FASANARA CAPITAL

"Learn how to see. Realize that everything connects to everything else."

— Leonardo da Vinci

July 3rd 2017

FASANARA CAPITAL | COOKIE

New Lows on Bond Volatility: Calm Before The Storm? - UPDATE

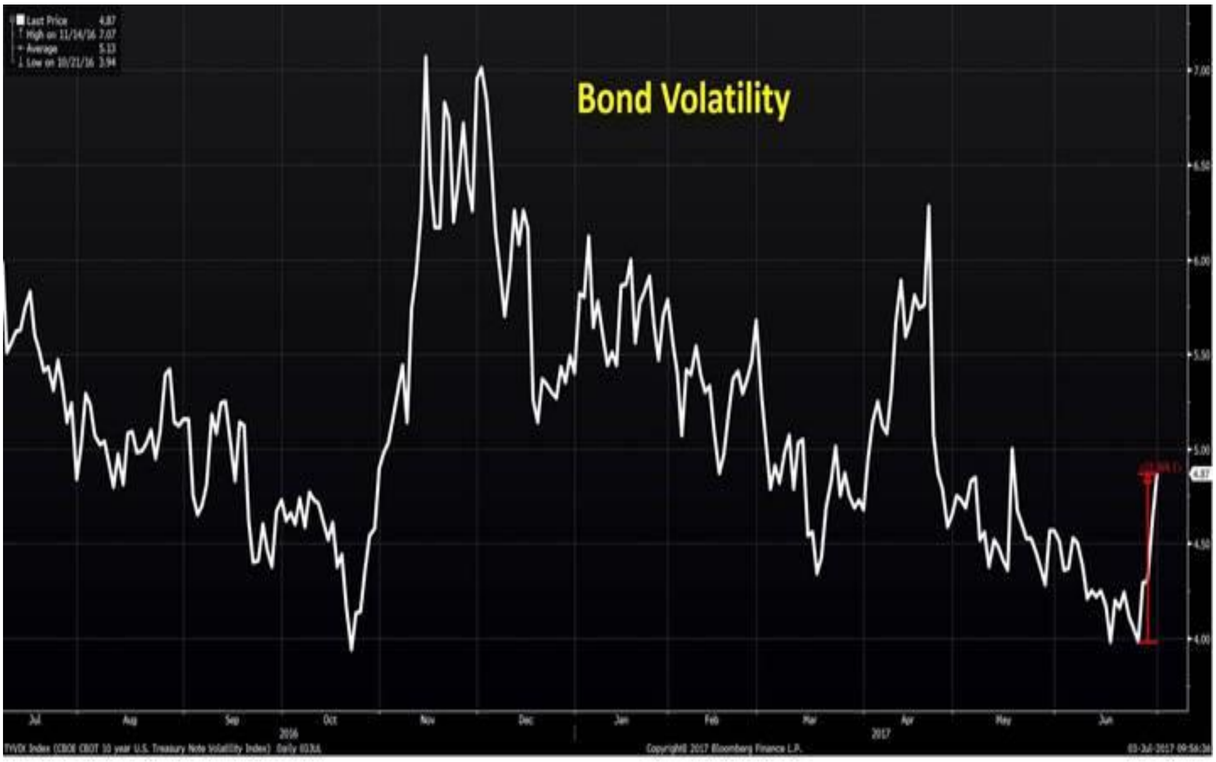
This brief note is an update to the original COOKIE "New Lows on Bond Volatility: Calm Before The Storm?".

