Chris Galbraith – Vocabulary Terms:

**Basis Points** (abbreviated “bps” and the jargon word is pronounced “bipps”) 1/100th of a percent. For example, 1.02% can be expressed as 102 bps. To give a sense, a 5 bps move in Treasury rates during the course of the day is considered a sizeable move in the market. A 10 bps move is a very large move. Treasury rates bounce around during the day, just like stocks. In a typical day, Treasuries might move up and down about 1-3 bps.

**Growth vs. Inflation** – whole purpose of the Fed is to foster economic growth at full potential, while containing inflation in the process. GDP and growth are synonymous. If the economy grows too fast, inflation kicks in and prices rise. (how does the Fed balance this seesaw? what is their primary tool? does the Fed target growth or inflation in deciding when to move the Fed Funds rate?)

**Tightening Cycle vs. Easing Cycle**
Tightening cycle is when the Fed is raising rates (to contain inflation or slow down the economy) and an Easing cycle is when the Fed is lowering rates (to stimulate the economy). The Fed alters its target rate at each FOMC meeting.

**FOMC Meeting** – a meeting about every 6 weeks (8 meetings per year) where the Fed chairman and the FOMC committee meet to discuss the economy and direction of monetary policy. (when was the last meeting and when is next meeting?) The market is keenly focused on this meeting. At each meeting, the Fed releases a 1-page policy statement which accompanies a speech from the Chairman. Ben Bernanke transitioned to the new Fed Chairman at Greenspan’s last FOMC meeting in January. At the March meeting, the Fed rose the Fed Funds rate by 25 bps to 4.75%.

**Fed Funds rate** (a.k.a. target rate, policy rate, “Fed Funds”. This is an overnight rate, which is about the shortest time period for which you can borrow money. Fed Funds is the first point as you draw out the yield curve. Where is it currently and what does market expect at the next FOMC meeting?) - This rate is used to stimulate or slow down the economy. Consequently, the market is constantly trying to predict what the Fed is going to do with this rate. The Fed will move this rate up and down by 25 bps increments (so either 25 bps or 50 bps up or down). It is the only rate that the Fed controls. Remember, the Fed controls Fed Funds, the market controls Treasury rates. As the probability increases that the Fed will become more aggressive in tightening the Fed Funds rate, Treasury rates take their cue and will typically rise accordingly

**Inflation** – three measures, CPI, PPI, and PCE. CPI is most broadly watched by the market. **Core** CPI (currently 3.6%) refers to consumer prices excluding food and energy (as food and energy tend to be highly volatile and may not give a clear indication of true inflation). Note, that a high inflation figure (released monthly) not only implies that the Fed will hike rates more aggressively, but inflation also erodes the value of bond interest payments. As we will discuss below under “Duration”, longer-dated bonds are more affected by inflation that shorter-dated.
Rates and Yields – the terms are used interchangeably.

Rally vs. Sell-off – Stock prices rise on a rally and fall on a sell-off. Bonds prices are the same. However, because bonds have an inverse relationship between price and yield, when bond prices rally, yields go down. As a result, when we talk about a rally in rates, we mean that rates go down (as prices goes up). Although it takes getting use to, just memorize that high demand for bonds drives rates down.

Bad news vs. Good news – the fixed income market loves bad news (poor economic data, etc). A simple way to think about it is that bad news drives investors out of equity and into bonds. Hence, bad news causes rates to rally (go down). A more sophisticated way to think about it is that bad news means the economy is not performing as well. This increases the probability that the Fed will lower rates, causing the market to adjust

U.S. Treasuries (UST’s) The most liquid, fundamental type of security. Treasury bonds are issued by the U.S. government and are considered risk free (0% probability of default). The yields of these securities can be plotted against maturity to create a yield curve. When used generically, the term “interest rates” refers to Treasuries rates.

Benchmark Treasuries (2-year UST, 3-year UST, 5-year UST, 10-year UST, and 30-year UST). For short we just say 2s, 3s, 5s, 10s, and 30s.

Treasury Auction Frequency:
2s  monthly
3s  quarterly (Feb, May, Aug, Nov)
5s  monthly
10s quarterly (Feb, May, Aug, Nov)
30s  semi-annually (Feb, Aug)

On-the-run Treasuries (OTR) vs. Off-the-run Treasuries (OFR)
Most of the market only cares about the OTR Treasuries (i.e. most recently auctioned Treasuries with a tenor of 2-, 3-, 5-, 10-, or 30 years). OTR Treasuries are known as on-the-run because they are highly liquid due to their high trading activity. OFR Treasuries refers to all other Treasuries that have been issued sometime in the past (not the most recently issued). Example: A 30-year UST that has only 12 years remaining is OFR, but is still used as a 12 year point in constructing the yield curve.

Yield Curve – the curve is almost always characterized as upward sloping (try and draw it out). Know the difference between short-end of the curve (Fed funds up to about 3-year USTs) vs. long-end of the curve (approximately 7-year USTs out to 30s).

2s/10s Curve [pronounced two’s ten’s curve; the spread or differential between 2s and 10s] – also referred to as the slope of the yield curve. If the 2-year is greater than the 10-year UST, the curve is considered “inverted” (very rare occasion). As this differential increases and decreases, the curve is said to “steepen” and “flatten”. Because inflation
affects the prices of longer-dated bonds more than shorter-dated bonds (see “Duration” below), any hint of increased inflation will cause the curve to steepen (long-end of the curve will sell-off more than the short-end of the curve).

