Breaking Down 'Constant Maturity Swap - CMS'

Constant maturity swaps are exposed to changes in long-term interest rate movements, which can be used for hedging or as a bet on the direction of rates. Although published swap rates are often used as constant maturity rates, the most popular constant maturity rates are yields on two-year to five-year sovereign debt. In the United States, swaps based on sovereign rates are often called constant maturity Treasury (CMT) swaps.

In general, a flattening or an inversion of the yield curve after the swap is in place will improve the constant maturity rate payer's position relative to a floating rate payer. In this scenario, long-term rates decline relative to short-term rates. While the relative positions of a constant maturity rate payer and a fixed rate payer are more complex, generally the fixed rate payer in any swap will benefit primarily from an upward shift of the yield curve.

For example, an investor believes that the general yield curve is about to steepen while the six-month LIBOR rate will fall relative to the three-year swap rate. To take advantage of this change in the curve, the investor buys a constant maturity swap paying the six-month LIBOR rate and receiving the three-year swap rate.

The spread between two CMS rates (e.g., the 20-year CMS rate minus the 2-year CMS rate) contains information on the slope of the yield curve. For that reason, certain CMS spread instruments are sometimes called steepeners. Derivatives based on a CMS spread are therefore traded by parties who wish to take a view on future relative changes in different parts of the yield curve.