MV Weekly Market Flash

From “Risk On, Risk Off” to “Risk Here, Risk There”

May 31, 2013

For the past three years the dominant paradigm in investment markets has been “risk on, risk off”. You know – if it’s Tuesday it must be gold and the Japanese yen, but come Thursday animal spirits are back and it’s full-on into small caps and frontier equities. Over this time the market has seemed bipolar as it pinballed back and forth between riskier exposures and perceived safe havens.

Where have all the havens gone?

As we approach the midpoint of calendar year 2013 that paradigm seems to be fading fast. What’s missing is the safe haven, a designation that seems to apply to fewer and fewer asset types. Currencies and precious metals – well, in truth they were never all that safe to begin with, and the recent gyrations of gold and the yen provide a clear demonstration of this. But it’s the fixed income market – the traditional epicenter of safety and predictability – that is the real story today.

Volatility in the bond market

Consider the past week. After reaching a record high of 1669 on May 21 the S&P 500 has seen higher than average volatility and by the close of trading on May 30 the index was a bit less than 1% off the 5/21 high. That’s typically perfect weather for the risk-off flight to the safest of fixed income assets. Not this time. The yield on the 10-year Treasury note – a bellwether for interest rate trends – shot up from just under 1.95% on May 21 to 2.1% on May 30. The total return for IEF, an exchange traded fund (ETF) that tracks the Barclays 7-10 Year Treasury Index, was -1.4% for the same period. Risk here, risk there, risk everywhere.

Taste of things to come?

Now, a nine day calendar stretch is not the defining word on where markets are headed in the immediate future. We think it is more likely to be a small taste of a larger problem that we may be dealing with for some time to come. That problem has a name – interest rate risk. The thing about bond market macro trends is that they tend to be very long. Here’s a little history to make the point: since the 1950s we have had only two such macro trends.

From Cheap Money to Credit Crunch

In 1945 the 10-year Treasury reached a low of 1.7% - its lowest yield since, literally, the founding of the Republic after the Revolutionary War. This was a result of deliberate monetary engineering – sound familiar? – to finance America’s involvement in the Second World War. After the war policymakers realized they had to bring an end to the era of cheap money in light of inflationary pressures. This decision was formalized in the Treasury Accord of 1951. From that point interest rates began a long,

steep climb that lasted 30 years until the 10-year yield, reflecting punitively harsh credit conditions, reached an all-time high of just under 16% in 1981.

From Credit Crunch to Cheap Money

Now, 32 years later, that yield is again just over 2% after plummeting below 1.5% in 2012. The Fed is still printing cheap money, but the minutes of recent Fed meetings make clear that this policy is under pressure. We don't know when we will see "Treasury Accord 2.0" – when the policymakers decide they have to formally acknowledge changing course. It may be awhile yet. But this is the giant elephant in the room, and we believe it is going to present a major challenge to portfolio managers. This challenge will require an innovative, active and flexible approach to managing risk.

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