Bond Market Observations

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Volatility May Present Opportunity for Fixed Income Investors

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"A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty."

– Sir Winston Churchill

Executive Summary

Standish Global Macro Strategist Tom Higgins says global financial markets are off to a strong start in 2012, but questions whether the risk rally can be sustained. Concerned that markets have become complacent regarding the risks to the outlook, he says a pick-up in market volatility would not surprise him. He notes that the accommodative stance of monetary policy, improving economic data, and attractive valuations remain supportive of credit. The global bond manager, he says, is keeping some of its powder dry to take advantage of opportunities as they arise and considering the implications of a possible divergence in interest rate and credit market volatility.

Global financial markets are off to a strong start in 2012. In January, U.S. investment grade credit returned more than 2%, high yield bonds were up 3%, and the Standard & Poor's 500 stock index gained nearly 5%.[1] European credit markets also performed well, despite uneven progress on resolving the region's sovereign debt crisis. The question is whether the risk rally can be sustained.

Optimists argue that financial markets will continue to be supported by the accommodative stance of monetary policy in the advanced economies, improving economic data, and attractive valuations. They cite the launch of the European Central Bank's (ECB) long-term refinancing operation (LTRO) in late December as the catalyst for the recent market rally. They believe the LTRO lowered the risk of a systemic banking crisis in Europe by allowing banks to meet their financing needs for

Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

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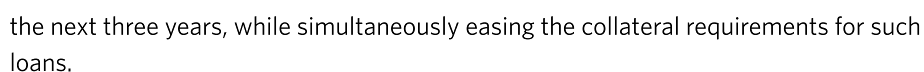


the next three years, while simultaneously easing the collateral requirements for such loans.

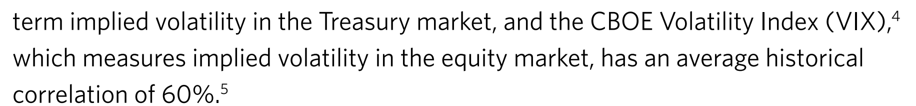
Pessimists counter that the LTRO does nothing to address the long-term solvency issues for countries such as Greece or Portugal. Consequently, they worry that a disorderly Greek default still has the potential to undermine other peripheral European debt markets. Moreover, they point to geopolitical uncertainty in the Middle East and contentious elections in the U.S. and France as potential sources of market volatility.

At Standish, we are cognizant of these risks, but we remain constructive on investment grade credit, select high yield bonds, and emerging market debt, given improving fundamentals and attractive valuations. That said, we are worried that markets have become complacent regarding the risks to the outlook, and we would not be surprised to see some pick-up in market volatility. Therefore, we are closely monitoring these developments and keeping some of our powder dry to take advantage of opportunities should they present themselves.

Uncertainty and Volatility

In financial markets, greater uncertainty typically manifests itself as higher volatility in asset prices. Over the past year, a number of events caused volatility to spike, including: the fall of governments in the Middle East as part of the Arab Spring, the Japanese earthquake/tsunami, concerns about a Greek default, and the U.S. sovereign credit rating downgrade. These shocks are often difficult if not impossible to forecast, yet they can have a significant impact on asset prices. Rather than attempt to predict the unpredictable, we believe investors can incorporate measures of *implied volatility* into their fixed income strategies. Implied volatility uses option prices to infer the level of investor uncertainty about future asset prices and thereby allows us to incorporate market information about potential shocks.

Implied volatility can take many forms. As fixed income managers we are particularly interested in volatility in interest rates and credit markets, which historically have been closely related. While there are no robust measures of implied volatility in the corporate bond market, equity market volatility is closely related and is a good proxy.[2] Indeed, the Merrill Lynch Option Volatility Estimate (MOVE),[3] which measures short-



term implied volatility in the Treasury market, and the CBOE Volatility Index (VIX),[4] which measures implied volatility in the equity market, has an average historical correlation of 60%.[5]

Both the MOVE and the VIX have dropped sharply since last summer as some risks, such as a double-dip recession in the U.S. or a hard landing in China, have abated. We believe that the MOVE and other measures of interest rate volatility may remain subdued due to Federal Reserve intervention in the Treasury market. However, the outlook for the VIX and broader credit market volatility is more ambiguous, given structural changes in the U.S. economy.

Will Interest Rate and Equity Market Volatility Diverge?

Central bank action can play an important role in dampening interest rate volatility. The ECB's LTRO mentioned earlier has lowered implied volatility in European rates markets by 20% since its launch in mid-December. The same is true for the Federal Reserve's recent actions. Last August, the Fed stated that economic conditions were likely to warrant an exceptionally low level of short-term interest rates through mid 2013. Then in January, the Fed extended this to "at least through late 2014."

As a result of these steps, both implied and realized interest rate volatility has fallen in the United States. The MOVE has tumbled 30% since last August, when the Fed first unveiled a time frame for its commitment to low rates. Realized volatility as measured by the standard deviation of the weekly change in two-year U.S. Treasury yields has fallen by half over that period. We expect this low interest rate volatility environment to prevail until the market begins pricing in tighter monetary policy, which by the Fed's own estimation probably won't be for the next two years.

