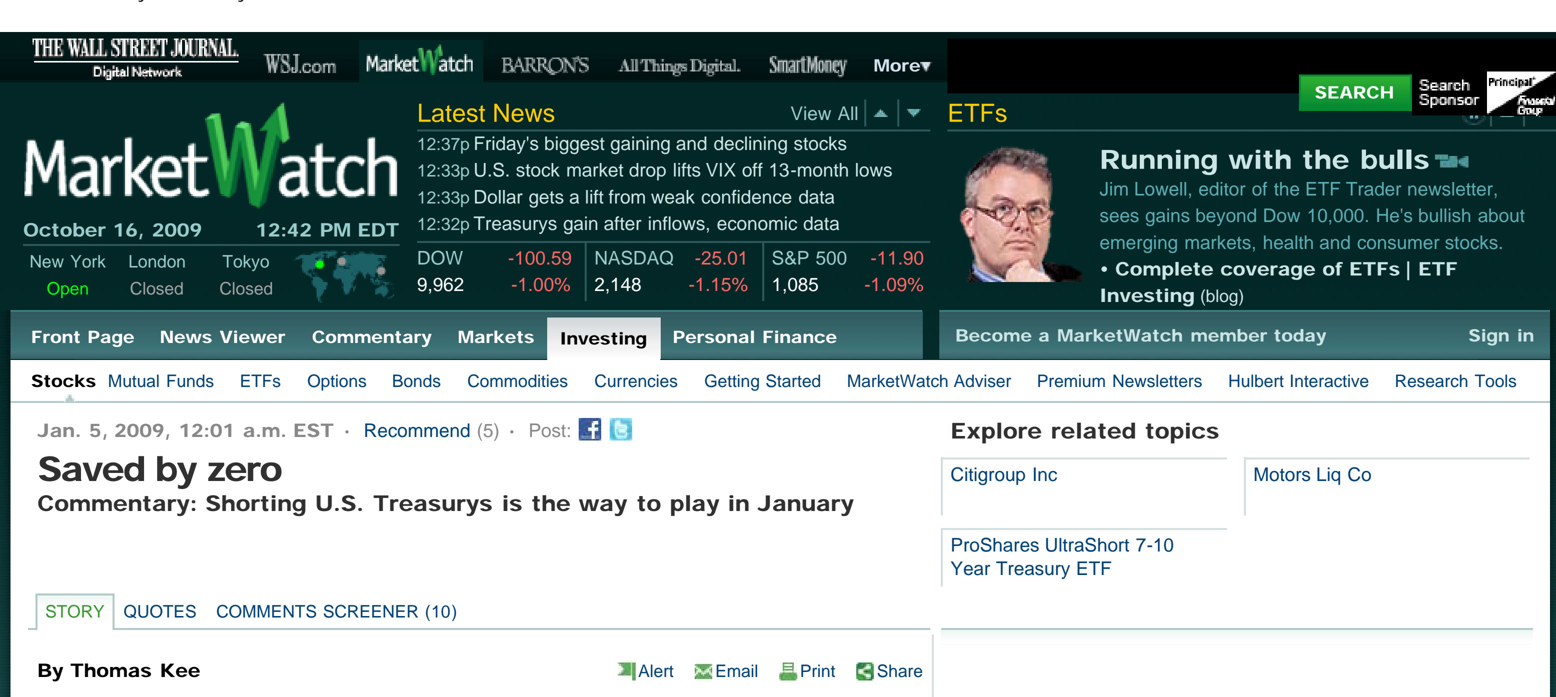


Jan. 5, 2009, 12:01 a.m. EST · Recommend (5) · Post:

Saved by zero

Commentary: Shorting U.S. Treasurys is the way to play in January

STORY QUOTES COMMENTS SCREENER (10)

By Thomas Kee

Alert Email Print Share

LA JOLLA, Calif. (MarketWatch) -- The drastic move by the Federal Open Market Committee in December to cut the target rate to virtually 0% illustrates the widespread concerns about deteriorating global economic conditions.

These are reverberating throughout the financial world, and they were the talk of virtually every holiday party I attended. However, this all-in approach has also created a circulatory trap which may cause any projected recovery in the equity markets to stall prematurely.

Even though the net return is nil, invested assets in U.S. Treasurys are still believed to be protected from decline. Therefore, 0% yields can provide opportunities for some investors to appreciate. Interestingly though, the best opportunities may not be what most people are aware of. At first glance, an opportunity for zero risk seems like an obvious decision. Not so fast.

