FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

22nd July 2016

USD yield curve and potential investment themes

For this week's FNL's commentary we are going to take a look at the very exciting world of the USD yield curve and potential investment themes around it. As the below Bloomberg screen grab nicely illustrates, the curve is probably the flattest it has been for quite a number of years. That is, the relative yield on longer dated treasuries compared to shorter dated is the closest it has been for a long time.

That in itself though should not be particularly surprising as we've experienced a period of all-time record low yields in the asset class and the global economic uncertainty has pressured the traditional buyers of treasuries such as pension funds, insurance companies and asset managers out of shorter dated treasuries into the relative safety of longer dated treasuries, in order to garner any sort of income.

There are several ways to play the curve depending upon your view. The simplest would be to short say 8-10 year treasuries in the view that the yields can't stay at these unprecedented lows and will eventually increase, which of course will be the result of treasury price falls, which a short position would benefit from. The draw backs on this trade idea are 1) you will naturally bleed money from the yield you'd have to pay away from short position, so the timing of your position and a rate increase are vital and 2) selecting the right point on the curve. That said, the relative costs / premium incurred in this physical positioning should be fairly minimal.

Rates (bps)		
	Current	Week Chge
GBP 1yr	53.90	-0.30
GBP 3yr	51.00	-1.50
GBP 5yr	59.10	-2.20

Equity Indices (%)		
FTSE 100	6725.79	0.85%
S&P 500	2163.81	-0.21%
Nikkei 225	16627.25	0.78%
Eurostoxx 50	2971.38	0.43%

Currencies (%)		
GBPUSD	1.3094	-0.54%

5yr Credit Spreads (bps)		
Citigroup	76.87	0.03
Credit Suisse	139.17	-6.80
Deutsche	217.14	6.32
GS	93.12	0.78
HSBC	80.58	-0.77
JPM	59.86	1.63
MS	91.58	0.34

Commodities (%)		
Gold	1324.43	-0.53%
Oil	44.48	-2.90%

3m Implied (vol pts)		
FTSE 100	13.82%	-0.30%
S&P 500	12.45%	0.17%
Nikkei 225	24.22%	0.38%
Eurostoxx 50	20.27%	-1.08%

5yr Implied (vol pts)		
FTSE 100	19.38%	-0.05%
S&P 500	21.48%	-0.05%
Nikkei 225	19.99%	-0.07%
Eurostoxx 50	19.77%	-0.08%

Source Bloomberg / Partner Banks
Data as at 22nd July, 2.30pm

Indicative Levels – 6yr	
FTSE 80/110 boost. 65% EKIP	240%
FTSE flat, 65% EKIP	10.0%
FTSE/S&P 5% step, 60% EKIP	8.70%

Call us for more details – see below

Upcoming Events	
	Fortem FTSE Enhanced Dividend Note Launch
27th	Fed Rate Decision
27th	UK GDP YoY figures

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Perhaps more interesting investment opportunities reside in playing a relative trade or indeed taking an investment view that yields won't actually fall mush lower on the longer end, but might not actually increase either. The easiest way to play the relative trade is by way of a "steepener". Oh no, not yet more financial jargon I hear you say! Well in lay person's terms, it is a trade that plays the spread (yield differential) between say 10 year yields and 2 year. So in effect you are taking the position whereby you are looking to see the spread widen. Referring back to the chart above, it would seem a sensible trade to look at the 10 year versus 2 year spread. If over the duration of your investment the spread widens by either 2 year yields dropping, 10 year yields increasing or both, then you will make money. The table below has indicative terms for such a trade. The more inquisitive of you might ask what CMS is. This is the constant maturity swap and is the benchmark that almost all yield derivatives are based and traded upon, extending to trillions daily. As the description might suggest, with the constant maturity swap if you take 10-year exposure then in a year's time, your investment will still be referencing 10 years' rates, unlike with a physical bond holding where you will have rolled down the curve slightly by one year. The one drawback with this trade is if the spread doesn't actually widen but it narrows! Whilst you won't lose money as we've floored the spread at zero, you won't make money which isn't much good either! Why might you ask could the spread narrow. Well, lurking in the background is the much speculated and discussed US Fed rate hike. Like most of us at Fortem, we've been predicting a rate rise now for some time and it has still not materialised, but with economic data in the US suggesting the economic recovery is still on course, then is a rate rise on the cards? What might happen with a rate rise, is for the shorter dated bonds to fall in value and therefore yields to increase, although again one might ask the question as to how much a rate rise is already priced into shorter dated treasuries and swaps. If 2 year yields did increase however, whilst at the same time longer dated yields stayed relatively unchanged, then the spread would actually narrow and indeed the curve would get flatter still.

Maybe then, a more specific play around 8-10 year yields is the more appropriate investment. If indeed you believe that 8-10 year yields can't possibly drop much lower, then how about a reverse convertible on 10 year rates? In simple terms you the investor sell a knock-in put on 10 year CMS and in return receive an annual non-contingent coupon. Should the 10 year CMS level be at or above the pre-defined barrier at the end of the investment term, you receive your capital back and if conversely 10 year CMS is below the pre-defined barrier at the end of the investment term, your capital is eroded. As with the steepener trade idea, indicative terms for such products are summarised in the table below.

It goes without saying that these investments can be tailored for specific views, be it points on the curve, investment duration, currency, barrier levels etc. if you want something pricing up with different iterations, please do give us a shout.

USD Yield Curve Plays	
Steepener	3 Years, Annual Coupon of 1.8 * (CMS10-CMS2) floored at zero and capped at 3%
Steepener	6 Years, Annual Coupon of 2.87 * (CMS10-CMS2) floored at zero and capped at 5%
RCB	1 Year, Fixed Coupon of 9.7% paid at maturity Redemption at maturity of 100%, if CMS10 > Strike * Barrier. Otherwise CMS10 / Strike -1 Barrier at 65% of current CMS spot (ref: CMS10 1.398)
RCB	2 Years, Fixed Coupon of 16% paid at maturity Redemption at maturity of 100%, if CMS10 > Strike * Barrier. Otherwise CMS10 / Strike -1 Barrier at 65% of current CMS spot (ref: CMS10 1.398)

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