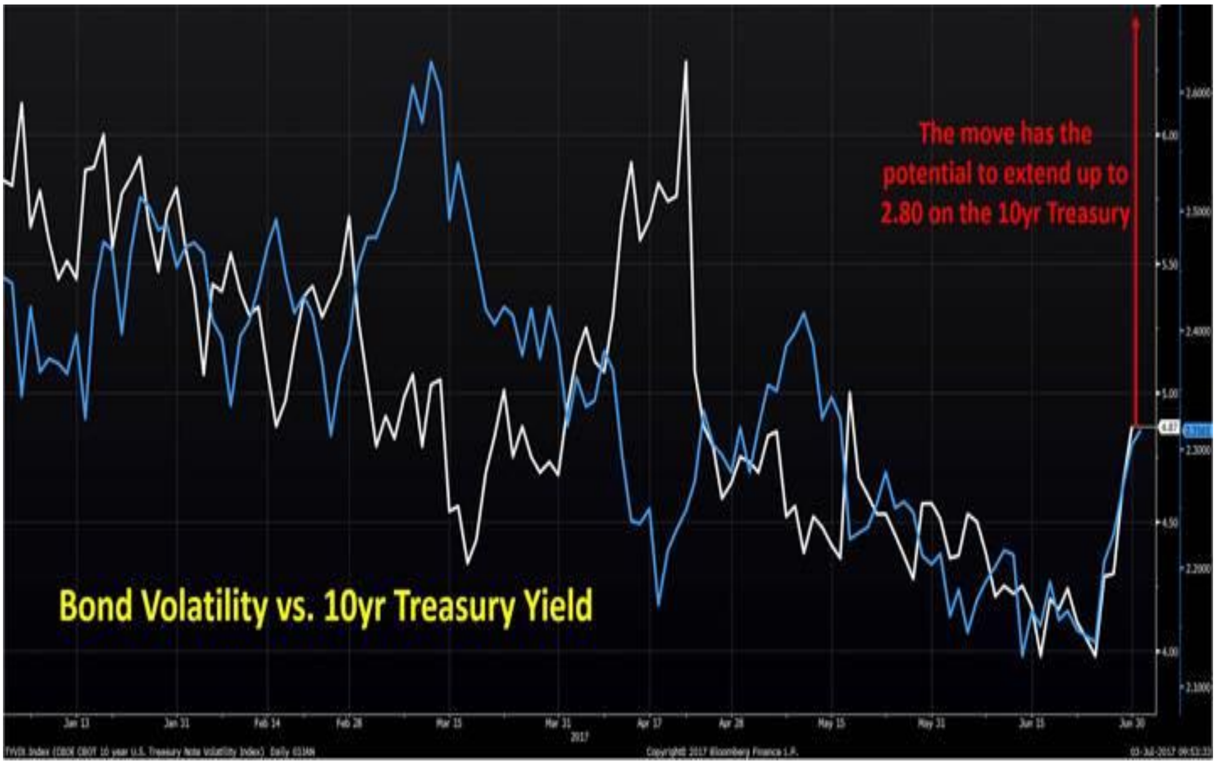
The point of that note was to signal how previous moments in history in which bond volatility printed so low (below 4 for 10yr Treasuries) were oftentimes followed by burst of volatility and subsequent 100bps-type moves in rates, either up or down. Perhaps, low volatility/complacency itself is a necessary ingredient of the instability that follows. It does not work that different in weather patterns. At the root of the old sailors' adage 'calm before the storm' is the fact that **storms need warm, moist air as fuel**, and they typically draw that air from the surrounding environment: ''as the warm, moist air is pulled into a storm system, it leaves a low-pressure vacuum in its wake. The air travels up through the storm cloud and helps to fuel it.''

Volatility has indeed picked up right after, with rates brutally moving upward by 20bps in short order (on Tuesday alone there was a 4-sigma event on Bunds). The move was likely helped by (i) **technically**, the difficulty to make new lows for rates and oil prices, and (ii) **fundamentally**, several Central Banks in Sintra jointly hinting to global tapering of Quantitative Easing and **shrinking monetary accommodation**.

From here on, **risk-wise, the move could extend and rates break into new highs, similarly in magnitude to what happened in May 2013, September 2014, February 2015, October 2016**. Needless to say, Central Banks will aim to limit the damage, if need be. However, economic releases to come may present headwinds, leading to **volatility in summer illiquidity**.

Next up in July will be inflation and Q2 GDP numbers**. In the UK, in particular, inflation could print above 3%, for the first time in years** (since March 2012), sparking new wind in the sails of rates. Inflation has been rising steadily there since end-2015, and an acceleration after Brexit and a weak Pound is in the cards (chart below). **In the US, seasonality to macro data might also play in short-term favor of rates** (chart below).


Bond Volatility


The move has the potential to extend up to 2.80 on the 10yr Treasury
Bond Volatility vs. 10yr Treasury Yield