What often seems like the path of least resistance turns out to be more formidable. I believe this situation will prove to be exactly that. Those investors who are rushing to protect their assets in no-return treasurys will end up being ensnared in those positions until they mature. This, in turn, will limit the recovery in the equity market by creating the circulatory trap referenced above.

The byproduct of the circulatory trap detailed below is a decline in U.S. Treasurys, and an opportunity to short them as a result. For January, my recommendation is to short U.S. Treasurys. I will explain the most efficient method for doing that in the details below.

First, the circulatory trap will develop as follows: The consequence of the "all in" approach of the FOMC is the problem. The already obvious decline in value of the dollar versus foreign currencies has produced added risks in otherwise safe investments.

Therefore, foreign investors, who are coincidentally being relied upon to support our growing national deficit, will be faced with an added hurdle when considering an investment in Treasurys. Not only will the return on investment be virtually zero, but the return of the investment itself is now questionable as well.

Trading Strategies: January 2009

Starting over

- Bold: Three funds for a January rebound
- Lowell: Try agriculture, mid-caps, nat gas
- Hirsch: January Effect vs. Barometer
- Clark: Try China, Brazil and Japan
- Hulbert: Parsing the inaugural markets
- Maltbie: Check maritime and education
- Ashbaugh: Pharma and China show life
- Kahn: Playing the bear market rally
- Kee: Shorting U.S. Treasurys in January

MULTIMEDIA

- Paulsen: Channeling Gordon Gekko
- Johnson: Hoping for the best
- Saddi: Emerging market troubles VIDEO
- Ianieri: Seeking the bottom VIDEO

Explore related topics

- Citigroup Inc
- Motors Liq Co
- ProShares UltraShort 7-10 Year Treasury ETF

Markets | Quotes | My Portfolio | My Alerts | Community

Reader Response »

"Sundrenched. I have heard a lot of people use the "drift" term and never understood what they meant. Now I do, and is not correct. Short ETF's track the DAILY index almost to the dot. They mark to market daily. Where this performance is coming from is precisely because they mark to market daily and because of compounding. That means that if the ETF went up say 10% today, but..."

Investors from euro nations, for example, may determine that the actual value of their potential investment in U.S. Treasurys will be lower when those bonds reach maturity. This will occur even though the investment returns the same dollar amount. This happens because the risk of continued devaluation in the dollar is high. In turn, potential foreign investors may perceive investments in U.S. Treasurys as more risky than we might otherwise believe.

Consequently, I expect demand for U.S. Treasurys by foreigners to dry up considerably. As supply increases in direct relation to our growing deficit, and demand contracts in direct relation to our declining dollar, I also expect prices of U.S. Treasurys to fall. This will trap current investments until maturity. Any investments made at current levels will be underwater in the near future, and that should force those investors to stay put, even if an equity recovery begins. This, in turn, will prevent the return to parity, which I discussed in my November Trading Strategies article, from having the same impact as I initially believed. See related column.

In essence, money will be tied up in Treasurys, and unavailable to reallocate into equities as a result.

Before I explain the best procedure for taking advantage of the declining value of Treasurys, I do believe the equity market will recover somewhat in 2009. However, given this scenario, I am now concerned that the recovery will be much more restricted than I initially expected.

In fact, more problems could surface quickly. Eventually I expect contemporary Darwinism to cause Citigroup Inc. (C **4.62**, -0.13, -2.74%), General Motors (MTLQQ **0.64**, -0.02, -3.61%), and other weak companies to fall, even with the recent support of the U.S. government.

Although this could be construed as a negative, especially when combined with the declining value of Treasurys, opportunities do exist. Interestingly, I perceive these opportunities to include inherent risk controls at the same time. Inherent risk controls are a natural component of the zero yields of Treasurys. In other words, Treasury yields cannot fall much lower than they already are, and therefore prices are unlikely to increase much more either. Therefore, short positions in U.S. Treasurys have limited downside, if they are opened properly.

I recommend the following exchange-traded fund in conjunction with shorting U.S. Treasuries: ProShares UltraShort Lehman 7-10 Year Treasury (PST **52.76**, -0.29, -0.55%). This is a double weighted short ETF based on the Lehman 7 to 10 year bond index.

It does not require sophisticated analysis or futures trading. This is already short, so this is a long recommendation in a professionally managed short-based ETF. A reasonable stop loss should be placed just under the 52-week low because of the dynamics of the investment vehicle, but I believe this position inherently incorporates risk controls already.

In addition, I believe PST offers a significant opportunity to patient investors over time. January should be a good time to enter this position, but expect to hold it for a while. Rather than a trade, this could be considered as a short term investment.

This position may trade sideways for a while, but once foreign demand starts to dry up and Treasurys are repriced, this position should start to perform well, and reward patient investors.

