

Title: Are Negative US Swap Spreads = Lower cost of private capital?

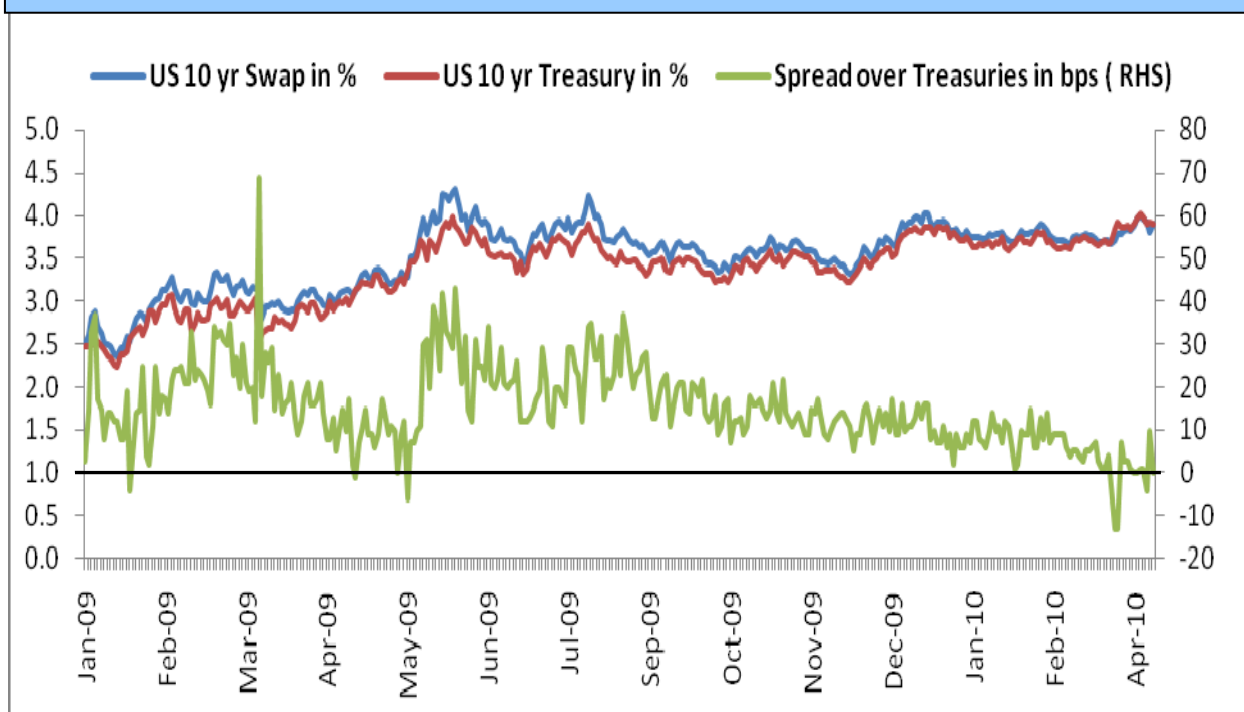
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Just prior to the recent Euro 30 bn solution to the Greece debt crisis, financial markets such as EUR-USD, Stock markets and Gold kept on gyrating in response to newer developments that took place every day in Greece. The pendulum kept swinging from risk aversion to risk taking. With the deteriorating credit quality of sovereigns such as Greece and Portugal and US and UK as well, the risk free benchmarks interest rates (sovereign) which we often use to price risks premiums, suddenly seems to have lost its relevance. And the recent moves in US Swap rates (in end March 2010) are an example of this. The US swap spreads (10 year) in March 2010 went briefly below the corresponding US treasury rates. (Chart I), though they are marginally positive now. In fact some of the AA and AAA rated US corporate bonds maturing in 2012-14, such as issued by Johnson & Johnson, Procter & Gamble etc were quoted at yields lower than corresponding US treasury yields. . Will the US government borrow at rates higher than the US Banks or a corporate?

Chart I: US Swap Spreads over US Treasury (10 years)



Source: US Federal Reserve, Delta Global Partners Research (data upto 09th April 2010)

US Swaps (interest rates) are the derivative contracts which typically exchange (swap) fixed rate interest rate payments for floating rate ones or vice versa based on 3m USD LIBOR. The financing rate charged by high credit quality (AA or above) banks to each other in money markets is known as LIBOR. It's a polled rate and the transactions are done a "clean basis" (without posting collateral). The swaps do not involve exchange of the notional principal payments between the counterparties. Only the interest flows at agreed rates and terms are exchanged. So the counterparties in swap markets do carry the credit risk, unlike US treasury holders which is default risk free. Though recently,

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more often the swaps are traded through central counter parties and are fully collateralized (Source: Mutkin, Morgan Stanley).

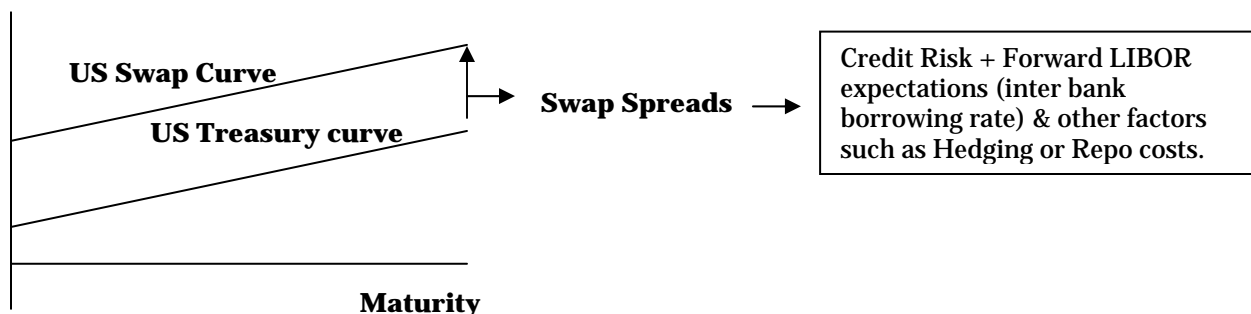
The swap markets are typically used to hedge fixed or floating rate liabilities or speculate in the interest rate markets. Swap markets are also used to hedge exposures to the US treasury markets. For instance a corporate that has issued a fixed rate bonds (10 years) can hedge the risk of rates going lower or save some costs by swapping the fixed rate into the 3m US LIBOR rates for next 10 years.

