

BOND VOLATILITY & INTEREST RATE SWAPS

by Jim Willie CB

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Jim Willie CB, editor of the "HAT TRICK LETTER"



Use the above link to subscribe to the paid research reports, which include coverage of several smallcap companies positioned to rise during the ongoing panicky attempt to sustain an unsustainable system burdened by numerous imbalances aggravated by global village forces. An historically unprecedented mess has been created by compromised central bankers and inept economic advisors, whose interference has irreversibly altered and damaged the world financial system, urgently pushed after the removed anchor of money to gold. Analysis features Gold, Crude Oil, USDollar, Treasury bonds, and inter-market dynamics with the US Economy and US Federal Reserve monetary policy.

The rising long-term USTreasury Bond yield continues to capture attention. The breakout chart for the 10-year Treasury shot up to 3.75% last week, but zoomed to touch 4.0% this week. Less attention has been directed at the short-term USTreasury Bill yields. What was a reasonably steady 2-year TBill yield in the 0.80% to 1.0% range has made a big move to 1.35% suddenly. Few have noticed, since mortgage rates are tied to the 10-year USTreasury. Much talk came in the last few weeks that China was rebalancing its USTreasury hoard, selling some long-term maturity bonds and buying shorter-term maturity bills. The rise in bond yields has actually been attributed to a USEconomic recovery, but that is absurd on its face, with a dozen statistics to debunk it. This China story was intended to mask the real events, to blame them in part for the US bond instability, and to divert attention away from a potentially important threat. Not only has the housing market stalled, with new mortgages and refinanced loans hitting a brick wall. **The other major threat is to the Interest Rate Swap, those powerful credit derivative contracts that tie together the bond world in complex knitting.** The instability of USTreasuries on the long maturity (10-year & 30-year) and on the short maturity (so far just the 2-year) will surely unleash great firestorms of disruption, heavy losses, and raging fires for the big banks. It is next! It will be the greater second chapter to the Credit Default Swap opening salvo. Twice as many IRSwaps exist than CDSwaps, a story that bankers refuse to discuss.

Over 65% of credit derivatives are Interest Rate Swaps, which mainly enable floating long-term bonds of different type to be swapped for and controlled by short-term LIBOR rates. They also enable swaps of floating rates for fixed rates. For over a year, the Credit Default Swaps (insurance contracts for asset backed bonds) have garnered most attention from this unregulated zone of darkness. For several months short-term USTreasuries have had bond yields under 1%, and long-term USTreasuries have also been absurdly low, set in desperation. The IRSwap contracts have been under tremendous strain, but have received almost no attention, hidden from view. The astute forensic bond analyst Rob Kirby calls the artificially low long-term interest rate the ultimate source of financial market bubbles in the last two decades, 'a pox on humanity' in his words. See his website called Kirby Analytics ([CLICK HERE](#)). He also calls it the 'Original Sin' in price controls that led to numerous bubbles, and even decade sequences of asset bubbles.

If the usury price (cost of money) is artificially suppressed, then the nation gets fat on cheap money. By that is meant is relies too heavily upon the financial sector, as financial engineering is given far too much respect, while at the same time the industrial sector is dispatched for foreign lands, deemed dirty. The IRSwap contract has enabled for 15 years the long-term rates to remain well below actual price inflation, kept down by force from the control originated from USFed short-term dictated rates. So the entire USTreasury complex has been controlled with a tight fist by the IRSwap, an example of horrible abuse.

USDOLLAR BOUNCE WILL BE BRIEF

The USDollar will suffer the brunt of USTreasury rescues, either by brute force futures contracts, or coordinated central bank interventions. Numerous factors read bearish on the billboard for the beleaguered USDollar: huge USGovt debt issuance, weak USEconomy, rising specter of price inflation, questionable bank leadership, foreign revolt in the form of reserves diversification, and calls for a new & improved global reserve currency to de-throne the USDollar. The chart for the DX index could not be more vulnerable. The next targets are 77 and then 72. Watch for a 20-wk moving average crossover below the more stable 50-wk moving average, a powerful technical signal to sell the US\$ down hard! It is coming like night follows day. The current bounce is dead on arrival, obstructed by the 81 level resistance from December, and the falling moving averages overhead. As the credit derivative issue, complete with fresh publicized losses, raises its ugly head, the USDollar will be the bigger loser. The US banks are extremely vulnerable to additional credit derivative losses. Insolvency could quickly turn into a skein of bank failures. The mysterious rise in the crude oil price confirms great risk and weakness built into the USDollar. The Powerz can blame the speculators, but the true risk is with the USDollar. Crude oil confirms the US\$ weakness.

