



Volatility May Present Opportunity for Fixed Income Investors

By Thomas D. Higgins, PhD,
Global Macro Strategist,
Standish Mellon Asset
Management Company LLC

Standish Global Macro Strategist Tom Higgins says global financial markets are off to a strong start in 2012, but questions whether the risk rally can be sustained.

Executive Summary

Standish Global Macro Strategist Tom Higgins says global financial markets are off to a strong start in 2012, but questions whether the risk rally can be sustained. Concerned that markets have become complacent regarding the risks to the outlook, he says a pick-up in market volatility would not surprise him. He notes that the accommodative stance of monetary policy, improving economic data, and attractive valuations remain supportive of credit. The global bond manager, he says, is keeping some of its powder dry to take advantage of opportunities as they arise and considering the implications of a possible divergence in interest rate and credit market volatility.

Global financial markets are off to a strong start in 2012. In January, U.S. investment grade credit returned more than 2%, high yield bonds were up 3%, and the Standard & Poor's 500 stock index gained nearly 5%.¹ European credit markets also performed well, despite uneven progress on resolving the region's sovereign debt crisis. The question is whether the risk rally can be sustained.

Optimists argue that financial markets will continue to be supported by the accommodative stance of monetary policy in the advanced economies, improving economic data, and attractive valuations. They cite the launch of the European Central Bank's (ECB) long-term refinancing operation (LTRO) in late December as the catalyst for the recent market rally. They believe the LTRO lowered the risk of a systemic banking crisis in Europe by allowing banks to meet their financing needs for the next three years, while simultaneously easing the collateral requirements for such loans.

Pessimists counter that the LTRO does nothing to address the long-term solvency issues for countries such as Greece or Portugal. Consequently, they worry that a disorderly Greek default still has the potential to undermine other peripheral European debt markets. Moreover, they point to geopolitical uncertainty in the Middle East and contentious elections in the U.S. and France as potential sources of market volatility.

At Standish, we are cognizant of these risks, but we remain constructive on investment grade credit, select high yield bonds, and emerging market debt, given improving fundamentals and attractive valuations. That said, we are worried that markets have become complacent regarding the risks to the outlook, and we would not be surprised to see some pick-up in market volatility. Therefore, we are closely monitoring these developments and keeping some of our powder dry to take advantage of opportunities should they present themselves.



¹ Bloomberg database and Barclays Point, February 2012. Bond performance based on the Barclays Capital U.S. Corporate High Yield Index and the Barclays Capital U.S. Aggregate Index.

Specifically, the U.S. and other advanced economies are in the midst of a multi-year deleveraging process, which in our view has reduced potential growth and increased the volatility of indicators of real economic activity.

Uncertainty and Volatility

In financial markets, greater uncertainty typically manifests itself as higher volatility in asset prices. Over the past year, a number of events caused volatility to spike, including: the fall of governments in the Middle East as part of the Arab Spring, the Japanese earthquake/tsunami, concerns about a Greek default, and the U.S. sovereign credit rating downgrade. These shocks are often difficult if not impossible to forecast, yet they can have a significant impact on asset prices. Rather than attempt to predict the unpredictable, we believe investors can incorporate measures of *implied volatility* into their fixed income strategies. Implied volatility uses option prices to infer the level of investor uncertainty about future asset prices and thereby allows us to incorporate market information about potential shocks.

Implied volatility can take many forms. As fixed income managers we are particularly interested in volatility in interest rates and credit markets, which historically have been closely related. While there are no robust measures of implied volatility in the corporate bond market, equity market volatility is closely related and is a good proxy.² Indeed, the Merrill Lynch Option Volatility Estimate (MOVE),³ which measures short-term implied volatility in the Treasury market, and the CBOE Volatility Index (VIX),⁴ which measures implied volatility in the equity market, has an average historical correlation of 60%.⁵

Both the MOVE and the VIX have dropped sharply since last summer as some risks, such as a double-dip recession in the U.S. or a hard landing in China, have abated. We believe that the MOVE and other measures of interest rate volatility may remain subdued due to Federal Reserve intervention in the Treasury market. However, the outlook for the VIX and broader credit market volatility is more ambiguous, given structural changes in the U.S. economy.

Will Interest Rate and Equity Market Volatility Diverge?

Central bank action can play an important role in dampening interest rate volatility. The ECB's LTRO mentioned earlier has lowered implied volatility in European rates markets by 20% since its launch in mid-December. The same is true for the Federal Reserve's recent actions. Last August, the Fed stated that economic conditions were likely to warrant an exceptionally low level of short-term interest rates through mid-2013. Then in January, the Fed extended this to "at least through late-2014."

