When volatility is low but uncertainty is high…….buy interest rate options.

There is something of a conundrum in interest rate markets at the moment.

Market View 1 (Thinking uncertainty):

Bond rates are near long-run lows due to large quantitative easing programs which could either end or be expanded in a significant way in the coming years – all depending on how the global economy goes. That means that uncertainty is relatively high and on let's say a two-year horizon, bond yields could either move back to normal levels (i.e. much higher than currently) or could end up still very low.

Market View 2 (Thinking volatility):

Historical volatility on the other hand has been very low in recent times, and extrapolating that forward would imply a much narrower range of bond yield outcomes on a two-year horizon than suggested above, i.e. volatility is suggesting uncertainty is low.

Question: Which of these views carries more weight when it comes to forecasting portfolio risk or valuing interest rate options?

For most investment people, very clearly it is view 2, but Ardea has doubts about whether doing so makes sense. Let's look a bit deeper into the assumption behind that view of future uncertainty.

When modelling movements in bond yields the usual assumption is that there is a random walk involving so-called Brownian motion. There is an assumption that new information relevant to the supply and demand for bonds is coming to hand at a steady rate, meaning that the volatility is consistent over time. Most of the time these assumptions are pretty realistic – after all there is a calendar of economic data releases that is more or less the same every quarter and every year.

Given the current state of the world are the above good assumptions for today's interest rate markets?

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The decision on whether to end or roll back QE programmes hinges or whether the outlook for the economy is robust enough to sustain a withdrawal or the unusual stimulus. Because that is very difficult to be sure about, probably it hinges on whether the outlook is such that there is an uncomfortably large chance of overheating. Right now there is no such concern nor is there much prospect that in the near term something could happen that would create such a concern.

To summarise, the near term information carries relatively little information in terms of when QE will be unwound, hence there is currently low volatility. Extrapolating that assumption too far forward in time would seem to be unwise because it seems reasonable to assume that at some point in the future, QE will end. It seems that the interest rate options market offers an opportunity to profit from the eventual volatility.

One view is that perhaps the sellers of options are extrapolating current low volatility too far into the future. Perhaps they are running low on opportunities to create “carry” or “spread” (since credit spreads are low and yield curves are fairly flat) so they are resorting to strategies that will ultimately prove their undoing, ie selling interest rate options too cheaply. The RBA’s Guy Debelle recently proposed that it was the latter. Perhaps it is a bit of both. Depending on which part of the world and at which point in time, sellers of interest rate options can be real money fixed interest investors, retail investors, hedge funds or corporate treasuries.

We think ‘market view 1’ has been overlooked and investors need to understand that market uncertainty is high and the potential risks this entails for their portfolios. With this in mind, and as per our previous paper on the current low levels of volatility, Ardea is purchasing long-expiry interest rate options for the client portfolios where that is allowed. We believe that while market uncertainty is high, market volatility, as measured by option markets, is quite low and this creates a unique opportunity for investors to protect their portfolios.

If you would like more information on this strategy please feel free to contact us.

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