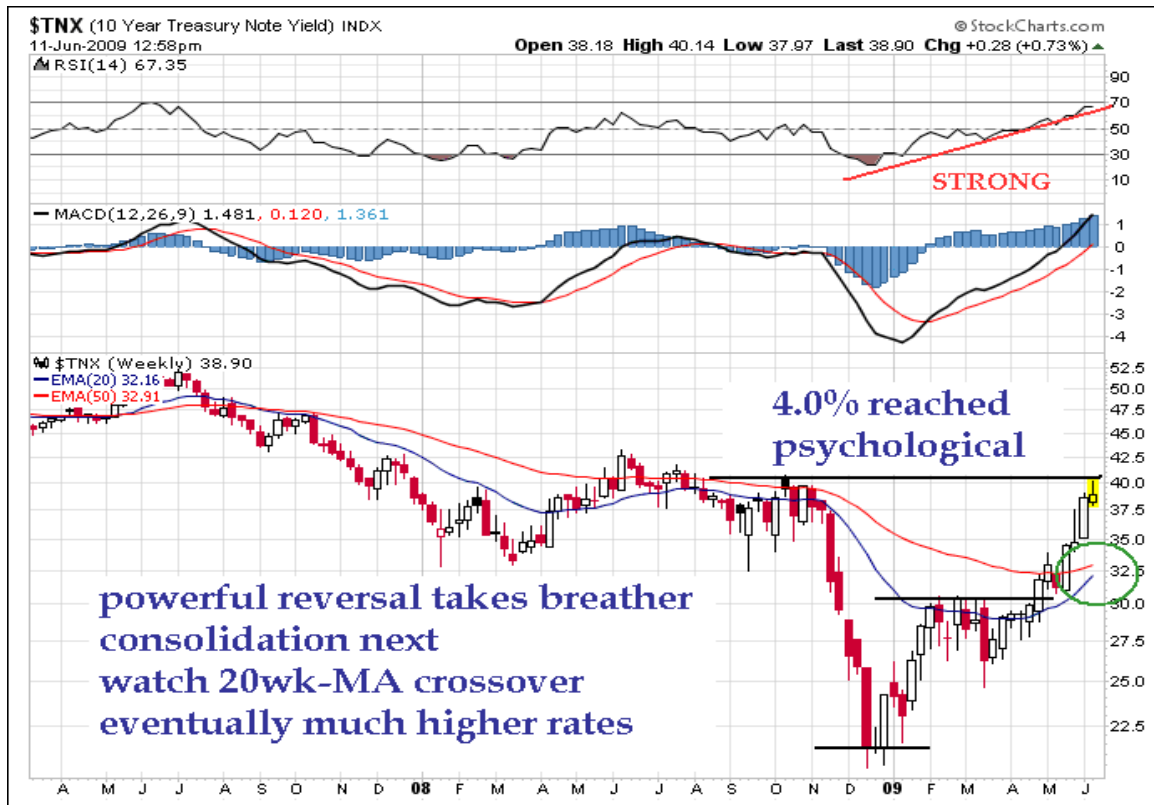


TURMOIL IN USTREASURYS

The main factor that Interest Rate Swaps CANNOT handle is volatility, the absence of linear movement in interest rates that form the underlying basis for these credit derivatives.

Unfortunately, instability has arrived. Blame it on the Chinese for rebalancing, and seeking the safety of shorter time horizons for redemption. Blame it on rising concern of extended moral hazard with low low rates near 0%. Blame it on bond vigilantes who foresee the rise of price inflation and the specter of a whipsaw hitting the USEconomy. Blame it on at least one announced huge monetization exercise by the USFed, and a likely series of such exercises, enough to tarnish the debt rating itself. Blame it on growing lack of faith & confidence in the USGovt finance, with federal deficits in the \$trillions for a few years, or as they say, as far as the eye can see. My expectation is for the USEconomy to suffer from an inflationary recession, where both price inflation rages and the recession drags on as endlessly as the housing decline. The stock market rally since the spring has transferred risk to the USTreasury market in a direct handoff of risk. **My other conclusion is that defense of the USTreasurys will be seen and noticed, but unfortunately, the risk will transfer to the USDollar.** The buck will fall hard when the credit derivatives take their toll, and burn through banker walls.

The initial reaction to the US banking system collapse last autumn was to hunker down into the perceived safe haven of the USTreasury Bond. It rallied enough to send the 10-year bond yield from 4.0% down to 2.1% insanely. The parade was engineered by JPMorgan and its bond futures contract purchases, and the US Federal Reserve which opened global swap facilities for foreign usage. As we see now, no such safe haven exists, since the USTreasurys are an inferno of acidic debt and depleted grease from the monetization printing presses. The 10-year USTreasury yield (TNX) finally reached the 4.0% mark, and like hitting any psychological point, it has backed off slightly. It has worked through a two-step runup from 2.1% to 3.0%, and then to 4.0% in completion. Look for the TNX to consolidate in the 3.8% to 4.0% range, much like a person digests a bad meal, complete with indigestion and a visit to the bathroom for relief. **Later on, the TNX will march higher still, in unison with more outsized USTreasury auctions.** The bottom line conclusions have missed the mark on systemic instability. Focus on price inflation, cost structures, creditworthiness, foreign creditor relations, they are relevant. **However, the bond market volatility takes a big toll on Interest Rate Swaps.** They require dynamic balancing. Like a man with his family on a large rowboat, the sudden shift of weight leads often to the boat capsizing. Such risk exists with the credit derivatives, except they are an armada of huge river barges loaded with bond ore.



