US Yield Curve Risk – QE3 Exit?

Trade Idea

27 February 2013

boost™

Three-thinking ETPs

Summary

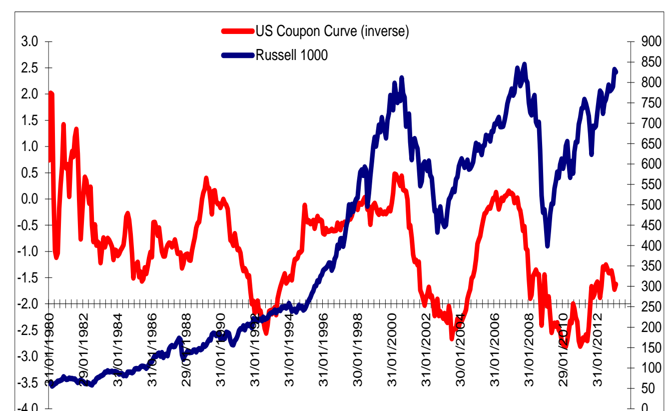
- **The release of the Fed minutes rattled equity markets last week as investors were reminded of the fact that the Fed will need to exit the QE3 programme at some stage, perhaps sooner than expected**
- **Ending a programme of aggressive bond buying may see bond yields rise in anticipation of the event, which will be negative for the US equities market in the short-mid term**
- **Investors who believe that US equities will fall could buy the Boost Russell 1000 3x Short Daily ETP (3USS) to provide a leveraged inverse return or hedge their portfolio**
- **They could also buy Boost NASDAQ 100 3x Short Daily ETP (QQQS) if they believe the NASDAQ, which tends to have a higher beta, will fall**

The release of the Fed minutes last week saw equity markets ease as the risk of the Fed exiting from their QE3 stimulus programme sooner than expected increased. It seems that investors had taken the Fed's 'target' of a 6.5% unemployment rate as the 'green light' for an exit from the Fed's bond buying programme, but comments from FOMC members suggested that some of those were not comfortable with the open ended (both in time and amount) commitment to bond buying that the QE3 programme entails. In other words, it may make sense for the Federal Reserve to reduce some of the stimulus if and when the economy improves, even if the unemployment rate is not at the target area. Keeping in mind that the Fed may not only have to reduce the amount and type of bonds they are buying, but would also have to raise rates from the unprecedented low levels that they are at and may have to shrink their bond holdings as well at some stage. Time is on their side as, barring any sharp rise in inflation risk, they can unwind their holdings and raise rates slowly. But markets do try and anticipate events, and the gryations seen last week suggest that even the slightest hint of exiting their QE3 progam may see bond yields rise sharply.

The investment concern for equity markets is that a rising or steepening yield curve in the US (or coupon curve, the spread between the US 10-yr Treasury note yield and the 2-yr US Treasury note yield) is associated with a potential fall in equity markets. This may reflect a sharp drop in the yield in the short dated bond as the Fed eases as the economy slows down, and may not be exclusively the fault of rising long end yields. In any case, as the chart shows, if the coupon curve does start to steepen (or the red line falls on this chart) then the stock market tends to fall as well. This may be more of 'medium term' risk for investors as the Federal Reserve is not expected to take any major steps that will reduce their stimulus support to the markets and economy over the coming months. But once the coupon curve starts to steepen (or in the chart below, the red line starts to fall), then investors may need to really think about downside risk in the equity markets.

Monthly Russell 1000 and the Inverted Spread between the US 10-yr Treasury Note Yield and the US 2-yr Treasury Note Yield

(The coupon spread is inverted to show a rising line supporting a higher Russell 1000 index and a falling line, i.e. a steeper or higher coupon curve, undermining the Russell 1000 index)



*   Source: Boost, Bloomberg. The prices used for the returns are primary market closing prices from Oct 18th 2012 to Feb 25th 2013, and are given in the base currency of each index. The returns may rely in part on back-tested prices prior to the inception of some ETPs. Past performance and back-tested performance are not indicators of future performance. Back-tested prices are those which precede Dec 4th 2012 for ETPs referencing the FTSE 100, Dec 7th for the DAX, Dec 10th for EURO STOXX 50, Russell 100 or NASDAQ-100, and Dec 17th for the commodities.
** Calculated as annualised standard deviation over the past 3 months of daily returns (some of which are based on back-tested prices.

boost™
Three-thinking ETPs

Disclaimer

This communication has been produced by Gerald Celaya from Redtower Asset Management Limited which is authorised and regulated by the Financial Services Authority. Boost ETP LLP is an appointed representative of Mirabella Financial Services LLP which is authorised and regulated by the Financial Services Authority. Boost ETP LLP have appointed Redtower Asset Management Limited to produce third party research and there is no financial incentive for Redtower Asset Management Limited to make a recommendation to Boost products. Therefore, there are no conflicts of interests between Boost ETP LLP and Redtower Asset Management LLP.

