Too Much Transparency Not A Good Thing

The road to hell is paved with good intentions. Mind you, I am merely passing on rumor and hearsay in this regard, not anything based on personal experience.

On the surface, the Federal Reserve's campaign to increase its own transparency must be regarded as a good thing. One of my longstanding criticisms of the Federal Reserve has been its somewhat extra-Constitutional standing. All branches of the government famously are bound in a system of checks and balances, and we as a people can decide all manner of issues, but somehow monetary policy is deemed to be the sole province of a priestly class. The more they subject their intentions to public debate, the less likely they are to surprise the markets.

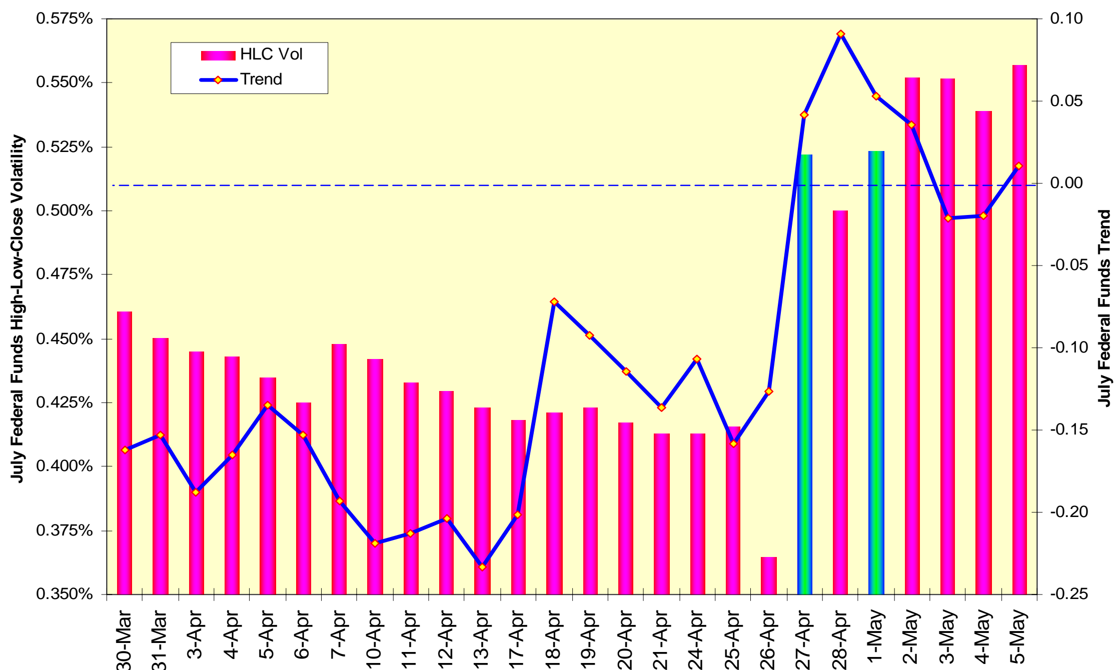
But every now and then you can be too transparent for your own good. If you want to make your spouse or significant other suspicious, tell him or her about seven or eight times in an hour where you are going and how innocent your intentions are. Federal Reserve Chairman Benjamin Bernanke, once directly on April 27th and once indirectly with some help from Maria Bartiromo on May 1st, found this out the hard way. These two dates are highlighted on the charts below.

A Jump In Volatility

Federal funds futures have taken the sport out of Fed-watching; it is and has been a foregone conclusion the target federal funds rate will be raised to 5.00% tomorrow. The uncertainty lies in what will transpire on June 29th, whether the target rate will be raised to 5.25% or left alone in a "pause" so often predicted incorrectly that its advocates resemble Doomsday cultists. The July federal funds futures contract, which will be priced off the target rate for all days in July, is used to assess the probabilities of action in this central bank version of *Deal Or No Deal*.

