# Volatility Resurfaces: What Fixed Income Investors Should Know

Reams Asset Management

## Key Takeaways

- After a lengthy period of artificially low volatility driven by unconventional central bank policies, we believe global markets have entered a phase that may exhibit higher baseline volatility than over the past decade.
- Volatility spikes may also be more pronounced compared to prior cycles, due to the potentially destabilizing influence of short volatility strategies and the reduction of traditional liquidity providers.
- The corporate debt market is exhibiting excesses along several dimensions, and there is growing evidence of late-cycle dynamics.
- Specialized approaches may help fixed income investors navigate this climate.

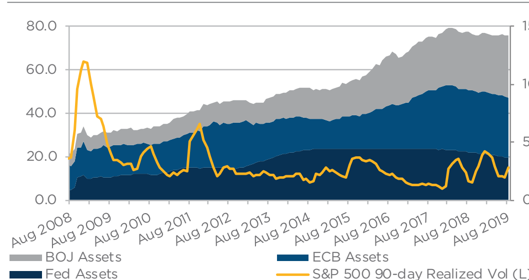
## Why could volatility be higher than it has been for the past 10-plus years?

In response to the 2008 Financial Crisis, the United States and other countries implemented unconventional policy measures like quantitative easing, which have persisted for more than a decade. The most obvious effect of this excess liquidity has been the boosting of risk assets and the suppression of volatility.

In our view, however, this period of prolonged volatility may be ending. The past 18 months have exhibited a level of volatility not observed since mid-2012. This recent increase in volatility has coincided with a rate hike cycle and quantitative tightening in the United States, as well as tapering of quantitative easing in Europe. This should come as no surprise: If monetary stimulus dampened volatility, then its removal will likely lead to an increase. What hasn't occurred yet is a meaningful re-pricing of risk assets.

We also note that central banks have fewer policy levers to pull than in 2008. Negative sovereign yields are more the rule now in Europe than the exception. As of Oct. 1, 2019, the Bloomberg Barclays Global Aggregate yields less than 1.5% with a duration of more than seven years, meaning a 50 bps increase in rates wipes out more than two years of income. This is not normal, not even "new normal."

**Central Bank Balance Sheet Assets, U.S. Trillions vs. S&P 500 Realized Volatility, Percent**



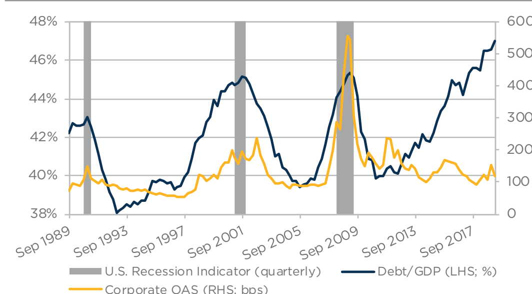

*Source: Bloomberg; U.S. Federal Reserve; European Central Bank; Bank of Japan. Data from August 31, 2008 through August 31, 2019*

When the next downturn occurs, central banks could take risk-free rates even more negative. Or they could add to already bloated balance sheets. But there has to be a limit. In addition, we are not sure how effective these policy tools will be. Cutting interest rates from 4% to 2% might have a different impact on risk appetite and behavior than cutting rates from 0% to negative 2%. We believe we are approaching the monetary policy event horizon, where the laws of macroeconomic physics start to break down.

## Where are we in the credit cycle?

The short answer is: late. Over the past 10 years, we have witnessed a huge amount of government and corporate debt issuance. We have also seen outsized growth in more speculative segments of the bond market — high yield, bank loans, direct lending, and emerging markets debt.

**U.S. Non-Financial Corporate Debt to GDP, Percent vs. U.S. IG Corporate OAS, Basis Points**




*Source: Bloomberg; U.S. Federal Reserve; U.S. Bureau of Economic Analysis Data from September 30, 1989 through March 31, 2019*

Evidence is growing of late-cycle behavior such as strongly over-subscribed new issues, prevalence of covenant-lite deals, rising balance sheet leverage, and high levels of leveraged buyout and other M&A activity. Meanwhile, the amount of leverage the typical BBB credit is allowed to carry today is much higher than 15 or 20 years ago. A significant portion of the BBB market would likely be given a junk rating in prior cycles, and these credits will be ripe for downgrades in an economic rough patch. Corporate spreads are simply not reflecting the amount of leverage and potential fragility that has built up in the system over the past decade.

When the next downturn inevitably occurs, many companies may likely be carrying too much leverage and a lot of debt that may be difficult to refinance if credit markets seize up, or prevailing rates are much higher than today.

## Why could the market be more volatile than it has been in past cycles?

Two critical dynamics are driving our belief that the market could be prone to more significant volatility spikes than in past cycles. They are the potential destabilizing influence of short volatility strategies and the concurrent reduction of traditional liquidity providers. This combination indicates that when market participants decide risk needs to be shed, many will likely be actively selling at once, and there may not be enough liquidity providers left for an orderly reduction.

The growth of assets pursuing short volatility strategies is one of the biggest trends stemming from easy monetary policy. We believe the resulting volatility suppression and low-yield environment have led investors increasingly to view selling volatility as an income surrogate. An iceberg is an apt metaphor. Above the surface are explicit short volatility strategies, which are more straightforward and relatively small at about $60 billion. Below the surface, a variety of strategies are implicitly short volatility, with an estimated size of $1.2 to $1.5 trillion.[1]

The vast pool of implicit short volatility strategies may look dissimilar, but we believe they share one common feature: In a volatility spike, these strategies would likely be selling risk. This could occur at the same time across seemingly unrelated strategies and set up self-reinforcing waves of selling pressure.

Another key data point is the collective size of the investment-grade corporate bond inventory for U.S. primary dealers. This is a measure of how much principal risk bond dealers are willing to take and also a rough gauge of liquidity in the corporate bond market. Although a meaningful portion of this critical market-making function has shifted to direct investor-to-investor trading platforms, it remains unclear how corporate bond market liquidity may be impacted during a broad and sustained selloff.

## How might fixed income investors navigate this environment?

In light of these factors, fixed income investors may need to consider specialized approaches to navigate the current climate. Some of those include seeking out investments that are positioned to benefit from volatility rather than be punished by it, and focusing on total return over a market cycle, not yield or current income.

**To read a detailed playbook about investing in the current challenging environment, visit harnessvolatility.com and download our whitepaper.**

(Unless otherwise noted, information is as of Oct. 1, 2019.)

### About Reams Asset Management

Reams Asset Management, a division of Scout Investments and an affiliate of Carillon Tower Advisers, is a fixed income investment management firm serving the institutional marketplace. Reams' mission is to provide the highest-quality investment management expertise and unmatched client service in all product areas over the long term.

FOOTNOTE:

[1] Christopher Cole (2017): Volatility and the Alchemy of Risk, Artemis Capital Management.

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