Bond Volatility Has Been Rising

Rules of trading, much like those "my top ten unexpected events for last year (this year is extra, mister) lists" that crop up every January, deliver much less than promised. There is one rule of trading that works, buy low and sell high; everything else has bad days.

However, I heard one rule from a visiting Italian trader two decades ago that has proven solid advice. He said in his broken English, "Don't get velocitated." Huh? He went on to explain it as follows: Note how you drive when you exit the highway. Chances are you are driving faster than the traffic as your base speed has shifted higher. In trading terms, we tend to adjust to higher and lower volatility in a similar fashion.

If it seems markets have been a tad haywire lately, you are correct in your assessment, at least for long-term bonds. I took the history of thirty-year bond yields back into 1981, converted them into prices and then looked at their daily return histories. More specifically, I constructed a rolling out-of-sample history of all daily price returns outside of a ±97.5% confidence interval.

The frequency of such large moves has more than quintupled since the Lehman Brothers bankruptcy in September 2008, from 1.95% to 11.34%. The answer would be a little more lopsided if I had pushed the starting point back into the spring of that year, but you get the idea.

What is interesting about these large moves is how little persistence they have in the market. If we measure one month-ahead returns for each one of these occurrences, they essentially are random. While I have not done a similar "large day" study for other markets, my intuition is large days matter. They are the breakaway gaps and range-breakouts of technical analysis lore, and they generally tell you where the long-term path of least resistance lies. This seems particularly true in the cases of short-term interest rate and currency markets.

Does this matter for investors? Yes, as I discussed yesterday in the context of Eurozone interest rate markets, higher volatility leads to higher hedge costs and should lead to greater risk aversion on the part of long-term investors. As investment-grade corporate bonds are priced as a spread to Treasuries and as stocks are priced in relation to corporate bonds, higher bond volatility reduces risk-acceptance in stocks. It both reflects and creates a loss of investor confidence, and from where I sit, investor confidence has been damaged.

This stands as one more piece of evidence why monetary stimulus has proven so ineffective in achieving macroeconomic goals. If short-term interest rates are driven artificially toward zero and if yield curves steepen as a result, volatility will rise in response to the obviously unstable situation. As capital market investments are made off of long-term interest rates, they become riskier. For stocks, this lowers bids; for bonds, it raises yields. The money that should have gone toward job-creating activities then goes toward financial engineering and defensive investments. Those dreaded "derivatives," this millennium's favorite four-letter word, often are involved.

Only the most short-sighted amongst us should confuse low interest rates with a favorable investment environment. Look at Japan; look at the U.S. and watch what is about to happen in Europe. Trying to write yourself a check as a quick and easy financial plan is or should be frowned upon and, once upon a time, it was.