

Bond Volatility Acting Abnormally

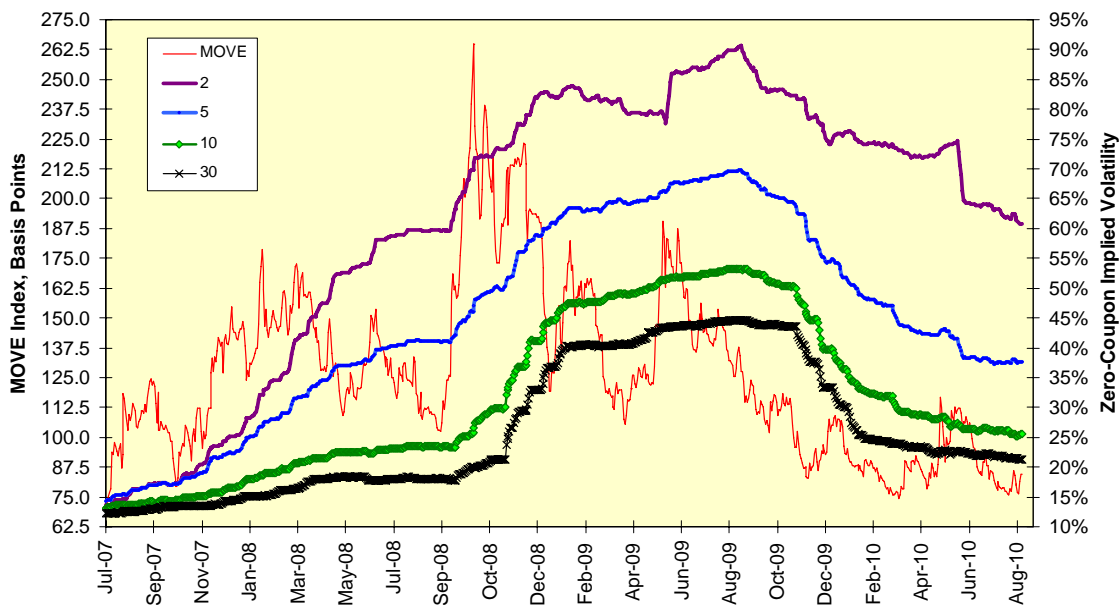
Bond traders are funny people, sometimes intentionally so. While the one thing that will get a stock fund manager fired quickly is not being long in a rally, the one thing that will get a bond fund manager fired quickly is having too much duration or exposure to rising interest rates in the portfolio.

When they hand you a blindfold and a cigarette, there's really no point in saying, "No thanks, I don't smoke."

One consequence of this asymmetric career risk is an equally asymmetric set of portfolio fears. Stock volatility tends to rise when the market breaks as everyone is longer than they should have been (if you bought after July 1932, you paid too much) and is looking to buy fire insurance on burning house. Bond volatility tends to rise when yields fall and when the [yield curve steepens](#). The one truism about bond investing in the present environment is someone at some point is going to wonder why they thought lending money to Uncle Sam for 30 years at 3.75% was a smart thing to do.

Yet bond volatility is falling, not rising, in the present environment. Have bond traders lost their congenital fear of their own shadows and have decided to pursue to brass ring of getting paid back at par after paying a premium? We can see this phenomenon occurring in several different measures of bond volatility. The chart below the Merrill Lynch MOVE index, what the boys-from-bull call a "yield curve-weighted index" of fixed-income futures volatility. The secret sauce behind this weighting scheme is a 20% weight the two-, five- and thirty-year futures and a 40% weight for the ten-year futures. If you are not getting paid for coming up with something like this, you are in the wrong business. It also includes annualized implied volatilities for zero-coupon bond strips.

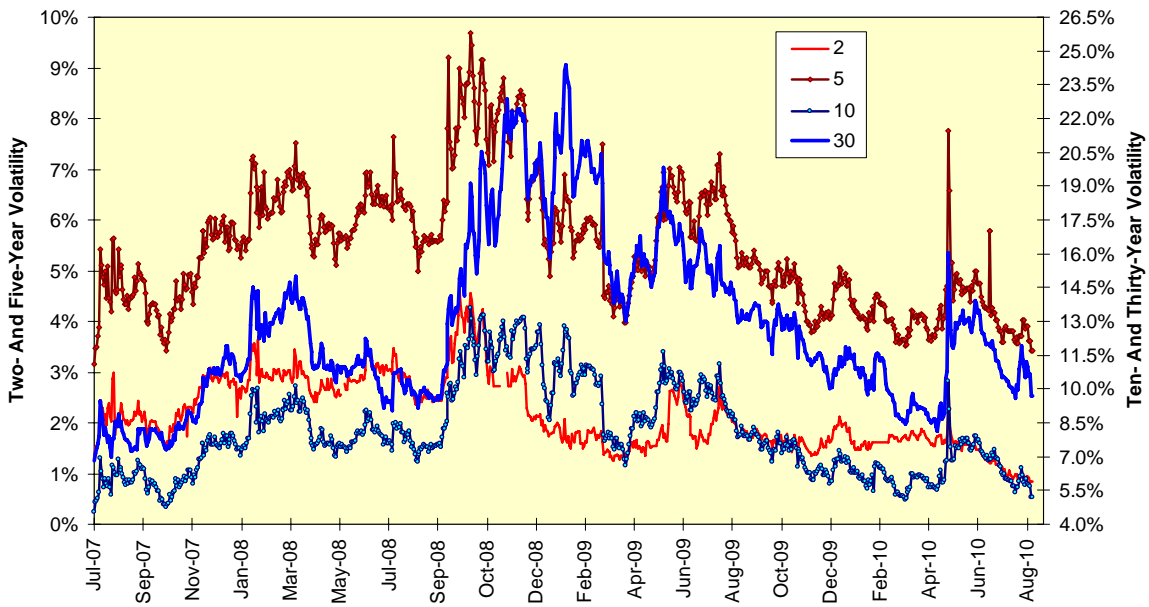
Comparative Fixed-Income Implied Volatilities



Please note how the MOVE, based on futures and therefore subject to exigencies such as a switch in the cheapest-to-deliver contract and a one-month timeframe has been declining more or less continuously since the Federal Reserve let it be known in July 2009 they were going to raise rates when you pried the "higher" button from their cold, dead hands. The decline in the zero-coupon volatilities began a little later, in September 2009, and has been characterized by much lower two-year volatility. This volatility usually rises when rates fall and when the yield curve steepens; this is the Hound of the Baskervilles get ready to treat bond portfolios like a fire hydrant.

We get the same results when we shorten up the timeframes to one month and break the MOVE components out separately. The volatilities for two- and five-year futures, shown in red and on a separate scale, are heading toward zero while ten- and thirty-year futures volatilities are getting into single-digit range. The big spike you see in May is the "flash crash" of blessed memory; this is the one that will not happen again because the government is on the case.

One-Month 50-Delta Futures Implied Volatilities



The conundrum here is all signs still point to bond yields going lower in a bullish flattening of the yield curve. As short-term rates are fixed near zero, anyone chasing yield has to move out the yield curve. So far, this has worked as evidenced by the 18.55% total return on the iShares 20+ year Treasury ETF so far in 2010. Yet years of experience have confirmed that when there is not a cloud in the sky you should be careful where you step: The lack of fear in the bond market is the very reason you remember how to be afraid.