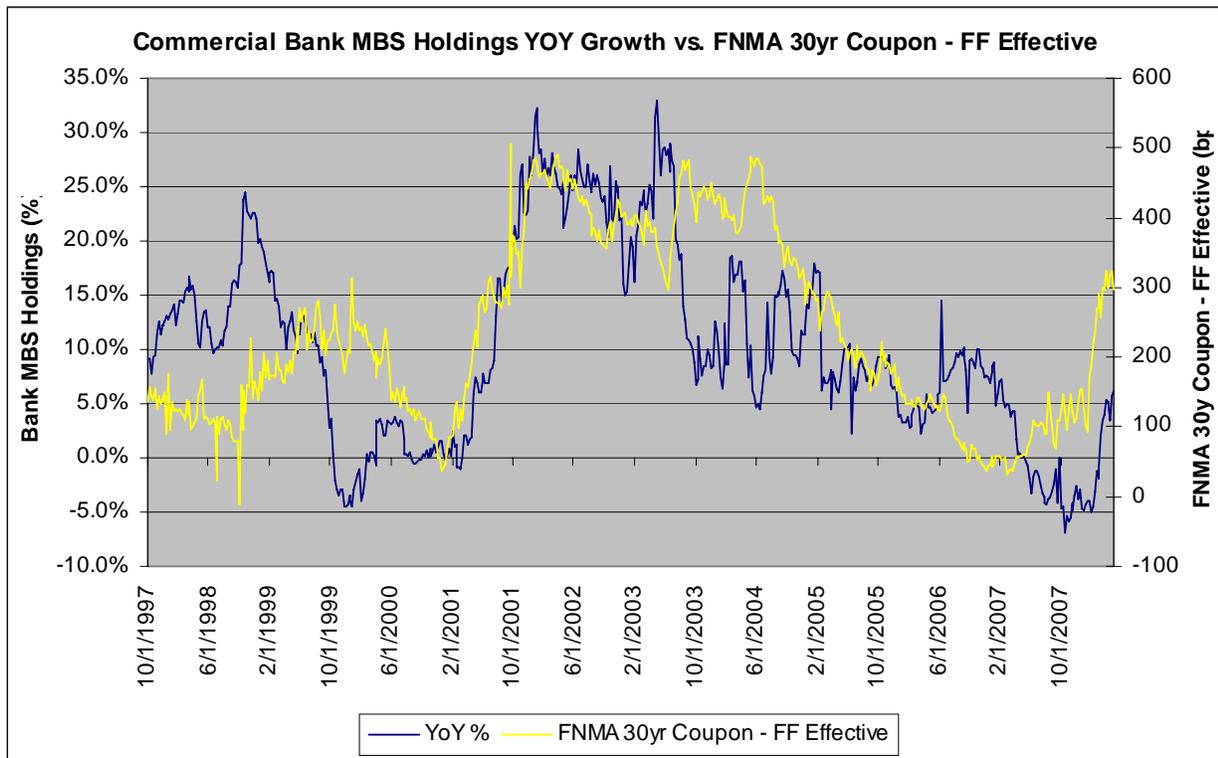
	3 mo 10 yr	1 yr 10 yr	5 yr 10 yr	10 yr 10 yr
Min	3.58	4.10	4.41	3.54
Max	10.95	9.24	8.05	6.76
Today	7.78	7.15	5.84	4.81
Average	6.66	6.65	6.10	4.97
Change on Week	(0.16)	(0.10)	(0.24)	(0.26)
Change on Month	(0.67)	(0.31)	(0.26)	(0.25)

Source: Barclays Internal Data, August 12, 1998 – May 16, 2008

Mortgages and Carry

Over the past several weeks, there has been a clear up-tick in market risk-taking. One of the favored assets in fixed income has been mortgages. Buying has emerged from banks, money managers and from foreign investors (notably Asia). In my view, mortgages have benefited from:

- A heightened belief that the Fed would bail out the agencies → This is not an unreasonable conclusion. If the Fed would bail-out an investment bank like Bear Stearns, why wouldn't it bail out the agencies who play such a central role in financing housing in the US? Moreover, the government has recently loosened the restraints on the Fannie and Freddie portfolios. This further suggests that they'd be willing to stand behind them were they to encounter problems. Why else would they allow them to add to their credit risk, directly under the government's eye, while mortgage defaults were increasing?
- Carry → Mortgages sell because they offer a heightened return, whether that is versus Treasuries or cash or whatever investment they are being substituted for. Over the past year, implied vols have moved up, the curve has steepened, and agency spreads vs. Treasuries have widened. To give a sense of how this feeds through the system, we have graphed the changes in mortgage holdings by US banks vs. the spread between the mortgage current coupon and Fed Funds. I am proxying the yield pickup of mortgages by this spread and proxying the participation of real yield buyers by year-over-year bank holding of mortgages.