Bond Volatility vs. 10yr Treasury Yield
+120bps
+100bps
???
Sep 2012
Dec
Mar
Jun 2013
Sep
Dec
Mar
Jun 2014
Sep
Dec
Mar
Jun 2015
Sep
Dec
Mar
Jun 2016
Sep
Dec
Mar 2017
Jun
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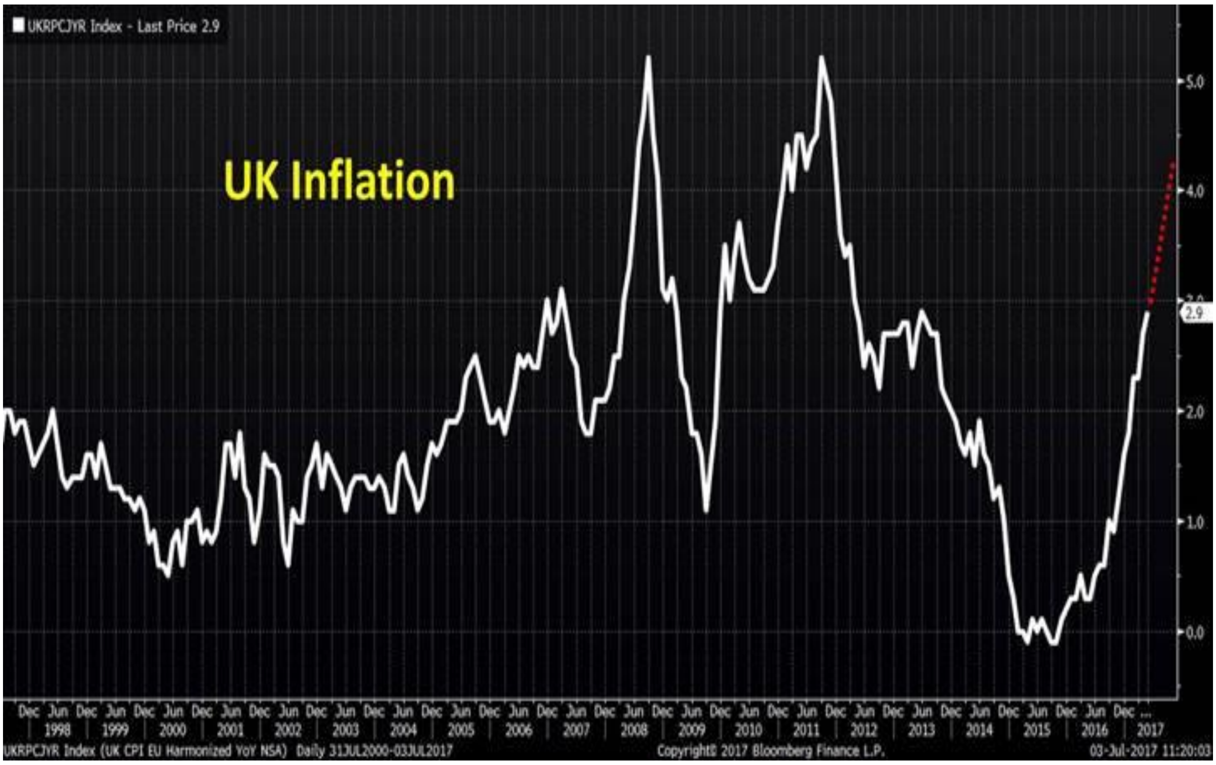
UKRPCJYR Index - Last Price 2.9
UK Inflation
5.0
4.0
2.9
2.0
1.0
0.0
Dec
Jun
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
UKRPCJYR Index (UK CPI EU Harmonized YoY NSA) Daily 31JUL2000-03JUL2017
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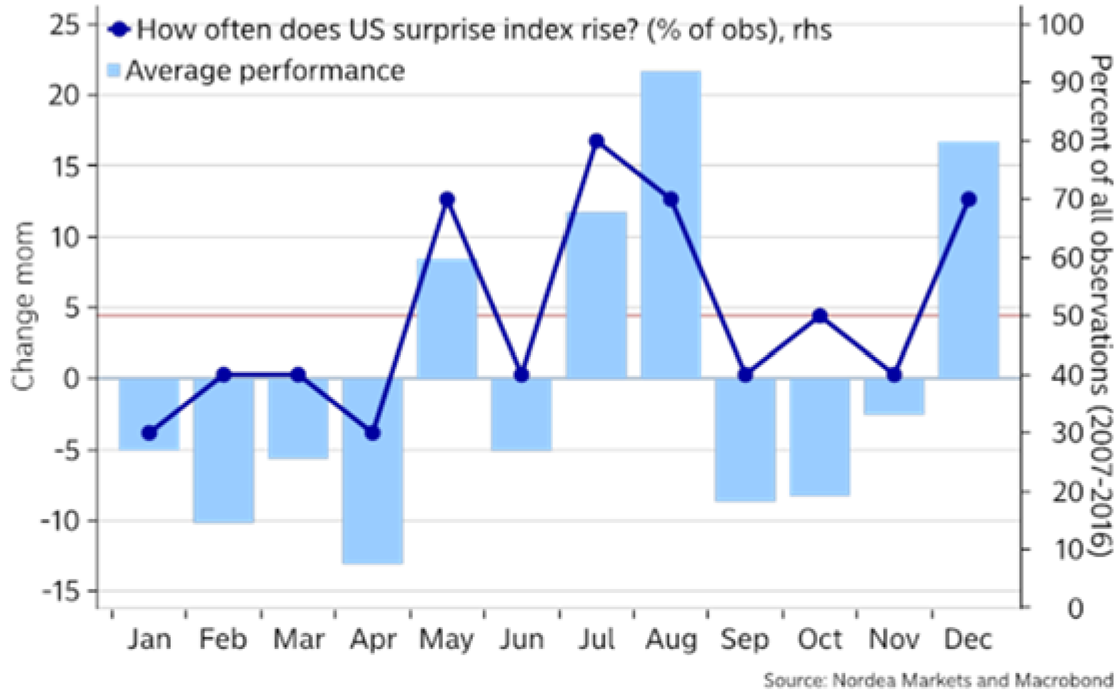

Our thoughts on **QE exit** are available here, video and here, outlook. In a nutshell, **markets have forgotten how much of current valuations is due to QE, at a time when QE is being phased out.** Most Central Banks openly evaluate exit strategies, as they are confronted with rising levels of **cost-push inflation** and lower systemic risks of global deflation (partly due to de-globalisation trends and protectionism). **Yields started rising, like the seconds in a clock that resumed ticking, running towards wake-up call time.**

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