Fixed-Income Markets Wising Up To QE Tricks

One of the many enduring mysteries of Wall Street is why fixed-income traders regard themselves as being more erudite and sophisticated than equity traders. I long have suspected the reason behind this narcissism is equity traders always are working with an embedded call option and tend to focus on maximizing gains while fixed-income instruments have more limited upside and investors who are focused more on capital preservation and current income than on getting drunk and rowdy en route to a general good time.

Worse, fixed-income traders regard their equity brethren as a collection of mouth-breathing rubes who simply have been lucky during the QE era. I noted last month QE was nowhere near as important to equity returns as commonly believed. In fact, all of the hints, winks, raised eyebrows, leaks to favored reporters of major business newspapers, grunts before Congressional committees and FOMC member speeches before local Rotary Clubs have failed to produce statistically different returns since the taper-talk era began in May 2013. Moreover, all of this communications folderol has been decreasingly important since August 2012.

Fed Zigs, Bond Markets Zigs, Too: No Zags Here, Sir!
The same could not be said for fixed-income markets, whether we were dealing with fixed-income markets such as 7-10 year Treasuries, investment-grade corporate bond or high-yield bonds prior to the actual commencement of tapering in December 2013.

Let's use the same methodology employed for analyzing the importance of QE to equities. To refresh, we can classify the QE era into thirteen different periods; the current one began on December 18, 2013 with the first tapering of QE and presumably will continue until the mortgage-backed security and Treasury bond buying program hits zero. We then can calculate the daily returns for the fixed-income markets noted above across all thirteen of these regimes. The dates of these periods and their means and standard deviations are presented below along with a probability each period is different statistically from the previous one.

The data in all three markets show very clearly how the fixed-income markets took the taper bait in Period 11, May-September 2013. Returns were negative and were very different from those of Period 10, December 2012 – April 2013, with the high-yield market's probability of difference reaching a night-and-day 98.8%. They then took the taper-postponement bait in Period 12, September-December 2013, with equal enthusiasm.

Once tapering began in December 2013, with an apparent intention of moving toward ending the whole QE era sometime in late 2014, fixed-income returns remained positive. The same self-proclaimed Masters of the Universe who ran face-first into the wall during Period 11 have kept returns positive during the current Period 13.

Another way of looking at this is the bond traders reached the same conclusion the stock traders did as far back as August 2012, but only after chasing their tails every time they got the signal to do so. They get paid handsomely for such herding behavior even when bond investors lose money as they did in 2013. Let's hope this early evidence of discriminating behavior in Period 13 continues.

The test results are presented below in tabular form.

7-10 Year UST Returns During QE Era Subperiods

	Startdate	Enddate	Mean	Std. Dev.	$\text{Per}_{t0} \neq \text{Per}_{t-1}$
1	25-Nov-08	17-Mar-09	0.040%	0.70%	
2	18-Mar-09	31-Mar-10	-0.001%	0.53%	37.8%
3	1-Apr-10	26-Aug-10	0.110%	0.45%	96.0%
4	27-Aug-10	29-Jun-11	-0.001%	0.49%	95.8%
5	30-Jun-11	26-Aug-11	0.174%	0.63%	90.5%
6	29-Aug-11	4-Apr-12	0.009%	0.44%	88.2%
7	5-Apr-12	6-Jun-12	0.100%	0.33%	86.6%
8	7-Jun-12	17-Aug-12	-0.010%	0.33%	89.9%
9	20-Aug-12	29-Nov-12	0.031%	0.32%	51.6%
10	30-Nov-12	30-Apr-13	0.006%	0.25%	42.0%
11	1-May-13	17-Sep-13	-0.075%	0.45%	**88.6%**
12	18-Sep-13	17-Dec-13	0.021%	0.35%	**87.5%**
13	18-Dec-13	26-Feb-14	0.034%	0.31%	**17.3%**

High-Yield Returns During QE Era Subperiods

	Startdate	Enddate	Mean	Std. Dev.	$\text{Per}_{t0} \neq \text{Per}_{t-1}$
1	25-Nov-08	17-Mar-09	0.126%	0.70%	
2	18-Mar-09	31-Mar-10	0.180%	0.31%	50.1%
3	1-Apr-10	26-Aug-10	0.032%	0.29%	100.0%
4	27-Aug-10	29-Jun-11	0.047%	0.13%	38.6%
5	30-Jun-11	26-Aug-11	-0.084%	0.41%	95.5%
6	29-Aug-11	4-Apr-12	0.054%	0.33%	95.2%
7	5-Apr-12	6-Jun-12	-0.016%	0.20%	91.5%
8	7-Jun-12	17-Aug-12	0.092%	0.13%	99.7%
9	20-Aug-12	29-Nov-12	0.048%	0.15%	91.9%
10	30-Nov-12	30-Apr-13	0.061%	0.10%	47.4%
11	1-May-13	17-Sep-13	-0.012%	0.27%	**98.8%**
12	18-Sep-13	17-Dec-13	0.050%	0.11%	**95.7%**
13	18-Dec-13	26-Feb-14	0.063%	0.09%	**48.7%**

Investment-Grade Returns During QE Era Subperiods

	Startdate	Enddate	Mean	Std. Dev.	Probability $\text{Per}_{t0} \neq \text{Per}_{t-1}$
1	25-Nov-08	17-Mar-09	0.040%	0.54%	
2	18-Mar-09	31-Mar-10	0.080%	0.39%	46.0%
3	1-Apr-10	26-Aug-10	0.075%	0.34%	9.4%
4	27-Aug-10	29-Jun-11	0.007%	0.34%	91.4%
5	30-Jun-11	26-Aug-11	0.049%	0.46%	42.9%
6	29-Aug-11	4-Apr-12	0.025%	0.33%	24.5%
7	5-Apr-12	6-Jun-12	0.037%	0.21%	22.3%
8	7-Jun-12	17-Aug-12	0.048%	0.25%	19.0%
9	20-Aug-12	29-Nov-12	0.044%	0.19%	8.6%
10	30-Nov-12	30-Apr-13	0.013%	0.19%	72.6%
11	1-May-13	17-Sep-13	-0.053%	0.33%	**91.1%**
12	18-Sep-13	17-Dec-13	0.034%	0.24%	**94.9%**
13	18-Dec-13	26-Feb-14	0.049%	0.21%	**27.7%**