Kee has recommended these strategies to his clients.

Thomas Kee is president and chief executive of Stock Traders Daily, Founder of the Investment Rate, Architect of the ATAP Program, and active supporter of risk control and proactive trading strategies; his automated, correlated, Market Timing and Stock Selection tools. http://www.stocktradersdaily.com

Add Comment › • Recommend (5) • Post:

Alert Email Print Share

SPONSORED LINKS

Market Trend Signal™
90% Accurate Trend Following System - Free Access - No Risk Guarantee!
www.MarketTrendSoftware.com

How to Market, Free Book
Free Book by the guy whose marketing campaigs brought in $500 Million.
BenHartMarketingSchool.com

- Armagedon | 8:05am 1/5/09

+5 Votes (6 Up / 1 Down)

First Take

GE brass is funnier than Jay Leno

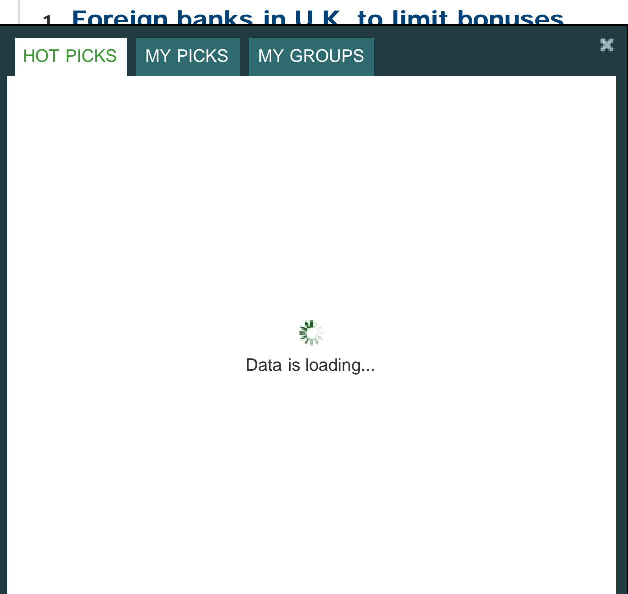
It's clear that NBC Universal misfired by installing Jay Leno in a primetime comedy show every night. General Electric senior management would have been a better choice, writes Jon Friedman.

11:13am Today | Comments: 21

Most Popular

MOST READ MOST COMMENTED

1. Foreign banks in U.K. to limit bonuses

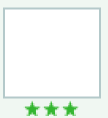


$17 Million Wiz Kid
Wiz Kid Stock & Option Trader Makes $17 Million Trading Stock Options!
WizKidTrader.com

Comments (10)

Comments Screener

sundrenched 284 days ago +2 Votes (5 Up / 3 Dn)



Warning!!! These ultrashort ETFs drift over time so I would not recommend holding them for anything longer than a couple of weeks.

Just compare the behavior of, say, SDS and the SP500 index over the past 2.5 years. The former should give twice the opposite movement but it clearly doesn't. Since its inception in July 2006, SDS is down about 10% and the S&P500 almost 25%. Someone who correctly foresaw the correction in the S&P500 and tried to play it with SDS should have been up 50% but instead lost 10%.

The "simple" short index SH shows a similar anomaly: should have been up 25% over the past 2.5 years, but instead is up just 0.28% over this period.

Reply | Link | Track Replies | Report Abuse

Armagedon 284 days ago +5 Votes (6 Up / 1 Dn)

Sundrenched. I have heard a lot of people use the "drift" term and never understood what they meant. Now I do, and is not correct. Short ETF's track the DAILY index almost to the dot. They mark to market daily. Where this performance is coming from is precisely because they mark to market daily and because of compounding. That means that if the ETF went up say 10% today, but tomorrow goes down 10%, then you are DOWN 1% not even as you stated. Additionally, returns compound, so small constant up or down movements make levered ETF's reach higher levels

What happened to SDS is that the S&P went down quickly and hard so it appreciated strongly but did not compound too much return. The ST&P then has gone up slowly steadily.

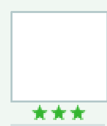
Reply | Link | Track Replies | Report Abuse

Rustypelican 281 days ago +1 Vote (1 Up / 0 Dn)

You guys should read up on inverse ETFs before you buy and hold one. A little due diligence can go a long way. An inverse ETF does not move in proportion to an index. They are designed to return a multiple of the performance of an index on a daily basis, based on options, derivatives, swaps and other shorting mechanisms. That means if you own the stock on the date of record (for ProShares SDS it was Dec. 23), you were enitled to a distribution and/or capital gain. The distribution/gain is based on how the fund performed internally each day during the preceding year. The price of the shares has no relation to the performance of the ETF.

