

Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

Volume 18, No. 48

1731 North Marcey, Chicago IL 60614

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Commentary

Market Opinions and Topics of Interest

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June 25, 2007

Fixed-Income Volatility Poised To Rise

We concluded in a May [Special Report](#) on fixed-income volatility:

A low volatility environment is analogous to standing in traffic; it does not mean you will get hit by a car, but it does raise the event's risk substantially.

The present state of low fixed-income market volatility is justified by the market environment. It is also eerily reminiscent of previous preludes to high-volatility markets such as August-October 1998.

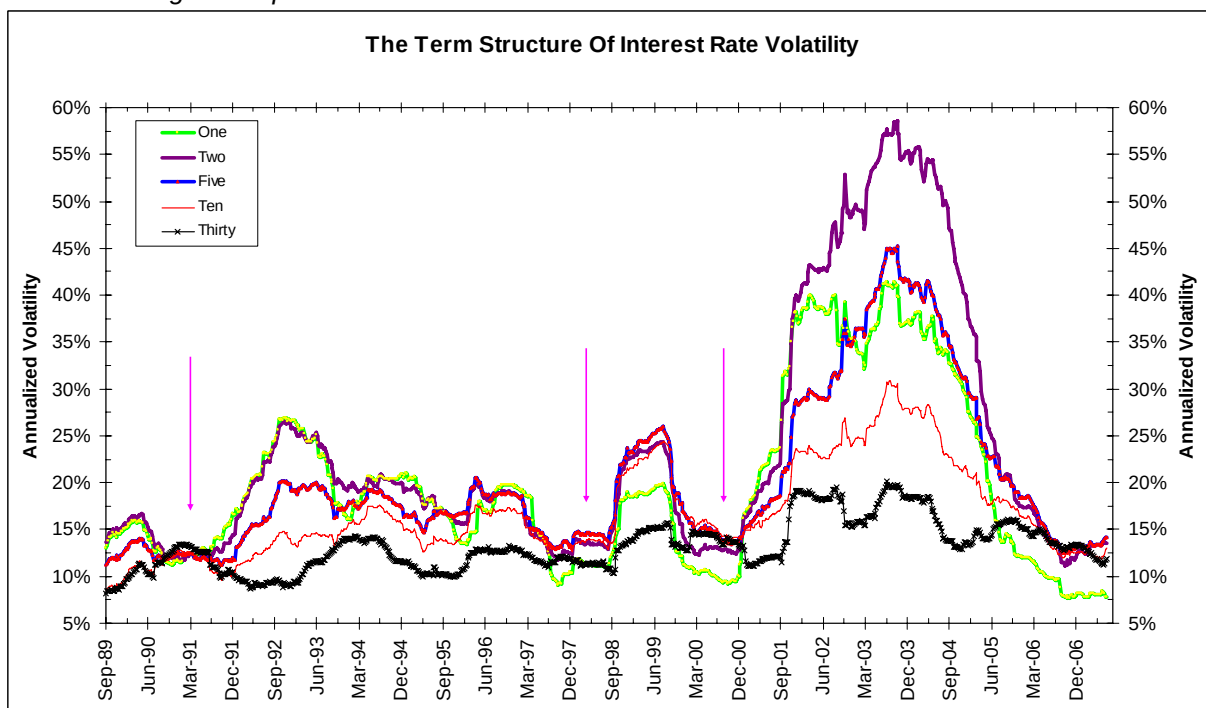
And with respect to the chart below, now updated, we commented:

The long-term history of zero-coupon volatilities at various maturities has only three other periods (magenta arrows) wherein different maturity volatilities converge near present levels. The last

*two episodes, those of 1998 and 2000, preceded the LTCM/Russian crisis and the 2001-2002 bear market, respectively. The first episode, in 1991, was not followed by anything of note. **This is of concern, but hardly is predictive of impending turmoil.***

This was written two days after long-term rates began their climb and well before the disruptions produced by Bear Stearns' subprime hedge funds.

Past ascents of fixed-income volatility driven by events have lasted for months, and in the 2001-2003 period, for years. **Even if we were to believe volatility is an intrinsically mean-reverting process – and we do not – it would be folly to assume a quick return to recent low levels. We should see higher volatility for the indefinite future.**

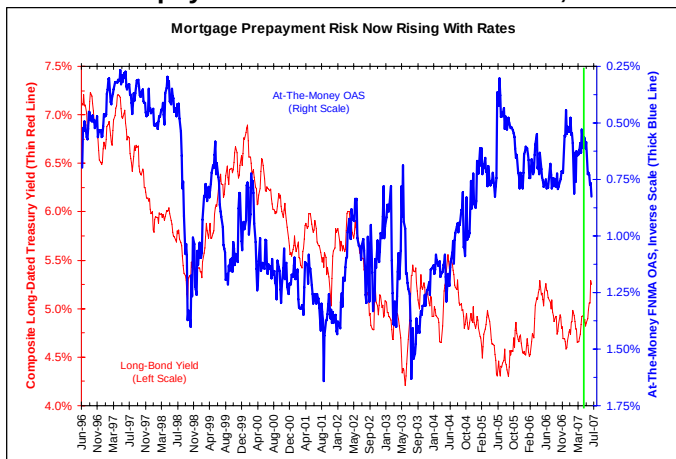


Conventional Mortgage OAS

So much noise has been made over the subprime mortgage market that it would be easy to forget the preponderance of conventional mortgages. Let's update one chart from the May [Special Report](#) and add a related one to illustrate a change in behavior.