How did this contract trade before, during and after the dates in question? Its high-low-close (HLC) volatility, a measure that incorporates intraday range as well as interday change, jumped on the 27th. HLC volatility expands during periods of market uncertainty, so its increase stands as evidence Bernanke's efforts at transparency game were self-defeating. Significantly, the jump in volatility was accompanied by a change in July's price trend. A rising trend indicates a lower implied yield and therefor a lower probability of an increase in the federal funds rate to 5.25% on June 29th.

The jump in HLC volatility on the 27th has remained and unsurprisingly was reinforced on the May 1st *l'affaire Bartiromo*. It rose once again on last Friday's employment report when the trend once again turned positive.

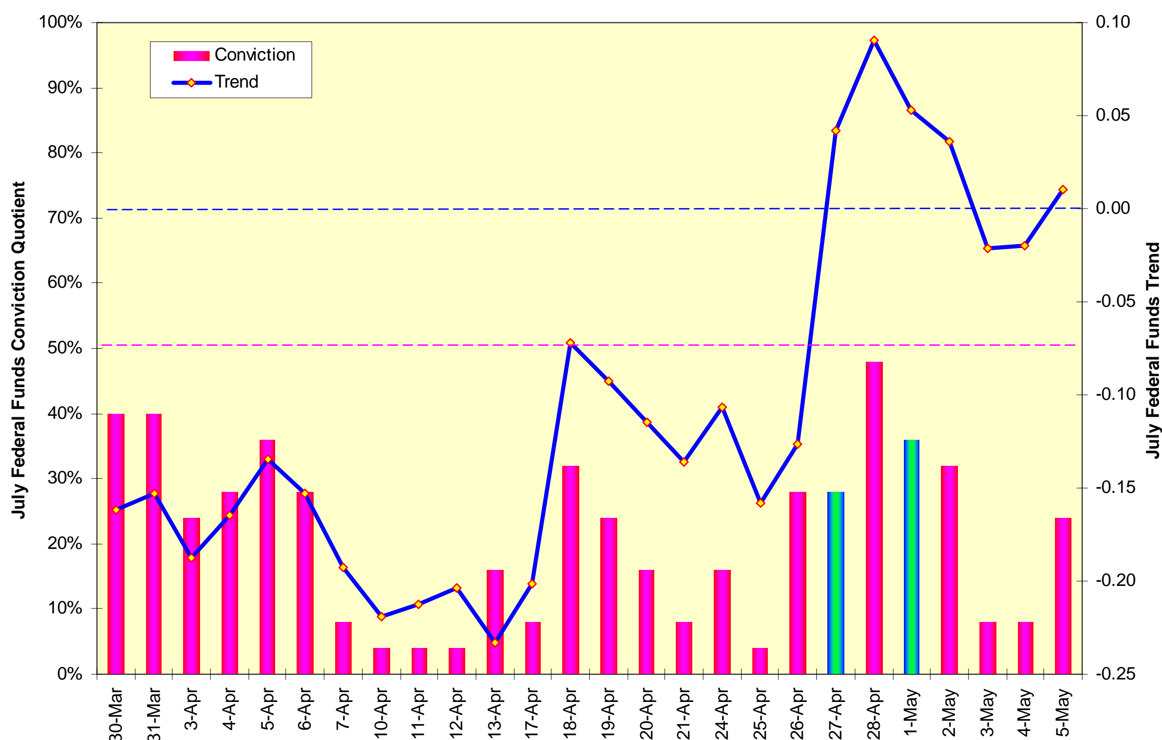


Courage Of Our Convictions

Was the market ever really certain of the Federal Reserve's intentions of going to 5.25% on June 29th? No, not at all. Let's create a measure of a market's conviction in its own opinions, one that reflects complete conviction at either a 0% or 100% probability of a rate increase and complete lack of conviction at a 50% probability of a rate increase:

$$Conviction \equiv \left| \frac{1 - \Pr obability}{.5} - 1 \right|$$

The market's conviction of whether the Federal Reserve would raise the federal funds rate to 5.25% was very low when the July contract was in a strong downtrend. Once the probability of moving to 5.25% fell on the 27th and the trend turned higher, conviction rose but never exceeded 50%. Until that level is exceeded, all forecasts of a rate increase to 5.25% should be treated as low-quality.

