Swaps Revisited – Now Even More Negative

I was recently asked to comment on why the Yen has strengthened recently. Upon examination, I concluded that the BOJ has been selling USTs from its QE portfolio, resulting in the sale of US $ and the repurchasing of Yen (an incredibly counterproductive central banking action given that the Abe government is trying to weaken the Yen!).

This led me to revisit an article I wrote earlier this year entitled [‘Interest Rate Swaps as a Benchmark – Bookending the End of an Era’] (2/9/2016). This is a topic that is dear to me, as I have been championing the use of Swaps as a Benchmark for Fixed Income and MBS since 1990. (You can find this and other related articles on [MBS Mantra’s Analysis page].)

As you might be aware, longer maturity Swap Spread are negative and have been so for quite some time. In the February article, I found that the reason for negative Swaps Spreads was UST selling by Foreign Central Banks, primarily the Bank of China and the Bank of Japan.

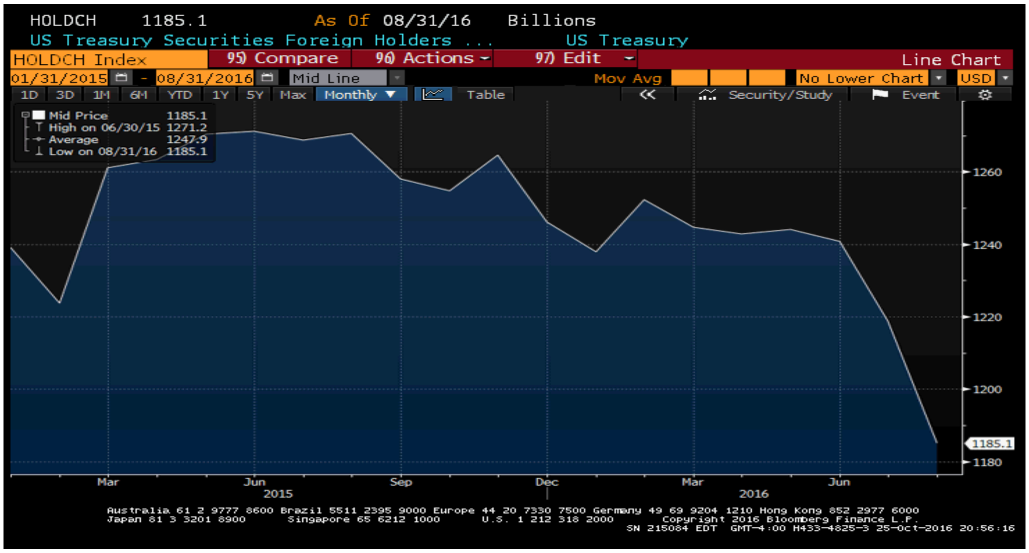
In this article I also concluded:

1. ***Swaps are less effective as a benchmark than they used to be, and hedging with swaps seems to have more risk than hedging with USTs.***
2. ***I would not use Interest Rate Swaps as a benchmark for Fixed Income valuation any more.***
3. ***Negative Swap Spreads tell us that Treasuries are cheap.***
4. ***Swaps are now an instrument with which to bet on QE-related Central Bank activity and flows.***
5. ***Swaps spreads can go more negative if central banks sell more of their UST holdings.***
6. ***Swap spreads will widen again if we get more UST purchases from further Central Bank QE. I believe we will see more easing via the Fed's Balance Sheet at least.***
7. ***The world of a single benchmark curve for valuing Fixed Income is ending***.

In this piece, we will revisit Conclusion#5: Swaps Spreads can go more negative if central banks sell more of their UST holdings.

The first graph shows the 30yr Swap Spread since 2015; the second graph shows more detail in 2016. **Indeed Swap Spreads tightened and went even more negative starting in June of 2016.**

The next 2 graphs show the UST holdings of the Bank of China and the Bank of Japan.



Pretty clear – both central banks sold USTs starting in June and July, causing UST yields to rise, and Swap Spreads to go more negative. (It is not clear to me why the Renminbi weakened over this period, but that is not a currency I follow.)

I think this validates conclusion #5, but also conclusion #4: ***<u>Swaps are now an instrument with which to bet on QE-related Central Bank activity and flows.</u>***

Once again, I will reiterate: Swaps can no longer be considered a benchmark for Fixed Income, and the use of IRS as a benchmark should be abandoned, as it will likely result in mishedging, and can cause major losses in the event of a volatility spike.

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