Reply | Link | Track Replies | Report Abuse

Brutto 283 days ago +1 Vote (1 Up / 0 Dn)



These short ETFs (PST and TBT) are probably best suited to hedge an existing Treasury holding of similar maturity, rather than using them as a one-way bet on the market.

Reply | Link | Track Replies | Report Abuse

blackbody 282 days ago +1 Vote (1 Up / 0 Dn)

it's better to short long ETF than to long short ETF.

Reply | Link | Track Replies | Report Abuse

ChiefBenBernanke 281 days ago

This comment did not conform to the MarketWatch Community Guidelines and was removed.

bobbyfred615 281 days ago 0 Votes

Seriously? Why? I'm curious about what you see as the difference.

Reply | Link | Track Replies | Report Abuse

poorhouse 282 days ago 0 Votes

Wouldn't there be coordinated moves on the dollar by the CB's (if possible) to keep this "circulatory trap" from occurring? Or maybe such moves would keep the slide slow enough that the herd would patiently stay in there.

Of course the article assumes all things would be orderly....what about the effect of panic on this idea? Would the short still work? What about a revolutionary move to turn in and replace or re-issue the dollar? What kind of effect would that have on this play?Just thoughts...

Of course there is the tidal wave of dollars hidden behind Wall Street that is waiting to drown all investments.

Reply | Link | Track Replies | Report Abuse

ToneyB 281 days ago +2 Votes (2 Up / 0 Dn)

If the variables in the author's scenario prevail (doubtful), then his strategy may be defensible. However, forecasting in this heavily manipulated economic environment with unprecedented government interventions is nearly impossible. A risky play at best.

Reply | Link | Track Replies | Report Abuse

publius123 281 days ago 0 Votes

I just want to say hello to "future me and you". That would be the future you and I that will be talking about how "the writing was on the wall" back in December 08 & January 09 - saying that it should have been obvious that all of the global currencies were going to be decimated together due to prodigal governments and poor monetary policy. (Kind of like the way media pundits are all saying how obvious it should have been that Madoff was operating a Ponzi.)

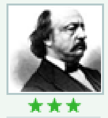
I've never been a "gold bug" but the more I watch this unfold, the more I realize that the world will seek to park their money into precious metals. I'm not saying sell your stocks, equities will adjust in the future, once people get back to work but the safe haven is in precious metals. I am saying that CASH IS TRASH. Hello -future you and future me!

www.MikeDitkaForSenate.com

Reply | Link | Track Replies | Report Abuse

greenbackben 281 days ago

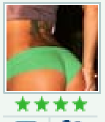
-1 Vote (0 Up / 1 Dn)



Why not shift money from maturing short term Treasuries to short term CDs.
The return will be a little higher and you won't be betting against the house, namely the Fed. And in six months you'll have a better idea on the direction of yields on short term instruments and Treasuries in general.

Reply | Link | Track Replies | Report Abuse

Integral 280 days ago



This comment did not conform to the MarketWatch Community Guidelines and was removed.

Add a Comment

Enter reply here

ADD CANCEL

Community guidelines ›

Track Responses

Log in or sign up to join the discussion—it's free!

Log In | Sign Up

MarketWatch Community: Discover. Share. Organize.

Featured Stories

U.S. futures trade lower after Bank of America

U.S. stock futures traded lower Friday as somewhat disappointing results from International Business...

Bank of America posts $2.2 billion loss

B. of A. posts third-quarter loss of more than $2 billion.

General Electric profit slumps 44%

General Electric Co. says that its third-quarter earnings dropped 44% as the industrial bellwether's...

Keeping up with an avalanche of troubled mortgages

Sony Ericsson loss widens to $245 million

Mobile handset maker Sony Ericsson says that its third-quarter loss widens following a sharp drop in the...

Copyright © 2009 MarketWatch, Inc. All rights reserved.
By using this site, you agree to the Terms of Service and Privacy Policy.

Intraday data provided by Interactive Data Real Time Services, a division of Interactive Data Corp. and subject to terms of use. Historical and current end-of-day data provided by Interactive Data Pricing and Reference Data. More information on NASDAQ traded symbols and their current financial status. Intraday data delayed 15 minutes for Nasdaq, and 20 minutes for other exchanges. Dow Jones Indexes(SM) from Dow Jones & Company, Inc. SEHK intraday data is provided by Comstock and is at least 60-minutes delayed. All quotes are in local exchange time. Real-time last sale data provided by NASDAQ.