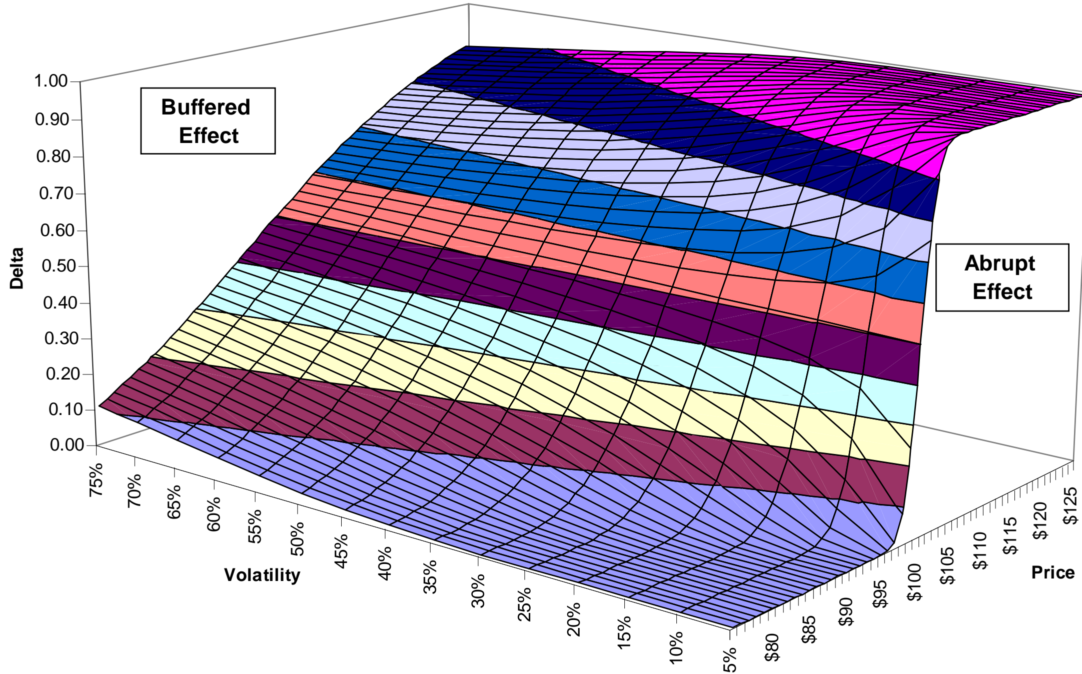


The Meaning Of Volatility

If Federal Reserve officials are going to engage in the sort of thinking aloud activity wags have dubbed FOMC for Federal Open Mouth Committee, we should expect to see going forward a lower degree of market conviction if volatility rises in response to the stream of mixed signals.

Options traders are used to this relationship. We can illustrate it by taking the delta, or expected movement of an option's price for a given movement in the price of the underlying stock, across a range of implied volatilities. Higher volatility lowers the probability any given price reflects the objective underlying value of a market and thus buffers the movement of delta. We expect greater uncertainty in such a market, so we are nonplussed when it arrives. A market with low volatility will reach our 0% and 100% perfect conviction levels abruptly, but a market with high volatility will hang around the 50% conviction level and thereby defeat the entire purpose of greater transparency.

Why Volatility Matters:
Delta Of A $100 Call With 30 Days Remaining



One thing we have seen so far in the still-young Bernanke era is he is held to a different standard than Alan Greenspan. He is going to have to prove his inflation-fighting credentials, and he is going to have to do so with deeds more than words. Words, just like those spousal pledges of fealty, are going to cause confusion. The more they try to be transparent, the greater volatility will become and the less effective their communications with the market will be. That is a game in which we all lose.