As a result of these steps, both implied and realized interest rate volatility has fallen in the United States. The MOVE has tumbled 30% since last August, when the Fed first unveiled a time frame for its commitment to low rates. Realized volatility as measured by the standard deviation of the weekly change in two-year U.S. Treasury yields has fallen by half over that period. We expect this low interest rate volatility environment to prevail until the market begins pricing in tighter monetary policy, which by the Fed's own estimation probably won't be for the next two years.

Measures of credit market volatility have moved lower in sympathy with the decline in Treasury market volatility. However, structural changes in the U.S. economy may leave markets more vulnerable than in the past to shocks that can adversely impact credit.

Specifically, the U.S. and other advanced economies are in the midst of a multi-year deleveraging process, which in our view has reduced potential growth and increased the volatility of indicators of real economic activity. For example, real GDP growth has been 68% more volatile since 2007 than it was the prior two decades during the period that has been labeled the Great Moderation. Likewise, growth in corporate profits has been more than twice as volatile.⁶

2 Chris Stivers and Licheng Sun, "Stock Market Uncertainty and the Relation between Stock and Bond Returns," Federal Reserve Bank of Atlanta, March 2002.

3 The Merrill Lynch Option Volatility Estimate (MOVE) Index is a yield-curve-weighted index of the normalized implied volatility on one-month Treasury options.

4 The Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which shows the market's expectation of 30-day volatility, is constructed using the implied volatilities of a wide range of S&P 500 index options.

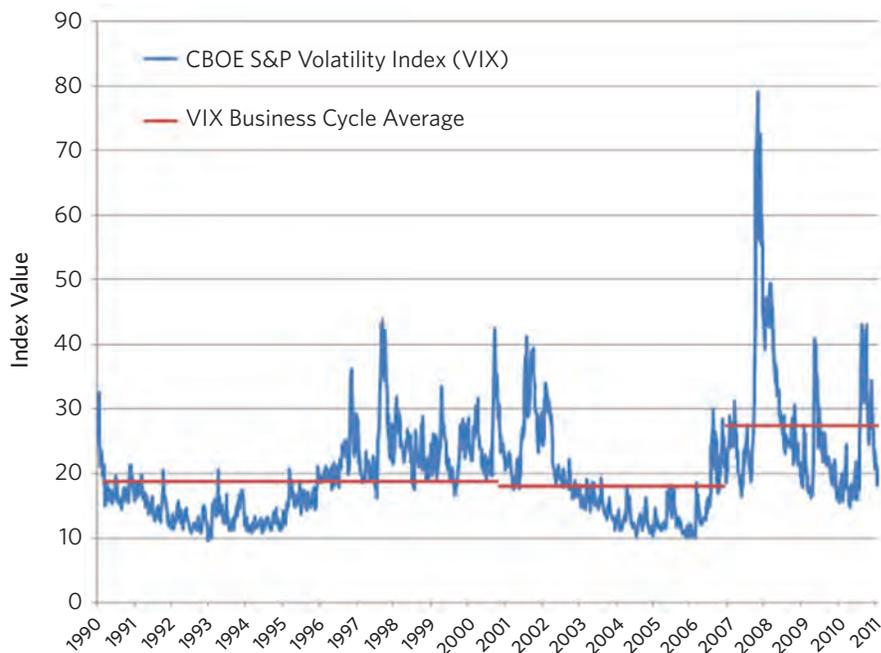
5 Bloomberg.

6 Standish calculations.

The idea that interest rate volatility and credit market volatility may diverge is supported by the experience of the 1940s when the Fed was last playing a more activist role in the Treasury market.

This may partly explain why the VIX has generally been higher during this economic cycle than it was during the prior two recoveries in the 1990s and early 2000s. Recent regulatory changes, including the Volcker Rule, may exacerbate periods of illiquidity in credit markets by reducing the ability of primary dealers to act as market makers. It is interesting to note that Treasuries are exempt from the limits on proprietary trading that are scheduled to go into effect in July. Thus, the case can be made that interest rate and credit market volatility could diverge in the future.

Exhibit 1 - Volatility May Be Structurally Higher



Source: Chicago Board Options Exchange, as of January 27, 2012.

Index Definitions

The **S&P 500 Index** is an unmanaged index considered representative of the U.S. stock market.

Barclays Capital U.S. Corporate High Yield Index is an unmanaged index that covers the universe of fixed-rate, noninvestment-grade debt.

