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How to Gauge Income-Market Risk

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The possibility of an end to the FedTrade could result in market volatility, but there are ways to gauge the risk.

Previously, I explained that while most Fed watchers are focused on the federal funds rate, a more interesting topic may be the so-called "FedTrade," which is keeping certain agency mortgage-backed securities' risk spreads at artificially low levels.

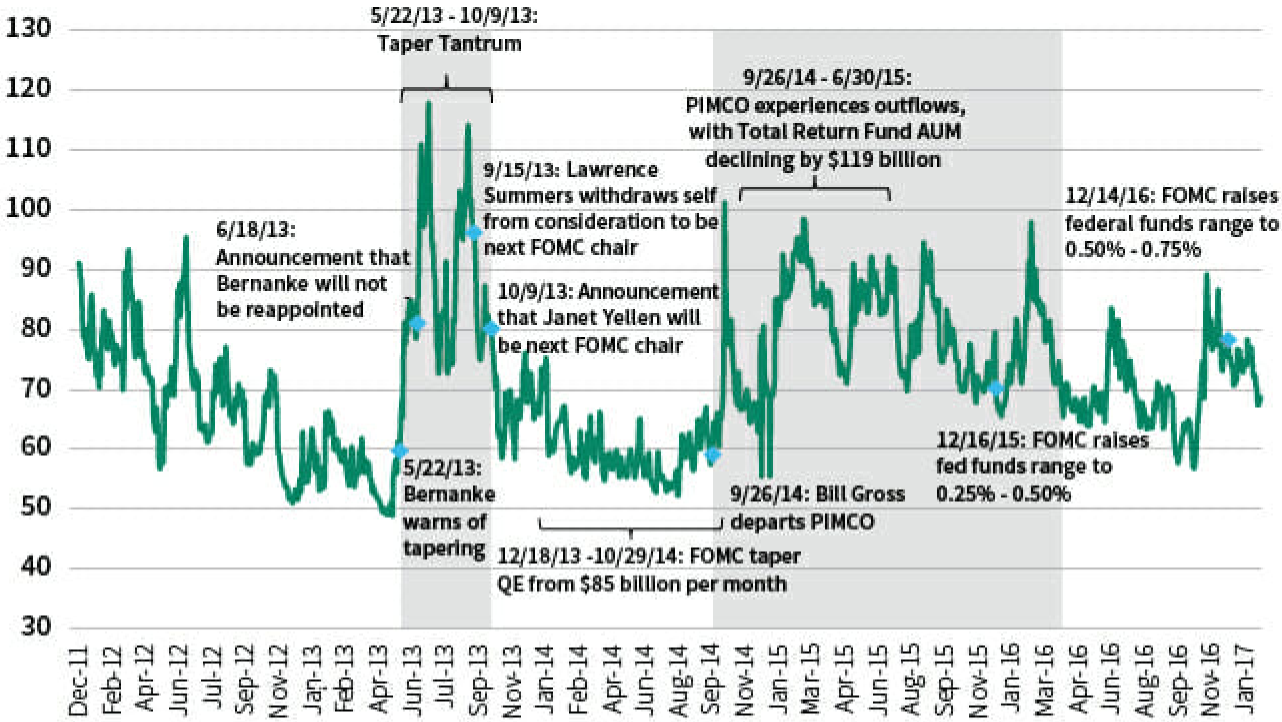
I speculated that any decision to sell these securities—or even a market expectation that the Fed will do so—could result in more broad-based volatility.

While such moves are difficult (if not impossible) to predict, one metric that has guided our decision-making over the past few years is the Bank of America/Merrill Lynch MOVE Index, which measures implied volatility of U.S. Treasury rates across the yield curve. Conceptually, it is similar to the CBOE Volatility Index (VIX), a popular measure of the implied volatility of U.S. stocks.

The Bank of America/Merrill Lynch MOVE Index has increased due to the fear of large-scale selling during the past few years. One bout of volatility occurred in 2013 with the "Taper Tantrum," when market participants feared that a new Fed leader would sell securities from the Fed's balance, ending quantitative easing.

Another episode occurred during the end of 2014 and beginning of 2015, when there were large-scale redemptions (and therefore large-scale selling) from the world's largest actively managed bond mutual fund.

Bank of America/Merrill Lynch MOVE Index (12/30/11 - 2/8/17)



Source: Bank of America/Merrill Lynch, as of February 8, 2017

However, this index did not react as violently to events at the end of quantitative easing or the Fed's two rate hikes because those activities were well-telegraphed and did not involve large-scale selling of securities.

Thus, we think the Bank of America/Merrill Lynch MOVE Index will continue to be instructive to follow, as it may indicate when market participants fear an unexpected change in the Fed's policies regarding FedTrade.

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