

Who's counting

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A QE3, 4 or 5? It's not as far-fetched as one might imagine. In the home stretch of the Fed's second quantitative easing regime, derivatives users are not only hedging any expected rate fallout, they are increasingly positioning for a QE3, or greater. **Kathleen Hoffelder** reports.

The Treasury's announcement last week that it will begin the orderly wind down of US\$142bn of agency-guaranteed MBS was a bit of a surprise to the market. But it did not cause any hair pulling. After knee-jerk spread-widening in MBS, treasury and interest rate swap spreads, all markets returned to normal.

The same is not likely to be said about the end of QE2 this June. So much uncertainty has been built up around the end of the Fed's purchasing power and its effect on the Treasury yield curve that derivative users are jumping into a variety of products to hedge against rate moves.

Indeed, the Bank for International Settlements said the volume of trade on international derivatives exchanges was higher in the fourth quarter of 2010 than the previous quarter. In particular, the turnover of short-term dollar interest rate futures rose by 29% during that time, which the BIS attributes to the Fed's announcement in November of the start of its QE2 bond-buying programme.

"Even though it [QE2] hasn't performed as expected, people are talking about QE3 and even another one," said an interest rate swap dealer, who noted that yields in the five to seven-year sector of the Treasury curve were likely to rise when QE2 ended.

Utilising products to lock in expected rate moves now would seem to follow good reason. After all, rates haven't exactly behaved rationally.

After both the Fed's QE1 and QE2, which were put in place to keep interest rates low, rates generally bucked the trend and rose. The 10-year US Treasury yield rose amid QE1 beginning March 2009 from 2.4% to 3.4% in May 2010, while the start of QE2 in November 2010 saw the 10-year yield jump from 2.5% to 3.3% last week.

"Already the expectation is that there will be some kind of gap at the conclusion of QE2 when the Fed halts at the end of June," said Walter J Zimmermann, chief technical analyst at United-ICAP. In the longer term, interest rates were going a lot higher, but in the near term it looked like rates could make a significant retreat lower, he said.

While Zimmermann is in the camp that believes it is actually economic expectations driving rates and not Fed policy decisions or Fed expectations of future interest rate policy decisions, he concedes that debates exist over the possibility of a QE3.

"Maybe we get a watered down QE3; it could be ineffectual to the same point of QE1 and QE2, but government will say they have to do something so therefore we must do it for show," he said.

Kansas City Fed President Thomas Hoenig, while vehemently against the idea of a QE3, also alluded in press reports to the possibility of another quantitative easing last month if economic data warranted such a move.

A QE3 is very possible, according to John Brynjolfsson, managing director at Armored Wolf, who said: "I would hope and think it would be data-dependent and associated with a failed hand-off from fiscal authority to the private sector, which frankly seems like a very real possibility."

External factors

Regardless of any potential rates move from a QE2 end or any start of a QE3, market participants who believe sustainable low rates and a rise in inflation could be more of the norm are also hedging now. In the fight against inflation, pension funds have been keen users of forward rate swaps and interest rate swaptions, according to dealers.

"Pension plans and other investors who don't necessarily need the liquidity of treasury securities find that swaps are more convenient vehicles for structuring their asset liability match," said Brynjolfsson. "In light of QE2 and rising inflation, they would be looking to shed duration. Swaps are an extraordinarily compelling opportunity."

The swap market is also cheaper than other products when it comes to looking for ways to shorten duration, added Eric Lascelles, chief economist at RBC Global Asset Management. "One of the drawbacks of a flattener [bond position] is it is quite costly to maintain. The swap market helps to sidestep that. Conceivably the swap market is where you want to do that."

Companies issuing bonds are also increasingly looking for interest rate derivatives to hedge curve moves. Though they still have to pay for the steepness of the curve in treasury options, for example, a lot of companies are interested in finding out about them, said Craig Orchant, partner at capital markets advisory firm EA Markets.

Two-year cap/floor options volatility has averaged about 80% during the past 12 months, he said, noting it has moved higher amid the uncertainty surrounding the regulatory and government market actions.