As if that is not enough, the 2-year USTreasury Bill has suffered even greater volatility. If the Chinese rebalanced in May by moving more to the 2-year, then they have experienced sudden losses. Their resentment, already strong, will turn acute. The upward movement by 50 to 60 basis points is sure to cause turmoil. IRSwaps hate turmoil! Perhaps the interest rate spread trade, linking the 10-year to the 2-year, helped to push up the short-term USTreasury yields in tethered fashion. **The easier conclusion is that official USTreasury auctions of magnificent size have forced up bond yields.** Finally, the reality of USGovt deficits have arrived in the credit markets. Last week, the plight of the USFed primary bond dealers was mentioned. The rise in bond yields is natural when supply arrives by the truckload, after decades when it arrived in wheelbarrows. The rise seen in the chart below is not normal. Nothing about the USTreasury Bond market has been normal in the last several months. For a long spell, even naked shorting of USTreasurys was used by desperate big US banks in order to raise cash for operations, to manage shortfalls, and to basically steal. The financial press gave the practice the name of 'Failures to Deliver' in sanitized manner. The USFed did close that door, but with mere 3% penalties when 20-year prison sentences might have been appropriate. Try selling a barge full of iron ore that you do not own to a steel factory, and see if an orange jump suit and a long prison stretch awaits!



The official auctions have continued, a veritable parade of debt securities for the financial markets to absorb. **My unflinching expectation is that the USFed and USDept Treasury will relieve the stress to the system, stress on full display, by announcing another monetization of \$1 trillion for bond purchase, and do so on a quarterly basis.** In the last week, \$35 billion in 3-year USTreasurys were auctioned at 1.960% on June 9th, and \$19 billion in 10-year USTreasurys were auctioned at 3.990% on June 10th. Recall that just one month ago, auctions sold the same 10-year USTreasury at 3.19%, which is a real shocking move and a hefty loss. The last week also had \$11 billion in 30-year USTreasurys auctioned at 4.720% on June 11th, in a more successful auction. But a huge indirect bid came, usually central banks. They probably were called in to remedy the tarnished image of the USTreasurys in general.

A huge conflict has come of monetary policy versus fiscal policy. The USFed must plan an end to free money and rivers of printed money. Unfortunately, they do not have the privilege of choice. **An Exit strategy is rendered an impossibility.** Practicality and political reality are certain to clash against USFed textbook goals. **They will instead opt for a 'Back Door Exit Strategy' in continued large scale monetization.** In May the lowered mortgage rates, below 5.0% in fact, helped to usher in consensus viewpoints of economic recovery, the mindless moronic Green Shoots. In June the fast rising long-term rates (and thus mortgage rates) brought on bad news to torpedo the housing market and mortgage finance recovery process. Much more is provided in analysis on the Interest Rate Swap threat and the limited options on Exit Strategy for the USFed in the June Hat Trick Letter. The United States is seeing a revolt not only by foreigners, but also by the financial market forces.

INTEREST RATE SWAP NIGHTMARE COMES

Interest Rate Swaps link long-term bonds typically to the short-term LIBOR rates. Other IRSwaps enable floating bonds of different type to be fixed rate. During the many months when USTreasurys have had bond yields under 1%, the long-term USTreasurys have also been absurdly low. The supposedly easy money comes with a heavy hidden price, that being shocks to the structural foundation and its gradual hidden weakness to the entire bond lifeblood to the banking system. **The IRSwap contracts have been growing tremendous strain. They assure tremendous and possibly catastrophic losses, whose attention will come in the next few**

months. The instability of USTreasurys on the long maturity (10-year & 30-year) and on the short maturity (so far just the 2-year) will surely unleash great firestorms of disruption, heavy losses, and raging fires for the big banks. It is next! It will be the greater second chapter to the CDSwap opening salvo. Some competent analysts, who were not fooled by the growing dangers that erupted into crisis last year, believe that a volatile USTreasury Bond could destroy the US banking system, delivering it final blows after the mortgage crisis rendered it insolvent. The commercial mortgage losses, the Option ARM mortgage losses, the credit card losses, these will add to bank distress and in more cases failures. But the Interest Rate Swap disaster looms close with heavily leveraged sledge hammer blows.

