

Bond Volatility Jumped With QE2

Ever remember those silly childhood games where everyone pretended to be from Opposite-Land and had to say they were hot when they were cold or that Orwellian double-speak, “War is Peace; Freedom is Slavery; Ignorance is Strength?” Perhaps the Federal Reserve should announce a program designed to raise long-term interest rates, double short-term interest rates inside a six-week period and push fixed-income volatility higher for no good reason; at least then we might have a fighting chance of getting some desirable results.

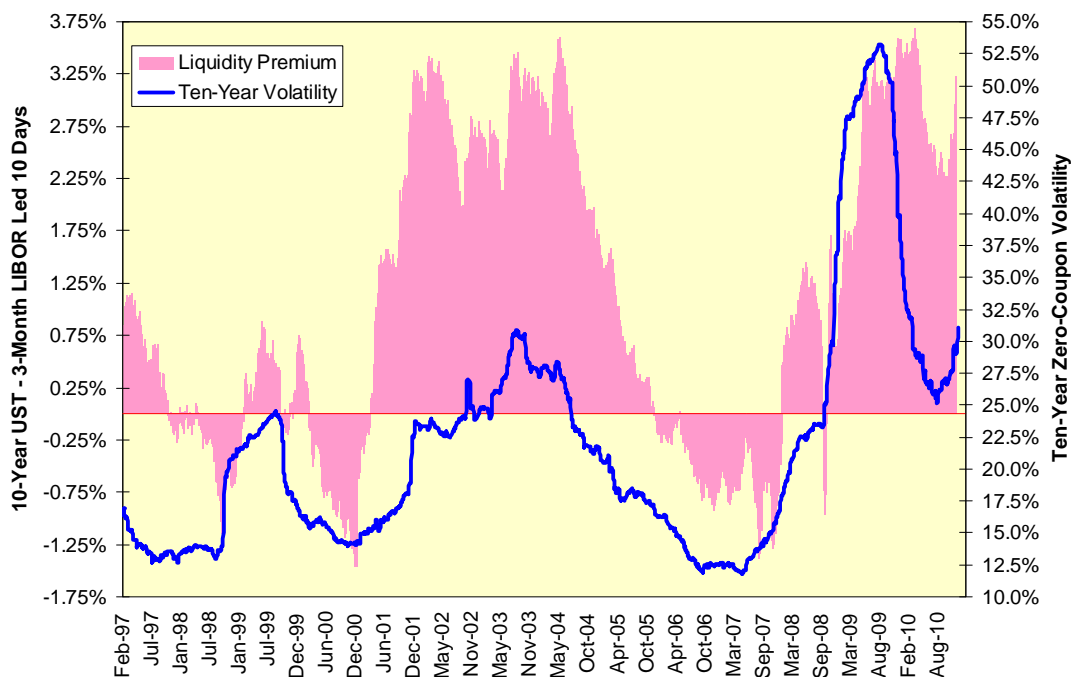
Unless, of course, you consider conjuring \$600 billion from sources indeterminate (they are not printing money; just ask Ben) and watching the price of what you are buying therewith drop like a rock to be a measure of success. One wonders how high interest rates could get if they bought a trillion dollars worth of bonds.

Volatility And The Yield Curve

Higher bond volatility raises the costs of doing business for lenders and for floating-rate borrowers as hedging a position or rolling a loan forward becomes a riskier activity. While this is not a grave concern at the moment as the absolute level of rates is still low by the standards of our lifetimes, it does work at cross-purposes against the one of the stated justifications of QE2, lowering the cost of capital.

If we map the spread between ten-year Treasuries and three-month LIBOR, the liquidity premium for most corporate borrowers, we see it loosely follows ten-year zero-coupon implied volatility. Both measures have spiked higher since the November 4, 2010 announcement of QE2. Volatility has increased from 27.74% to 31.09%, while the liquidity premium has increased from 2.203% to 3.23%. I might say I would be happy to listen to arguments as to why this is a Federal Reserve success story, but the simple fact of the matter is I would start glaring angrily at whoever was speaking.

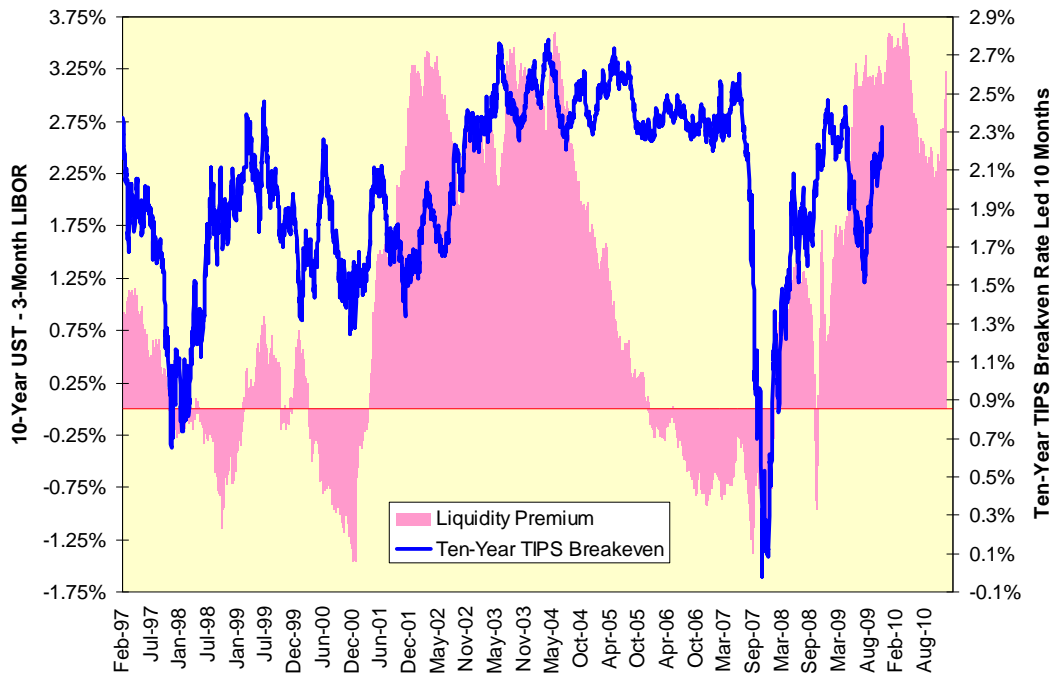
Volatility And The Yield Curve



Inflation And The Yield Curve

If we map ten-year TIPS breakeven rates against this very same liquidity premium, we find the yield curve leads inflation expectations by about ten months on average. This means the recent jump in inflation expectations, something the Federal Reserve is taking credit for, (Orwell would understand even though I remain appalled) was baked in the cake as early as February. The present situation is somewhat mixed as the liquidity premium narrowed for much of 2010 as Treasury yields fell; normally, this would have led to containment of inflation expectations in the first half of 2011, but the recent expansion of the liquidity premium and QE2 are likely to short-circuit that process.

Are Expected Inflation And The Yield Curve Related?



None of this means we are ready to step into the abyss yet in the fixed-income world. There is still time to stop spraying money hither and yon just to see what happens, though. As anyone who lived through the inflation of the 1970s knows, once inflation expectations become embedded in markets, they are not removed easily. Of that we can be 100% certain.