Example: 2s are trading at 4.50% and 10s are trading at 5.47% - that means 2s/10s is at 97 bps. If during the course of the day, the 2-year remains unchanged but the 10-year rallies 3 bps to 5.44%, the curve flattens 3 bps to 94 bps.
The market pays very close attention to the slope of the curve. Currently, we are at historically flat levels. 2s/10s curve is currently trading at 12 bps (2s at 4.92% and 10s at 5.04%)

Volatility (synonymous with risk and standard deviation). If a bond is volatile, it implies that the changes in its price from day to day deviate a lot, and consequently is considered risky

Corporates (short for corporate bonds) Like the government, companies issue bonds to acquire funds. Corporates differ from USTs in that they have some type of probability of default (known as their credit rating). Each company falls somewhere along the spectrum of credit ratings (AAA, AA, A, BBB, BB, B, CCC, etc). Any company with a rating of BBB or higher is considered an “Investment Grade” company. Any company with a rating of BB or lower is considered a “High Yield” company (i.e. junk bonds).

Credit Spread – the amount of basis points above the benchmark treasury rate that a company must pay for its fixed coupon on a bond. Example: AA companies currently have a credit spread of approximately 50 bps. If a AA company wants to issue a 10-year corporate bond, and the 10-year OTR Treasury is trading at 4.78%, the company will issue the bond at a rate of 5.28%.

Keep in mind that a company’s credit spread is changing each day, just like Treasuries are changing. Granted credit spreads are not nearly as volatile as Treasury rates, nonetheless, they are determined by supply and demand for a company’s particular bonds. If investors are in high demand for an IBM bond, the credit spread will decline, and IBM will be able to issue at a lower rate (i.e. receive cheaper funding). Companies try and time their new bond issues around the times when investor demand for their bonds is high. This is the role of “Debt Capital Markets” within Investment Banking. I’m sure you can imagine what the role of the “Equity Capital Markets” group is within Investment Banking.

Non-farm Payrolls (a.k.a. employment report, payroll report, payrolls, jobs report) Payrolls are released the first Friday of every month, and reflect how many jobs were added to the economy over the prior month. The payroll figures have averaged right around 200k each month throughout the current tightening cycle – that is a very healthy growth figure for the economy. Hence, the Fed continues to raise rates to keep the economy from growing too fast (beyond its potential), otherwise prices will begin to rise (inflation).
**Duration** – (100% guaranteed you will get a question about duration in any job interview within Fixed Income. Nothing too technical, just an overall understanding is necessary). Duration is measured in years and is fairly easy to calculate. Remember that a bond’s duration is shorter than its maturity. There are three ways to look at duration:

1) “The present-value weighted average maturity of a bond’s cash flows”. That just means, on average, how many years will it take you to receive your payments on a bond. The 5-year UST has a duration of about 4.3 years, 10-year UST about 7.7 years, and a 30-year UST about 15.3 years (keep in mind these numbers move around a little)

2) A measure of the price sensitivity of a bond to changes in interest rates. The longer the duration, the more sensitive a bond is to movements in interest rates. Generically speaking, for every 1.0% movement in rates, the price of the 5-year UST will change by 4.3%, and the 10-year UST by 7.7%. That should make sense since a longer-duration bond has more time and cashflows which can be affected by a movement in rates

3) A measure of risk. This is more or less saying the same thing as the point above. A longer duration bond is more sensitive to interest rates and logically riskier to own

**DV01** - (stands for dollar value of 1 basis point, and is pronounced Dee Vee O one). It is calculated off duration and simply shows how much the price of a bond will change per 1 bp movement up or down in rates (as opposed to 1% movement). As a back of the envelope calculation, per $100 million Treasuries, the value of 1 basis point on the 10-year UST is $77,000 (hence the DV01 is 77,000). Hence, if rates sell-off by 2 bps, you would lose $154,000. You can see why every basis point movement in the market has a large affect for bond holders, particularly longer duration bonds

**Current Economic Environment**
The current tightening cycle began in June 2004, when the Fed raised the target rate from 1.00% (historically a very low level) to 1.25%.

Since June 2004, the Fed has hiked rates by 25bps increments (0.25%) at each of the past 15 FOMC meetings, bringing the Funds rate to 4.75%. All along the way, Greenspan communicated to the market that the Fed would continue to raise rates at a “measured” pace (key phrase). The market interpreted the “measured pace” language in the policy statement to mean a 25 bps rate hike at each meeting as long as the “measured” language remained in the statement. Finally, after the January 2006 meeting, the Fed dropped the “measured” language from the statement to allow the Fed more flexibility as the target rate approached neutral.

Where is neutral? Nobody knows exactly. The market currently believes it is around 5.00% (maybe 5.25%). Expectations of future rate hikes are highly data dependent. As economic data is released most mornings at 8:30 a.m. (about 12 important data figures each month, with payrolls leading in importance), the market reacts and adjusts to the new probability of future rate hikes.
The economy is clearly in a very healthy state. Some market participants believe the risk is that the Fed overkills the economy by raising rates too high or too fast, which would lead to a subsequent easing cycle. Credit Suisse believes the Fed will raise rates to 5.00% at the May FOMC meeting, and will engage in an extended pause (neither up nor down). In either event, near-term economic data will help dictate what the Fed decides to do at the May meeting.

Ben Bernanke took charge as the new Fed Chairman and led his first FOMC meeting in March.

The 10-year UST is at its highest level since the beginning of the tightening cycle, currently trading at 5.04%. The 2-year UST is trading at 4.92%, so the 2s10s curve is currently at 12 bps (flirting with inversion).