# Two-Year Interest-Rate Swap Spreads Narrow to a Five-Year Low

**By Liz Capo McCormick**

**September 11, 2009**

(Bloomberg) -- Two-year swap spreads narrowed to the least in more than five years as the cost of dollar loans between banks held near a record low.

The difference between the rate to exchange floating- for fixed-interest payments and U.S. Treasury yields for two years decreased to as little as 29.5 basis points today, the smallest gap since March 2004. The spread, based in part on expectations for the London interbank offered rate, or Libor, and used as a gauge of investor perceptions of credit risk, widened to a record 167.27 basis points on Oct. 2 in the weeks following the collapse of Lehman Brothers Holding Inc.

Spreads are narrowing as "there is a healing in the markets and a return to risk," said Marc Fovinci, head of fixed income at Ferguson Wellman Capital Management in Portland, Oregon, with about $2.2 billion in assets. "Money is starting to look for a new home where it can get some yield."

The five-year swap spread narrowed 0.56 basis point to 35.69 basis points. The 10-year spread fell 0.25 basis point to 16.75 basis points, and the 30-year swap spread decreased 0.31 basis point to negative 16.31 basis points. One basis point equals 0.01 percentage point.

Swap rates are usually higher than Treasury yields in part because the floating payments are based on interest rates, such as Libor, that contain credit risk. Swap rates serve as benchmarks for investors in many types of debt, including mortgage-backed and auto-loan securities.

**Treasury Yields**

Yields on U.S. Treasuries fell, with the benchmark 10-year note heading for a fifth week of price gains after the relative value of U.S. government debt helped fuel demand at auctions of $70 billion in bonds and notes over the past three days. The yield on the 10-year security decreased four basis points today to 3.31 percent.

Three-month dollar Libor was set today at 0.299, down from 0.30 percent yesterday and just above a record low of 0.2987 on Sept. 9, according to the British Bankers' Association. The Libor-OIS spread, a gauge of demand for cash and banks' willingness to lend, was little changed at 13 basis points.

The Libor-OIS spread quoted in contracts traded in the forward market decreased to little changed. The so-called FRA/OIS spread priced to June 2010 was 20.45 basis points, compared with 20.94 yesterday, and the spread priced to June 2011 was little changed at 22 basis points, according to data compiled by Tullett Prebon Plc.

**Eurodollar Futures**

Implied yields on Eurodollar futures, the world's most actively traded contract and a driver of movements in swap rates, were mostly lower.

The December 2009 contract yield was 0.415 percent, down 1.5 basis points, while the implied yield on the December 2011 contract was 2.965 percent, down 4.5 basis points. Movements in implied yields, which are calculated by subtracting the quoted price from 100, give traders bets on where three- month dollar Libor will trade in the future.

Volatility on options for U.S. interest-rate swaps, which are known as swaptions and used to speculate on and hedge interest-rate risk, was lower today and versus last week.

On three-month options for two-year interest-rate swaps, or 3m2y swaptions, so-called gamma was 104.41 basis points, from 115.47 on Sept. 4. Normalized volatility, or so-called basis- point volatility, on three-month options for U.S. 10-year swaps, 3m10y swaptions, was 148.65 basis points, down from 148.99 yesterday and below last week's closing level of 153.87.

Normalized volatility signals traders' expectations for fluctuations in swap rates over the next year by adjusting the implied volatility of the option by the interest rate struck on the swaption.

Longer-term swaption volatility, or so called vega, also was mixed. The normalized volatility on five-year options on five-year interest rate swaps, 5y5y swaptions, was 126 basis points, unchanged from yesterday. The normalized volatility on 3y10y swaptions was 131.96 basis points, down from 132.05 basis points yesterday and 133.03 on Sept. 4.