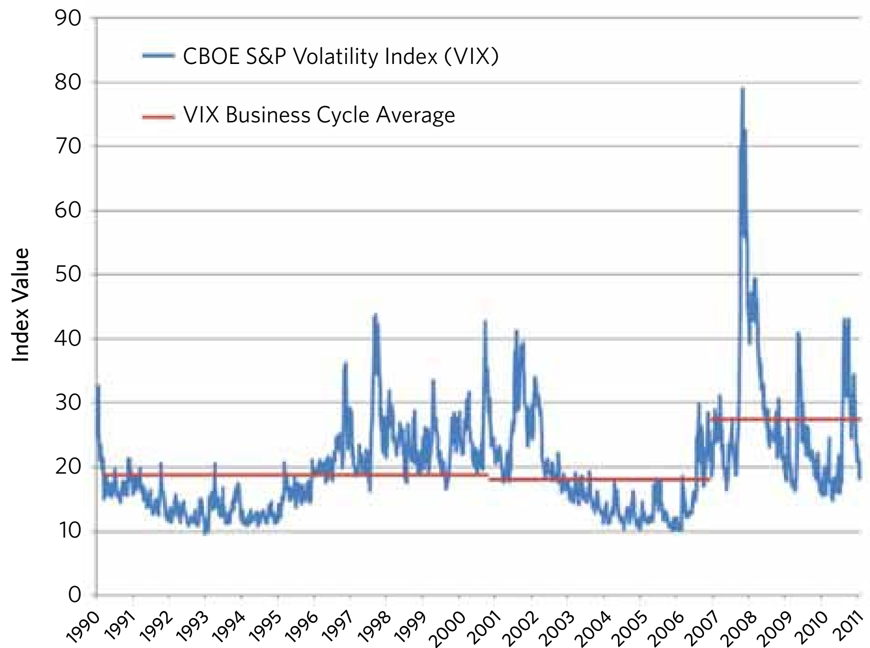
Measures of credit market volatility have moved lower in sympathy with the decline in Treasury market volatility. However, structural changes in the U.S. economy may leave markets more vulnerable than in the past to shocks that can adversely impact credit.

Specifically, the U.S. and other advanced economies are in the midst of a multi-year deleveraging process, which in our view has reduced potential growth and increased the volatility of indicators of real economic activity. For example, real GDP growth

has been 68% more volatile since 2007 than it was the prior two decades during the period that has been labeled the Great Moderation. Likewise, growth in corporate profits has been more than twice as volatile.[6]

This may partly explain why the VIX has generally been higher during this economic cycle than it was during the prior two recoveries in the 1990s and early 2000s. Recent regulatory changes, including the Volcker Rule, may exacerbate periods of illiquidity in credit markets by reducing the ability of primary dealers to act as market makers. It is interesting to note that Treasuries are exempt from the limits on proprietary trading that are scheduled to go into effect in July. Thus, the case can be made that interest rate and credit market volatility could diverge in the future.

EXHIBIT 1 – VOLATILITY MAY BE STRUCTURALLY HIGHER



Source: Chicago Board Options Exchange, as of January 27, 2012.

Taking Advantage of Volatility

The idea that interest rate volatility and credit market volatility may diverge is supported by the experience of the 1940s, when the Fed was last playing a more activist role in the Treasury market. Between April 1942 and March 1951, the Fed publicly committed to maintaining an interest rate ceiling of 0.375% on Treasury bills and 2.5% on long-term government bonds.[7] During that period, Treasury market volatility was virtually nonexistent, yet the stock market continued to fluctuate in a wide range. Although the Fed is not explicitly targeting Treasury yields in the current period, it is actually playing a larger role in the Treasury market today than it had in the 1940s.

We think there are at least three implications for portfolio positioning. First, the risk premium in credit markets may be higher than it was in past economic cycles, because the risk-free interest rate is being artificially suppressed by the central bank. Yet structural changes in the economy may imply higher variability in corporate profits. Second, selling interest rate volatility may be attractive since interest rates will likely trade in a range until the deleveraging cycle is closer to completion in the advanced economies. Third, volatility may present opportunities to add exposure to areas of the fixed income markets with strong fundamentals, including investment grade credit, emerging market bonds, and select areas of the high yield market.

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[1] Bloomberg database and Barclays Point, February 2012. Bond performance based on the Barclays Capital U.S. Corporate High Yield Index and the Barclays Capital U.S. Aggregate Bond Index.

[2] Chris Stivers and Licheng Sun, "Stock Market Uncertainty and the Relation between Stock and Bond Returns," Federal Reserve Bank of Atlanta, March 2002.

[3] The Merrill Lynch Option Volatility Estimate (MOVE) Index is a yield-curve-weighted index of the normalized implied volatility on one-month Treasury options.

[4] The Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which shows the market's expectation of 30-day volatility, is constructed using the implied volatilities of a wide range of S&P 500 index options.

[5] Bloomberg.

[6] Standish calculations.

[7] Robert L. Hetzel and Ralph F. Leach, "The Treasury-Fed Accord: A New Narrative Account," Federal Reserve Bank of Richmond Economic Quarterly, Volume 87/1 Winter 2001.

Index Definitions

S&P 500 Index is an unmanaged index considered representative of the U.S. stock market.

Barclays Capital U.S. Corporate High Yield Index is an unmanaged index that covers the universe of fixed-rate, noninvestment-grade debt.

Barclays Capital U.S. Aggregate Bond Index is an unmanaged index considered representative of the U.S. investment-grade, fixed-rate bond market.

An investor cannot invest directly in any index.

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