I. D. E. A.

TRADE RECOMMENDATION:

The 2-3-5 Butterfly and Fed Tightenings

Looking at a chart of the 2-3-5 butterfly spread since the regularization of U.S. debt issuance in 1976, it is clear the spread has been influenced greatly by the state of monetary policy, as well as by the Fed's choice of operating procedure (i.e. reserve targeting vs. interest rate targeting). Other factors, such as relative supply, the switch to Dutch auctions, cancellation of competing issues like the 4 year note, the 1993 debt mix shift, and the switch to a monthly 5 year note also play a role of course, but the factor we can immediately exploit appears to be the current change in monetary policy.

Calculating the 2-3-5 spread as the sum of the 2 year and 5 year yields minus twice the 3 year note yield, we see that the 2-3-5 spread tends to widen during easings and narrow during tightenings. As the chart below shows, the 2-3-5 spread narrowed sharply during Volcker's 1979-82 tightening, as well as during Greenspan's first tightening in 1987-89, and widened steadily during the easing of 1989-93. Oddly, the spread started narrowing in the spring of 1993, almost a year before the Fed started its current tightening move. Nonetheless, the 2-3-5 spread is at its narrowest level since mid-1991. The narrowing move in 1993 does appear closely tied to the Treasury's debt mix shift, which may have been a factor. Regardless, it appears clear the 2-3-5 spread has more narrowing in store, since this last Fed tightening is surely only the first of several tightenings. We would recommend selling the 2-3-5 butterfly to take advantage of the further fed hikes.

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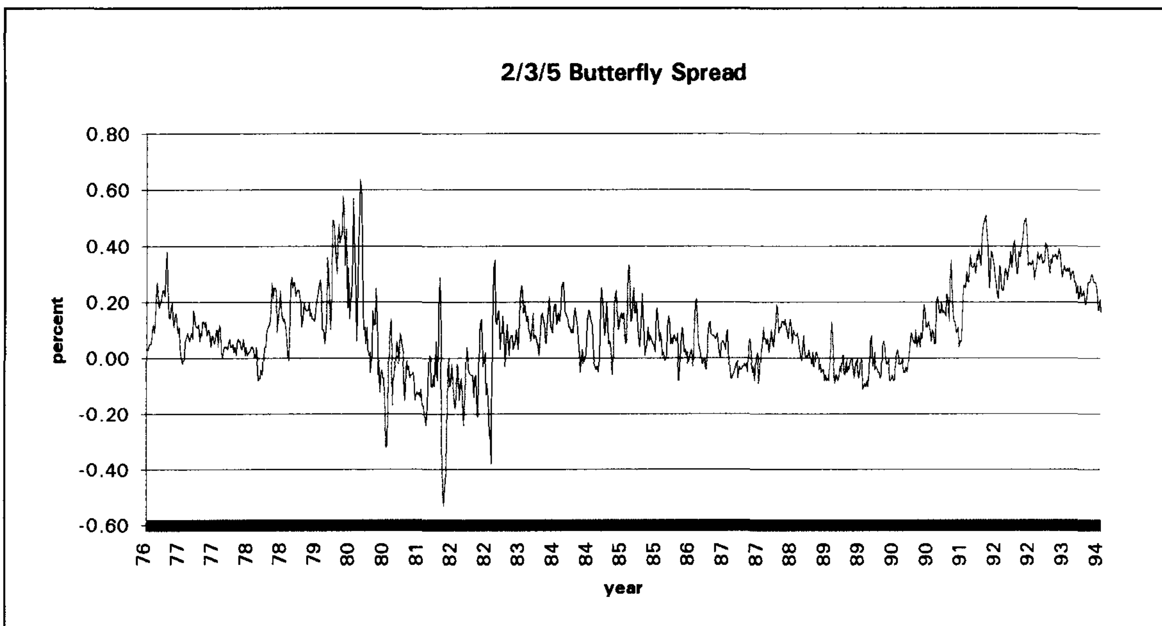
The on-the-run 2-3-5 spread (comprised of the 4 5/8 of 2/96, the 4 3/4 of 2/97, and the 5 1/2 of 2/99) currently stands at about 16 bps. During the 1987-89 tightening, the 2-3-5 spread got to about -15 bps. In our view, profits should be taken in the current move at a 2-3-5 spread of about zero. In order to take advantage of this trade in the most risk-free manner (i.e., best protection against parallel shifts in the yield curve) we would recommend a trade that is both DV01-neutral and convexity-neutral. The weights for such a trade would be in the following proportions: for every 100 mln of 3 year notes shorted, buy 96 mln 2 year notes and buy 21 mln 5 year notes. Profit potential for a move from current levels to a spread of zero should be about $2,000 for every million par value of the 3 year sold short.



NOTE: This strategy was recommended on March 9th on the I.D.E.A. on-line product. The trade stayed stable for a few weeks, but then came into the money. The spread narrowed to 5 bps by May 4th, and to the recommended target level of 0 bps by May 26th.