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All routes lead to the same exit

Nick Bullman | CheckRisk | 09 September 2013

It is supposed to be central banks that set rate policy – but, it is clear that one of the effects of negative real interest rates and the suppression of real rates by monetary policy is that at some point a central bank is at risk of losing control. Investors may not consider this to be a risk at present, however, it is precisely the sort of risk that surprises when it happens, and one that may cause large downward forces on equity markets in particular.

As an earlier CheckRisk report showed, interest rate shock risk can be a major component in the readjustment of asset flows, and seismic asset allocation shifts. Most investors are ignoring this risk as can be seen in Figure 1 and Figure 2 below. The first is the spread between US equity market volatility and bond market volatility, while the second shows the rise in US bond yields over recent months.

Figure 1 looks complicated but it is worth a bit of effort:

- The orange line in the top segment is the Move bond volatility index; the white line is VIX.
- The second panel shows that the spread, or difference between the two volatilities, has widened considerably and is almost back to annual highs.
- The third panel shows the correlation between the two indices. Falling correlations show a divergence between bond market investor views and those of equity market participants.

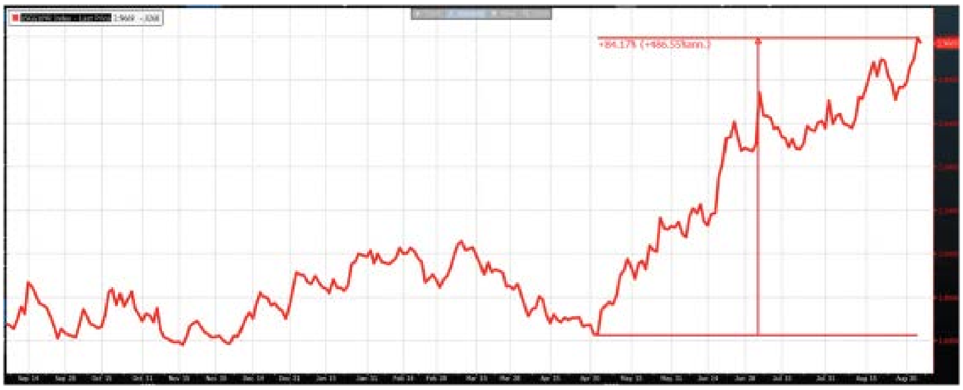
It may not yet be time to panic but, with US 10-year Treasury yields reaching the 3% level, it is time to start being cautious – which may be difficult and uncomfortable for investors particularly if another leg up in markets occurs.

Figure 1: Move and VIX volatility index

Sources: Bloomberg LLP, CheckRisk LLP

Figure 2 shows that US Treasury yields have risen 84% since the first week of May and are now bouncing off what many view as a critical level for rates. The 3% level appears to be a key level for stop loss triggers and so it is quite possible that any serious breach of the 3% mark could lead to an upward rise in rates unless the Fed intervenes.

Figure 2: US 10-year Treasury yields



Sources: Bloomberg LLP, CheckRisk LLP

Given the above, it is important to look ahead and analyse the possible outcomes from a risk perspective. For all of the reasons we have stated in the past few months, and the rise demonstrated above, it seems that Bernanke is facing a big dilemma.

Quantitative Easing has failed to the extent that it has not reignited the global economy. It may have stopped a massive deflationary trend, but we will never know. Decreasing the level of liquidity – or just the talk of it – is forcing rates higher and threatens the global economic recovery. Alternatively, extending the level of QE or increasing it now may also create a deflationary effect via the creation of credit and the lack of available collateral. This is a key issue and one that is not well appreciated.

It is the latter part of Bernanke's dilemma that is concerning for medium-term risks. CheckRisk has stated that we believe the Fed has very limited options in terms of tapering. It is possible that there will be a nominal amount to show the market they are serious ("tapering lite"). There is also the likelihood that it does not occur at all for the near term. If the latter is the case and tapering is suspended, this may provide the fuel for the next upward move in stock markets. Clearly, that move would be on increasingly shaky ground.

The continuance of QE, however, is beginning to create a big risk - namely, a collateral squeeze. The direct impact of the purchase of high quality collateral by the US Government has been to tighten supply of it to banks and other financial institutions. That tightening in turn has led to a tightening of credit issuance to bank customers. The tightening of credit availability, therefore, can occur during a time of monetary largesse.

What this really means is that the creation of new money will only push asset prices higher. It will not create an increase in the velocity of money. The Fed and other central banks will have to think of a new strategy to reopen the availability of credit - and that is a problem.

At present, all the routes of Bernanke's QE maze lead to the same exit - deflation.

Nicholas Bullman, BBA, is founder and managing partner of CheckRisk, a risk consultancy which uses a proprietary risk-based system for pre- and post-investment risk analysis. The firm advises on $30 billion of risk assets. Nick is a member of the PortfolioConstruction Forum core faculty of leading investment professionals and a regular speaker at PortfolioConstruction Forum programs including Conference 2012 and Markets Summit 2013.

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