

## Fixed-Income Volatility Rising

Dorothy in *The Wizard of Oz* was instructed to click her heels and say, “There’s no place like home!” to fulfill her otherwise inexplicable desire to leave the Emerald City and return to Kansas. For those of you who have not flown into Wichita, please do so and check out the *Wizard* diorama in the airport; it will be the highlight of your trip.

FOMC officials should be made to click their heels and say, “There is no free lunch!” I noted in September’s [The Logic of Operation Twist](#) how the Treasury was the primary beneficiary of the Federal Reserve’s low-rate campaign; savers certainly have suffered, and if these policies actually achieved macroeconomic goals such as increasing output and employment, we would not be discussing whether QE3 is on its way.

### Rational Expectations

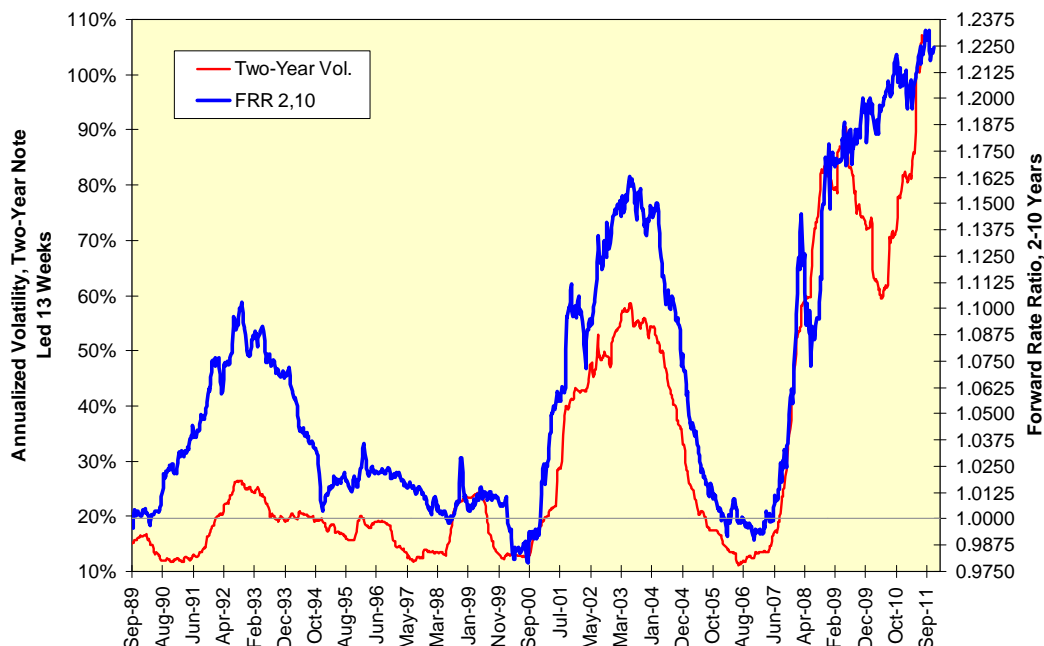
As recent Nobel laureate Thomas Sargent has pointed out, expected changes in policy invite rational responses thereto; other Nobelists such as Milton Friedman and Edmund Phelps noted the same thing in the permanent incomes hypothesis. In the present case of ultra-low interest rates, investors and employers understand an artificial policy of low short-term interest rates is unstable and therefore will end unhappily. Why base a decision today on what you expect, rationally, will not be here tomorrow?

If there is no free lunch, every benefit must have some offsetting costs. The Treasury’s lower debt-service costs are being offset by higher swap spreads and by record levels of zero-coupon implied volatility. Higher swap spreads lead to higher option-adjusted spreads for corporate bonds and therefore to lower multiples for stocks. Higher fixed-income volatility leads to greater pricing risk, hedging costs and to a steeper yield curve than would exist otherwise.

It would not be too extreme to say the Federal Reserve’s policies are benefiting the public sector at the expense of the job- and wealth-creating private sector. Needless to say I was not pleased when Charles Evans of my hometown Chicago Federal Reserve dissented last week in favor of doing more of the same that has yet to work.

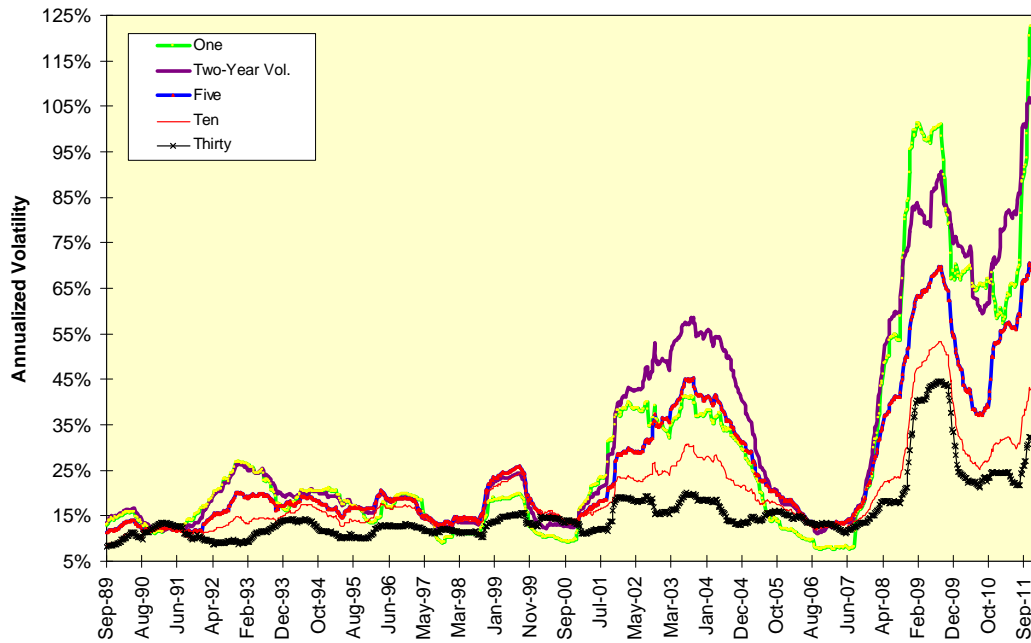
Let’s take a look at implied volatility and the yield curve as measured by the forward rate ratio between two and ten years ( $FRR_{2,10}$ ). This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this number exceeds 1.00, the steeper the yield curve is. The  $FRR_{2,10}$  leads two-year zero-coupon implied volatility by thirteen weeks, or one quarter. This is not just some statistical trick; steep yield curves such as the present one hovering just below its all-time high, are seen as unstable.

The Yield Curve Leads Volatility



As a result, volatilities for one-, two- and five-year zero-coupon Treasuries are at record levels and those for ten- and thirty-year Treasuries are rising as well. These risks are transferred to private borrowers via higher hedging costs and wider swap spreads.

### The Term Structure Of Interest Rate Volatility



You will not see this as a headline anywhere. However, this risk- and cost-shift from the Treasury to everyone else is one reason why monetary policy has been so ineffective and why we should not allow the Federal Reserve to dig a deeper hole.