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Investment Intelligence

The end of volatility in bonds? Beware.

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is included, please note that this is not a guide to future performance.

Senior fund manager, Richard Ryan discusses what the current levels of spread volatility might mean for credit markets. A great deal was written over the summer months on the topic of bond market volatility – why is it low, and what does that mean? Yet something rarely addressed in all those column inches was how these various measures of market volatility are being used.

Volatility is typically represented by the standard deviation of credit spreads over certain period and current measures are relatively low, having coincided with the recent run of strong positive returns.

Some strategist models are pointing to further spread tightening due to the decline in credit spread volatility, arguing that because volatility is low, investors need less compensation for risk.

However, one of the components of the spread models is the volatility itself, so let's consider that more closely. For the European high yield market, volatility has been erratic over time (using a rolling 52 week standard deviation of credit spreads over Libor).

Volatility in the European High Yield market has been far from consistent

Source: ICE BAML, M&G. HPIC index asset swaps spreads as of 26 Oct 2017

This chart goes back 20 years since the inception of European high yield indices and shows how volatility has varied and is now below the long-term average (since the start of 1998).

The argument that lower spreads are justified by low volatility is based on the belief that current volatility levels are the new norm. That belief, in turn, assumes that the historical experiences of higher levels of volatility are a thing of the past and no longer relevant to current investment realities.

However, we believe it's highly unlikely that the world has entered a new state of permanently lower volatility in the same way that we don't believe that there aren't economic or investment cycles any more.
Certainly volatility is lower now than it was a few years ago, but it says nothing about what it will be tomorrow, the day after, or another day after that. The implicit assumption that volatility will never return to the long-term average, is just that, an assumption.

Looking at spreads alongside volatility may provide compelling support for the low volatility argument but the two are not independent – they are related.

Should low volatility now imply lower spreads ahead?

Source: ICE BAML, M&G. HPIC index asset swaps spreads as of 26 Oct 2017

Let's consider an alternative interpretation of the charts. Spreads are now almost as tight as they were when they reached a trough prior to the financial crisis in 2007/8. Volatility was low then too.

The rhetoric around this low volatility environment is reminiscent of 2005-2007. Then there was a growing belief that, with little volatility, financial assets could be leveraged with little additional risk. Why not, if spreads were going to remain tight and values were secure?

We all know how that turned out. Rather than being an endorsement of the freedom to add risk, we believe that low volatility and tight spreads should be considered a flag for exercising caution.

Instead of increasing risk to achieve a return objective, we retain our approach of taking risk only if we are compensated for it.

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