See Rob Kirby's illuminating article entitled "[Theater of the Absurd: A View From the Inside](#)" (CLICK [HERE](#)). He provides great detail and cogent arguments to make the case of profound market interference. That wrench in the works of a supposed free market has come to render great harm to the system, the economy, households, life savings, job prospects, and national stability. Kirby travels through Bond Land in an interesting ride and lesson. He disputes that Credit Default Swaps lie at the epicenter of the derivatives crisis. AIG is its most visible victim of those insurance contracts. The Office of the Comptroller of the Currency issues a quarterly report, which unfortunately is lagged badly in its data provision. The three major villains, all protected from prosecution even though the nation has lost its vitality, industry, and much of its life's savings, are JPMorgan Chase, Goldman Sachs, Citigroup, and Bank of America. **A mountain of IRSwaps are traded, even though no counter-party could possibly exist. The reason is simple: to keep interest rates low. Now they are backfiring, and danger rises for major credit derivative accidents twice as great as the CDSwap accidents that killed AIG.** The falsification for 15 years of the Consumer Price Index goes hand in hand with falsification of interest rates, both long-term and short-term. The victims list also includes Bear Stearns and Lehman Brothers. The list is sure to grow.

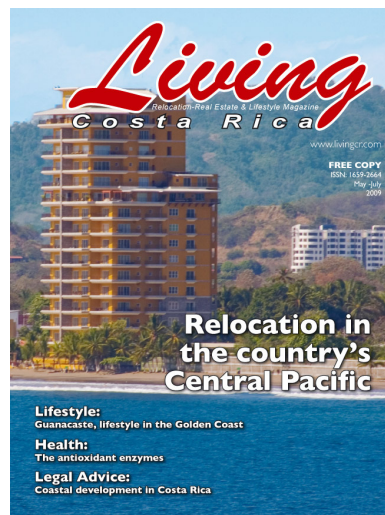
JPMorgan alone has \$66 trillion in notional value of Interest Rate Swaps. They must constantly balance this load, in what is called dynamic hedging. That task has been rendered very difficult, if not impossible. **The entire hedged position in IRSwaps remarkably exceeds the value of the entire USTreasury Bond market, a fact kept quiet by bank officials.** With most IRSwap contracts, fixed net payments are made on a quarterly basis. So the hot fires that burn in big bank basements must be dealt with each quarter, as loss damages are assessed and paid for promptly. JPMorgan in all likelihood just is as insolvent and possibly bankrupt as Citigroup. Toss in the US Federal Reserve. A prickly quote was offered by James Grant of the *Grant Interest Rate Observer* recently. Grant said, "*If the Fed examiners were set upon the Fed's own documents, unlabeled documents, to pass judgment on the Fed's capacity to survive the difficulties it faces in credit, it would shut this institution down. The Fed is undercapitalized in a way that Citicorp is undercapitalized.*"

The USFed has no Exit Strategy available to it, since raising interest rates would exacerbate a trend that began without any direct active decision on the official rate. **The IRSwap represents a major obstacle to reversing the easy accommodative monetary policy of near 0% rates, but also serves as a coffin nail final blow to the US banks.** They are not recovering; they remain insolvent; they face further losses; they are toast. Next comes the unraveling and

Christmas Tree of explosions in the credit derivative arena. The challenge will be for the USFed and USDept Treasury and Wall Street to hide the fires and damage.

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Living Costa Rica is an online magazine about many aspects of life in the tiny country perched strategically on the land bridge between North and South America. The magazine is a great means not only to learn about Costa Rica, but also to take actual steps on relocation. It has become an excellent means to find important information about the country, a bonafide tropical paradise. Property, banks, natural wonders, climate, and demographics are covered. Visit their magazine to gain interesting information about lifestyle and options, in particular the truly spectacular Central Pacific coast. Visit www.livingcr.com. GIT WHILE THE GITTIN' IS GOOD!



CREDIT CRISIS AUTOPSY

Trace Mayer comes to the gold community with a different slant and background. He has a law scholar with emphasis on the Constitution, especially how it applies to the gold and currency topics. In his e-book entitled “The Great Credit Contraction” one can read about the historical significance of a crisis that will surely reshape the world. The global economy is built upon a currency whose illusion is evaporating before our very eyes. This book is an autopsy of the current worldwide systems and begins with financial history, discusses the current great deflationary credit contraction, projects the future environment, and concludes with suggestions on how to generate and preserve wealth in this challenging time. An appendix analyzes important topics. (CLICK [HERE](#) TO ORDER)

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(RobertN in Texas)

Jim Willie CB is a statistical analyst in marketing research and retail forecasting. He holds a PhD in Statistics. His career has stretched over 25 years. He aspires to thrive in the financial editor world, unencumbered by the limitations of economic credentials.

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