Barclays Capital U.S. Aggregate Index is an unmanaged index considered representative of the U.S. investment-grade, fixed-rate bond market.

The indexes are trademarks of the foregoing licensors and are used herein solely for comparative purposes.

Taking Advantage of Volatility

The idea that interest rate volatility and credit market volatility may diverge is supported by the experience of the 1940s when the Fed was last playing a more activist role in the Treasury market. Between April 1942 and March 1951, the Fed publicly committed to maintaining an interest rate ceiling of 0.375% on Treasury bills and 2.5% on long-term government bonds.⁷ During that period, Treasury market volatility was virtually non-existent, yet the stock market continued to fluctuate in a wide range. Although the Fed is not explicitly targeting Treasury yields in the current period, it is actually playing a larger role in the Treasury market today than it had in the 1940s.

We think there are at least three implications for portfolio positioning. First, the risk premium in credit markets may be higher than it was in past economic cycles, because the risk-free interest rate is being artificially suppressed by the central bank. Yet structural changes in the economy may imply higher variability in corporate profits. Second, selling interest rate volatility may be attractive since interest rates will likely trade in a range until the deleveraging cycle is closer to completion in the advanced economies. Third, volatility may present opportunities to add exposure to areas of the fixed income markets with strong fundamentals, including investment grade credit, emerging market bonds, and select areas of the high yield market.

⁷ Robert L. Hetzel and Ralph F. Leach, "The Treasury-Fed Accord: A New Narrative Account," Federal Reserve Bank of Richmond Economic Quarterly, Volume 87/1 Winter 2001.

BNY Mellon Asset Management is one of the world's leading asset management organizations, encompassing BNY Mellon's affiliated investment management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. • The statements and opinions expressed in this document are those of the authors as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This document is of general nature, does not constitute legal, tax, accounting or other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice given based on the information supplied.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. • While the information in this document is not intended to be investment advice, it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for use by professional and wholesale investors only and not for onward distribution to, or to be relied upon by, retail investors. • Products or services described in this document are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. This document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to local law or regulation. This document may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this document comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this document in their jurisdiction. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.** • This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited.

In **Australia**, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. • In **Brazil**, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. • Investment vehicles may be offered and sold in **Canada** through BNY Mellon Asset Management Canada Ltd., a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager. • In **Dubai, United Arab Emirates**, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. • In **Germany**, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between BNY Mellon and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. • If this document is used or distributed in **Hong Kong**, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Level 14, Three Pacific Place, 1 Queen's Road East, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. • In **Japan**, this document is issued by BNY Mellon Asset Management Japan Limited, Marunouchi Trust Tower Main Building, 1-8-3 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • In **Korea**, this document is issued by BNY Mellon AM Korea Limited for presentation to professional investors. BNY Mellon AM Korea Limited, 29F One IFC, 10 Gukegeumyung-ro, Yeongdeungpo-gu, Seoul, 150-945, Korea. Regulated by the Financial Supervisory Service. • In **Singapore**, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. In Singapore, this document is to be distributed to Institutional Investors (as defined in the Securities and Futures Act, Chapter 289 of Singapore) only. • This document is issued in the **UK** and in **mainland Europe** (excluding Germany), by BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. • This document is issued in the **United States** by BNY Mellon Asset Management.

BNY Mellon holds over 90% of the parent holding company of The Alcentra Group. The Group refers to these affiliated companies: Alcentra, Ltd and Alcentra NY, LLC. Only Alcentra NY, LLC offers services in the U.S. • BNY Mellon ARX is the brand used to describe the Brazilian investment capabilities of BNY Mellon ARX Investimentos Ltda. • BNY Mellon Western FMC, Insight Investment and WestLB Mellon Asset Management do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon holds a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC). • BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • BNY Mellon Western Fund Management Company Limited is a joint venture between BNY Mellon (49%) and China based Western Securities Company Ltd. (51%). The firm does not offer services outside of the People's Republic of China. • BNY Mellon owns a 19.9% minority interest in The Hamon Investment Group Pte Limited, the parent company of Blackfriars Asset Management Limited, Hamon Asset Management Limited and Hamon Asian Advisors Limited, through which Hamon offers investment services in the U.S. • The Newton Group refers to the following group of companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC, and Newton Fund Managers (CI) Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offers services in the U.S. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.



BNY MELLON ASSET MANAGEMENT

The Alcentra Group
BNY Mellon ARX
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management
Company Limited
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management