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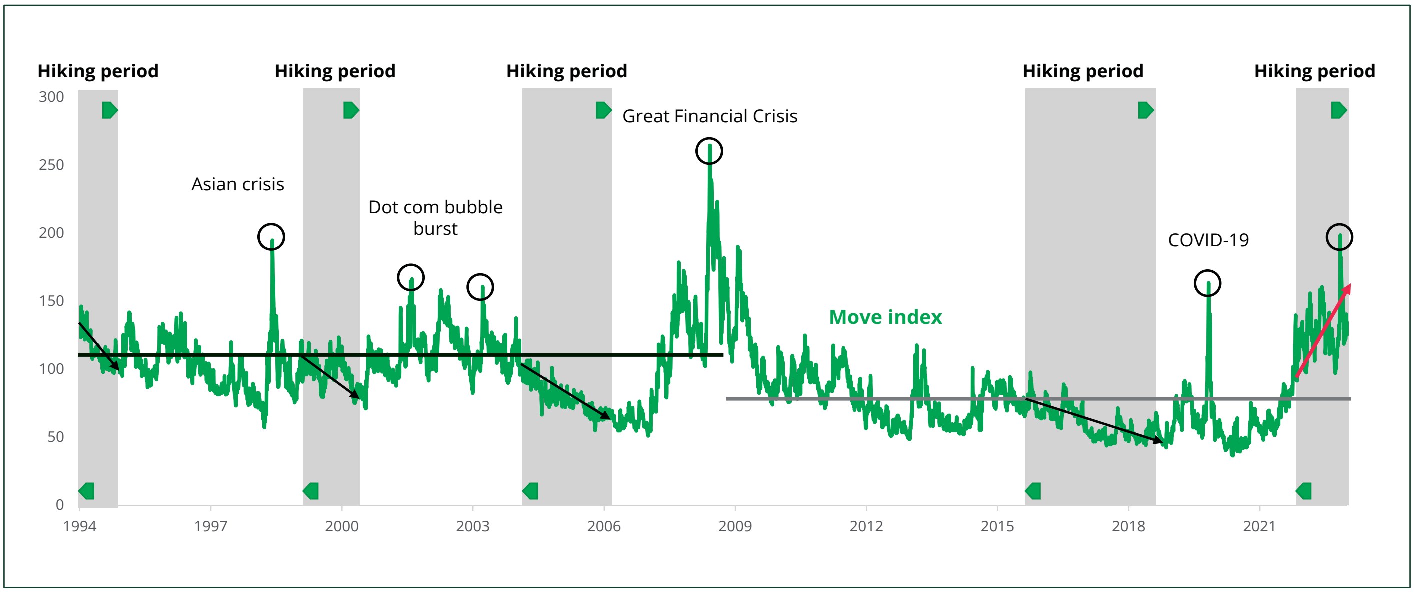
WHEN BOND VOLATILITY IS ON THE MOVE

31/05/2023 | KEVIN THOZET

Uncertainty is particularly high at turning points and ebbs as a trend emerges.

Evolution of the volatility on fixed income markets and periods of hiking rates



The MOVE index is a gauge of investor uncertainty on US Treasury markets, based on expectations of US yield-curve movements over the coming weeks. The MOVE index is to bonds what the VIX index is to stocks.

And these yields have been particularly volatile over the past 12 months. **The MOVE index** is flirting with levels typically seen during crisis, such as the Asian financial crisis, the bursting of the dot-com bubble, the 2008 Great Financial Crisis or the COVID pandemic (black circles on the graph).

WHY HAS BOND MARKET VOLATILITY BEEN SO HIGH?

The massive inflationary wave (reaching levels not seen in 40 years) coupled with a delayed response from the Fed[(1)] created major uncertainty on both the magnitude of upcoming rate hikes and the distance the US central bank would need to cover to bring interest rates into restrictive territory[(2)]. This uncertainty is what caused the atypical movements in the MOVE index. **Usually, bond market volatility declines as the monetary tightening cycle([3]) advances (black arrows in the graph)**. As policy rates get closer and closer to their terminal levels and long-term bond yields reach a ceiling as

Source: Bloomberg, May 2023. (1) **FED**: The Federal Reserve Board of Governors. (2) **Restrictive rates** correspond to positive real rates. (3) **Monetary tightening**: When central banks aim to slow an overheating economy – which can drive up inflation – through a combination of higher interest rates and reduced liquidity injections into the market.

the business cycle advances and GDP growth expectations are lowered. But it hasn't been the case with this round of monetary tightening (red arrow on the graph).

Or at least, that wasn't the case until cracks started to appear in the US regional banking system and the Fed seemed ready to end its current tightening cycle[3], which has been exceptional in many respects. Since then, bond market uncertainty has eased – a trend fuelled further by the decline in realised volatility.

We can therefore expect today's atypical market volatility to normalise. The rapid succession of rate hikes is drawing to a close, disinflation is well underway, the economy is slowly but surely heading towards recession , and diversification is once again offering its traditional benefits. Should this sequence of events continue, core sovereign bonds are poised to become a worthwhile investment.

That said, the MOVE index probably won't return to its 10-year average (of 75 as per the grey line in the graph). The exceptionally accommodative monetary policies (notably the quantitative easing[4]) that had dampened volatility are coming to an end, and we're in for a much less benign inflationary environment owing to the very nature of today's inflation and the possibility that current fiscal and monetary policies will be reversed before inflation is fully tamed.

The MOVE index will likely level off in the coming years at values closer to those preceding the Great Financial Crisis – that is, around 100 (black line on the graph) – which corresponds to typical daily bond-yield fluctuations of +/–6 bp.

These factors are creating an economic climate that's favourable to sovereign bonds, especially medium- to long-term maturities, and that structurally calls for an active investment approach – the one best suited to turning market volatility into opportunity.

The MOVE index is calculated from the implied volatility of 1-month US Treasury options at different maturities of the US yield curve. These volatilities are aggregated and weighted as follows: 20% for 2-year Treasuries; 20% for 5-year Treasuries; 40% for 10-year Treasuries; and 20% for 30-year Treasuries.

The higher the MOVE index, the bigger the magnitude of expected movements in Treasury yields, and therefore the greater the uncertainty among investors. The index was at 50 in June 2021 but sits at 130 today, indicating there's much more uncertainty about the extent of movements in bond yields.

The MOVE index can be used to infer investors' expectations about how much bond yields will fluctuate. An index value of 130 corresponds to daily fluctuations of +/–8 bp, barring extreme events. But over the past 20 years, the daily fluctuation has been an average of +/–3 bp. A good illustration of just how much uncertainty there is in today's fixed income markets!

DISCLAIMER

(3) **Monetary tightening**: When central banks aim to slow an overheating economy – which can drive up inflation – through a combination of higher interest rates and reduced liquidity injections into the market.
(4) **Quantitative easing**: A type of monetary policy whereby central banks carry out large-scale purchases of government bonds or other assets in order to inject liquidity into the economy and stimulate economic growth.

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