We should expect the at-the-money OAS of conventional Fannie Mae mortgage pools trading in the to-be-announced market (thick blue line, inverse scale, left-hand chart) to rise as yields (thin red line, both charts) fall; this reflects the greater risk of prepayment. That relationship changed and changed abruptly in mid-April (green vertical line, both charts): OAS levels now were rising along with yields. For all of the self-flagellation over mispricing of risk, the mortgage market has been adding prepayment insurance at the same time rates have been rising, not falling.

One possible explanation for this is mortgages can be prepaid for reasons other than refinancing. Mortgagors who feel stretched by the current payments can sell their homes, find



Impact On Yield Curve

We concluded in a recent [Market Facts](#) on yield curve inversions, with red font emphasis added:

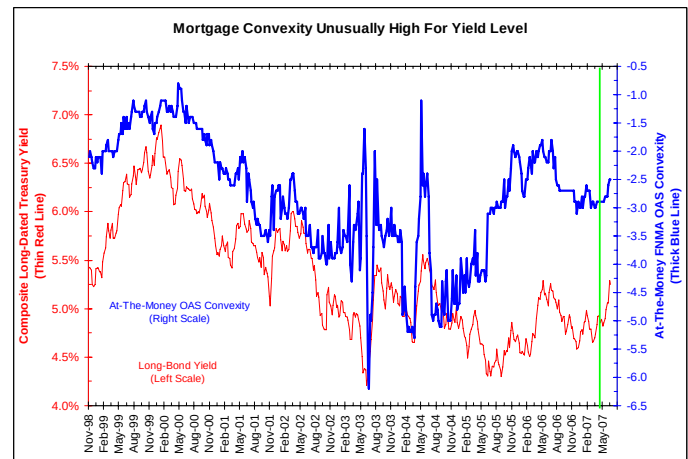
*While long-term interest rates can rise for the reasons given in the recent [Commentary](#), it appears unlikely they will be accompanied by a steeper yield curve unless the Federal Reserve feels compelled to relax credit suddenly. **This is unlikely in the present environment, which would force us into a series of unexpected events to realize the bearish steepening of the***

lower-cost housing and prepay their existing mortgage.

A second and confirming view is provided by the convexity of these ATM OAS pools (thick blue line, right-hand chart). We should expect mortgage OAS convexity to become increasingly negative as yields fall. That relationship started to break when the yield curve flattened in 2004 and has yet to restore itself.

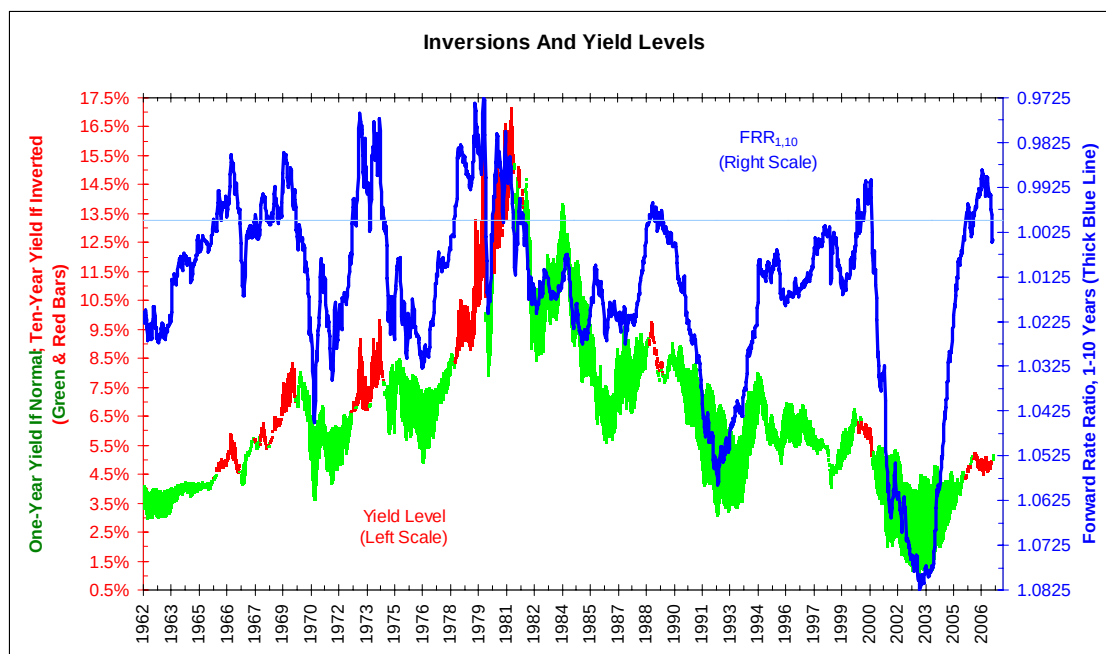
We normally should expect greater mortgage OAS levels to be accompanied by higher volatility as mortgagees buy prepayment protection in one form or another to hedge their prepayment risk. While this force remains operative, it will be offset slightly by the decreasingly negative convexity of conventional ATM pools. Less-optional mortgages will not propel volatility as high as we might expect.