Important Notice
This commentary is for information only and the comments and forecasts are intended to be of a general nature and are current as at the date of issue. Redtower Research and Redtower Asset Management take no responsibility for any individual investment decisions based thereon. Redtower Asset Management provides this data on the understanding that the data is sourced from the public domain or authorised sources, and that while Redtower Asset Management will endeavour to ensure that the accuracy of the data in our reports, no responsibility is taken for any errors in the data and no responsibility or liability of any sort is taken for any losses that you or your company may incur, either directly or indirectly, through the use of this information. The source of data within this communication can be sourced directly from Bloomberg and Reuters. Redtower Asset Management is registered in Scotland, registered office: Crystal Valley, Fettercairn, Kincardineshire, Scotland AB30 1DU, registered number is SC325065. VAT registration no. 751 6880 11. Redtower Asset Management Limited is authorised and regulated by the Financial Services Authority. FSA no. 473656.

The products discussed in this document are issued by Boost Issuer PLC (the "Issuer") in accordance with the Prospectus published on the Central Bank of Ireland's website. The Central Bank of Ireland has certified that the Prospectus of the Issuer has been drawn up in accordance with the Directive 2003/71/EC. The Prospectus has been passported from Ireland into the United Kingdom. Please read the Prospectus before you invest in any Exchange Traded Products ("ETPs").

Boost Issuer PLC, Boost ETP LLP or Mirabella Financial Services LLP is not acting for you in any way in relation to the investment to which this communication relates, or providing investment advice to you. The information is not an offer to buy or sell or solicitation of an offer to buy or sell any security or investment. As no recommendations can be provided you are advised to seek your own independent legal, investment and tax or other advice as you see fit.

The value of an investment in ETPs may go down as well as up and past performance is not a reliable indicator of future performance. An investment in ETPs is dependent on the performance of the underlying index, less costs, but it is not expected to match that performance precisely. ETPs involve numerous risks including among others, general market risks relating to the relevant underlying index, credit risks on the provider of index swaps utilised in the ETP, exchange rate risks, interest rate risks, inflationary risks, liquidity risks and legal and regulatory risks.

ETPs offering daily leveraged or daily short exposures ("Leveraged ETPs") are products which feature specific risks that prospective investors should understand before investing in them. Higher volatility of the underlying indices and holding periods longer than a day may have an adverse impact on the performance of Leveraged ETPs. As such, Leveraged ETPs are intended for financially sophisticated investors who wish to take a short term view on the underlying indices. As a consequence, Boost ETP LLP is not promoting or marketing Boost ETPs to Retail Clients. Investors should refer to the section entitled "Risk Factors" and "Economic Overview of the ETP Securities" in the Prospectus for further details of these and other risks associated with an investment in Leveraged ETPs and consult their financial advisors as needed.

This marketing information is derived from information generally available to the public from sources believed to be reliable although Boost ETP LLP does not warrant the accuracy or completeness of such information. All registered trademarks referred to herein have been licensed for use. None of the products discussed above are sponsored, endorsed, sold or promoted by any registered trademark owner and such owners make no representation or warranty regarding the advisability on dealing in any of the ETPs.

* Source: Boost, Bloomberg. The prices used for the returns are primary market closing prices from Oct 18th 2012 to Feb 25th 2013, and are given in the base currency of each index. The returns may rely in part on back-tested prices prior to the inception of some ETPs. Past performance and back-tested performance are not indicators of future performance. Back-tested prices are those which precede Dec 4th 2012 for ETPs referencing the FTSE 100, Dec 7th for the DAX, Dec 10th for EURO STOXX 50, Russell 100 or NASDAQ-100, and Dec 17th for the commodities.
** Calculated as annualised standard deviation over the past 3 months of daily returns (some of which are based on back-tested prices.

Contact Information: ☏ +44 (0)20 3515 0050 ✉ info@boostetp.com www.boostetp.com