Many large commercial and investment banks are market makers in swap markets. The bid ask spreads and a small fee from its swap clients are the usual source of income for such banks. These banks deal with each other or with non bank entities such as corporates or other institutions. In most of the cases a bank offloads (dissemination of risk) any swap position which it takes in the inter dealer broker markets, keeping its end of the day open position little lower to control risk.

Since Swaps carry counterparty risk, the rates usually go above the corresponding US treasury yields, which are risk free. This incremental yield (compensation for risk) over US treasuries is known as Swap Spreads (Chart II), which are usually positive. But in recent times the swap spreads has turned negative. (Chart I above). These spreads compensate for the credit risk undertaken by the counterparty to the swaps, as well reflect the forward LIBOR expectations too.

Chart II: Interpreting US Swap Spreads

Yields



Source: Delta Global Partners Research & PIMCO

The pink press all over the world had covered the US Swap spreads going negative extensively. And most of them had this interpretation “US corporate can now borrow lower than US Government, which means that it’s a call on the US sovereign credit by the US credit markets”. I am afraid this is not entirely true. A sovereign stress in US, if at all should have been manifested in swings in US Credit Default Swap rates as well in currency (USD) movements or sharp interest rate rises. None of this has accompanied the negative swap spreads.

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Apart from the credit risk or cost of funding, the swap spreads are often influenced by “many other factors” which may be technical or specific to the structure of swap markets. Many of these factors are tied up to limitations of arbitrage or synthetic replications of assets or liabilities positions which might help to continue with the negative swap spreads. I have tried and cover some of them from my experience in working abroad. Here are they:

- The anticipated excess supply from the global governments is causing the sovereign yields to move up, thus compressing the positive spreads into the negative zone.
- Many of the Pension funds/Corporate have ended by on the receiving side (in pursuit of higher yields) of the swap markets to hedge their liabilities, thus putting pressure on the swap spreads. In fact as Government bond yields rise, insurers and pension funds may use a hedging strategy which tilts towards government bonds rather than swaps or synthetically replicate government bonds. A steeper yield curve also prompts receiving positions since lower short rates (3m LIBOR) and the expected delay in Federal Reserve raising the rates entails lot of cost savings.
- The Limits of Arbitrage between Swap and US Treasuries: A negative swap spread should quickly close out in an efficient market, due to the interplay between swap and US treasury markets and the ensuing arbitrage (Table I). But there do exist limits to funding/capital, leverage or synthetic replication of asset/liabilities position in US treasury markets or corporate bond markets to take advantage of the negative swap spreads, which might allow the negative spreads to continue for a while. Remember Swaps don't need upfront capital or balance sheet commitment like US treasury. Moreover the negative swap spreads are required to be high enough to make the arbitrage attractive.

The interplay between the **LIBOR, Swap, Corporate Bonds and US Treasury markets** as well as the limitations to arbitrage and synthetic replications is enunciated in Table I below. For instance an issue (short) of Fixed Rate Bond by a corporate can be replicated and arbitrated in swap markets if “no restrictions” prevail by a combination of a Short FRN + Short Swap position. Similarly, an issue (short) of a Floating rate note can be replicated by Short Fixed rate Note + Long Swap. And so for fixed or floating rate assets too.

Table I: Synthetic Replication of Liabilities/Assets and Limits of Arbitrage				
Position	Floating Rate Note (FRN)	Fixed Rate Bond (US treasury or Corporate)	Swap Leg I	Swap Leg II
Long	Receive Floating or Invest in LIBOR linked FRN	Receive Fixed	Receive Fixed	Pay Floating
Short	Pay Floating or Issue an LIBOR linked FRN	Pay Fixed or Issue Fixed Rate Bond	Receive Floating	Pay Fixed

Source: Delta Global Partners Research (with inputs from a close friend and an experienced market participant)

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- Limits or difficulties in short selling or inability to borrow or counterparty risk restrictions may also be an impediment to the above mentioned arbitrage opportunities which may allow the negative swap spreads to sustain for some time.
- Moreover to close the arbitrage and re align the spreads, one needs critical number of fixed rate payers (new issuers), which sometimes are not around, with reduction in general of borrowing corporate levels.
- The recent negative swap spreads were not accompanied by other sovereign risk concerns pertaining to US such as rise CDS or a sharp USD weakness, which clearly indicates the disconnect between deteriorating sovereign credits and the negative swap spreads.
- All the countries (PIIGS) with higher fiscals and public debt incidentally have negative swap spreads, though the sovereign risk may not be the reason for the same. In UK the longer end swaps have been lower than corresponding gilt yields since 2008. In US the 30 year swaps have been below the corresponding treasury yields for a while now.

To conclude, negative swaps spreads may be on account of structural or due to other factors such as limitations to arbitrage by synthetic replication mentioned above. It's not always a case that negative swap spreads imply the corporate or banks in US will be able to raise money at lower rates than the US government does. There do exist practical problems which act as impediments for corporate to borrow at costs lower than the government does.

And if the world faces another credit crisis, what will be the safe havens? Sovereign Bonds or Gold?

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