The net impact of increased ATM OAS levels for conventional mortgages on volatility will be higher.



yield curve. While possible, this is not the way to plan.

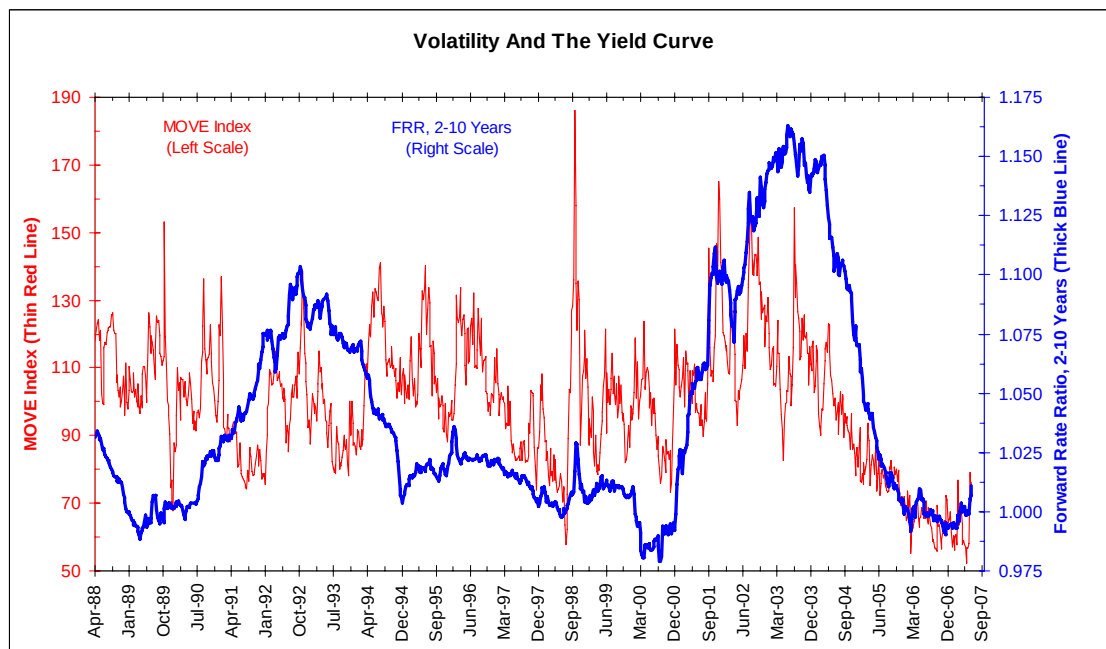
The subprime situation qualifies as an unexpected event; it clearly negated the conclusion offered above. The yield curve as measured by the [forward rate ratio](#) between one and ten years (thick blue line, following page) has returned to a normal slope even as one-year rates (green highlight) dropped only a mere two basis points over the past three weeks.



If volatility, here measured by the Merrill Lynch MOVE index (thin red line) is poised to rise, the yield curve as measured by the $FRR_{2,10}$ (thick blue line) would rise anyway. Higher volatility increases the range of adverse outcomes for bond investors; we noted as far back as a March 2005 [Special Report](#) how the mortgage market and both fixed-income and currency volatilities are far more important in

determining the liquidity premium in the yield curve than are inflation expectations.

Barring a sudden and unexpected resolution of the subprime market and some spurt of higher inflation expectations that would galvanize the Federal Reserve into an unexpected tightening, we must remain biased toward a steeper yield curve for the indefinite future.



Conclusion

We have remained of the consistent opinion that events alone will not alter the long-term picture for volatility; that honor remains with divergent and non-transparent monetary policies by the major central

banks. Transparency seems safe, but as we noted in a March [Commentary](#), policies are moving away from convergence.

That is signal. The subprime situation is noise reinforcing that signal.

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