Source: Federal Reserve H8

This time around, I would expect banks to be less active in mortgages overall, due to their liquidity constraints. Nonetheless, the sharp move up in yield pick-up has drawn in more participation. On a broader point, I believe the other segments of buyers – money managers and foreign buyers – are reacting in a similar way to the increased yield pick-up. They are substituting mortgages for Treasuries, high grade corporates, cash, and other lower yielding alternatives.

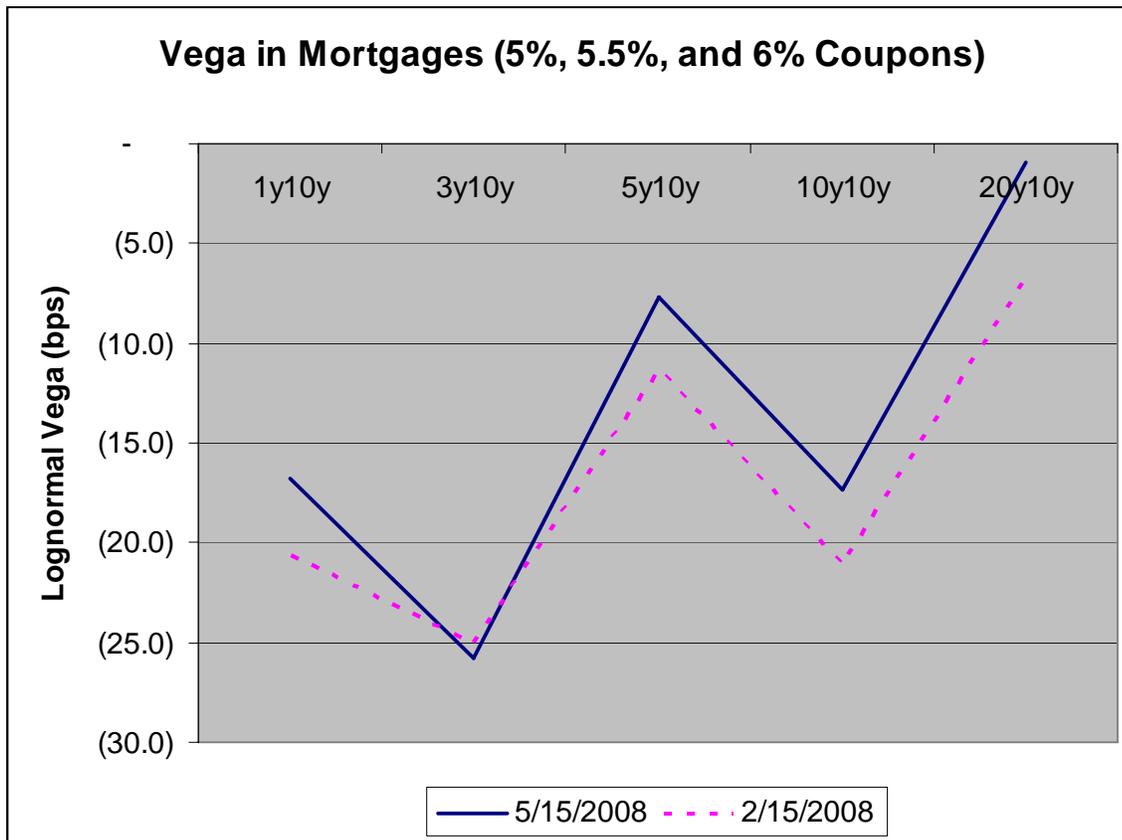
In doing so, I think there are knock-on effects for the rates market. Specifically I think:

- As real money purchases mortgages, they are reducing the vol needs of the markets. In effect, they are reducing the needs of hedgers to hold mortgages.
- As real money purchases mortgages, they are reducing the inventory on Wall Street balance sheets. As such, they are reducing the need for Wall Street to hold swap hedges against these bonds. This is pressuring swap spreads lower and helping reduce the steepness of the curve. (More broadly, one could argue that credit assets are also leaving Wall Street and this is reducing the need for swap spreads as a hedge).

Interestingly, none of the factors making mortgages so attractive – notably, the yield curve, mortgage spreads, and implied vols – are particularly compelling on their own. Taken together, they are enough to motivate a meaningful market behavior.

Vega Trends in Mortgages

From time to time, we like to examine the vega sensitivities of the key mortgage coupons. This helps us identify where mortgage hedging demand, should it arise, may focus. In the next chart, we show the vega sensitivity in bps. This is for lognormal vega, but a normalized analysis should present a crudely similar picture. The major coupons are currently the 5%, the 5.5%, and the 6%. We have summed the sensitivity of the three together in the chart. We present these sensitivities for May 15 as well as February 15. The numbers are negative because mortgages lose money when vols go up.



Source: The Yield Book

What do I take from this chart?

- The greatest sensitivity remains with the shorter expiries. This is consistent with an inverted vol curve.
- Vega sensitivity for longer-dated maturities has declined. This is consistent with the weaker performance of long-end vols.

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