Quant insight

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Equity investors - you're watching the wrong part of the bond market

Last year, macro tourists looked at the bond market and latched onto the inverted yield curve and its role as a lead indicator for recessions.

More recently the headlines have followed the back up in bond yields.

Both can be important, but they are not the critical indicator for equities *right now*. Interest rate volatility is *the* one to watch.

There's lots of focus on the depressed levels of VIX currently. Understandable, some of the stats are striking.

- last Thursday VIX closed at 12.8, a new low in the post-Pandemic era
- in fact, VIX has only closed < 13 on 75 occasions over the last 5years
- VIX has now spent over 125 days trading below the 200 day Moving Average
- its been over 120 trading days since VIX posted consecutive closes over the 20 level - the longest such streak since 2017

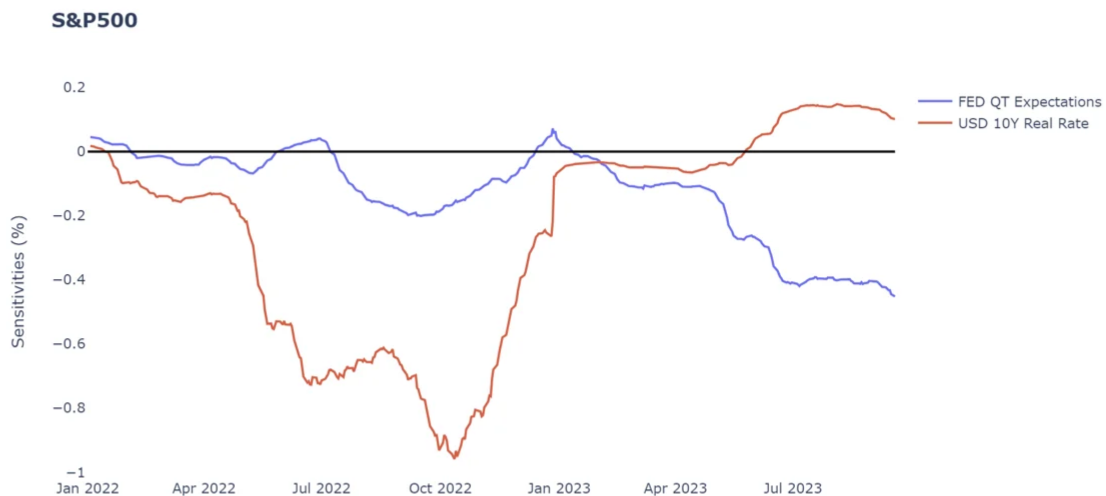
Less well publicised is that the most popular indicator of interest rate volatility - the MOVE index - closed at its lowest level since Mar 2022 on Friday.

Qi employs swaption (instead of US Treasury) volatility but they capture the same story. Higher volatility in the rates market tends to be associated with periods of stress. Obvious culprits in recent years have been monetary policy fears - the 2013 Taper Tantrum, the 2022 inflation fight.

Traditionally, higher rate vol is a headwind for risky assets like equities. So the chart above showing the collapse in rate vol in z-score terms in the US, Europe and UK is good news.

But why should equity investors care about this relatively obscure part of capital markets? Because Qi's models show that falling rate volatility is critical right now.

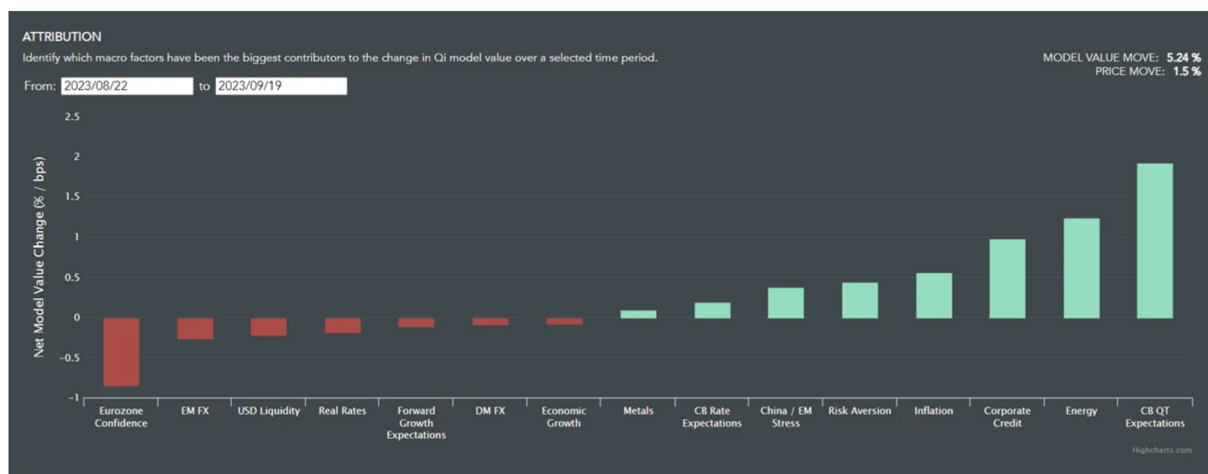
More important, in fact, than the level of bond yields. The chart below shows the percentage shift in the S&P500 for a one standard deviation shock higher in both 10y US real yields and US rate vol. Remember every other macro factor is held **constant** each time to show the true, **independent** impact of each factor shift on SPX.



Real yields were the story in 2022. As the Fed abandoned transitory and embarked on an aggressive rate hike campaign, real yields became the main transmission channel by which policy tightening impacted the equity market.

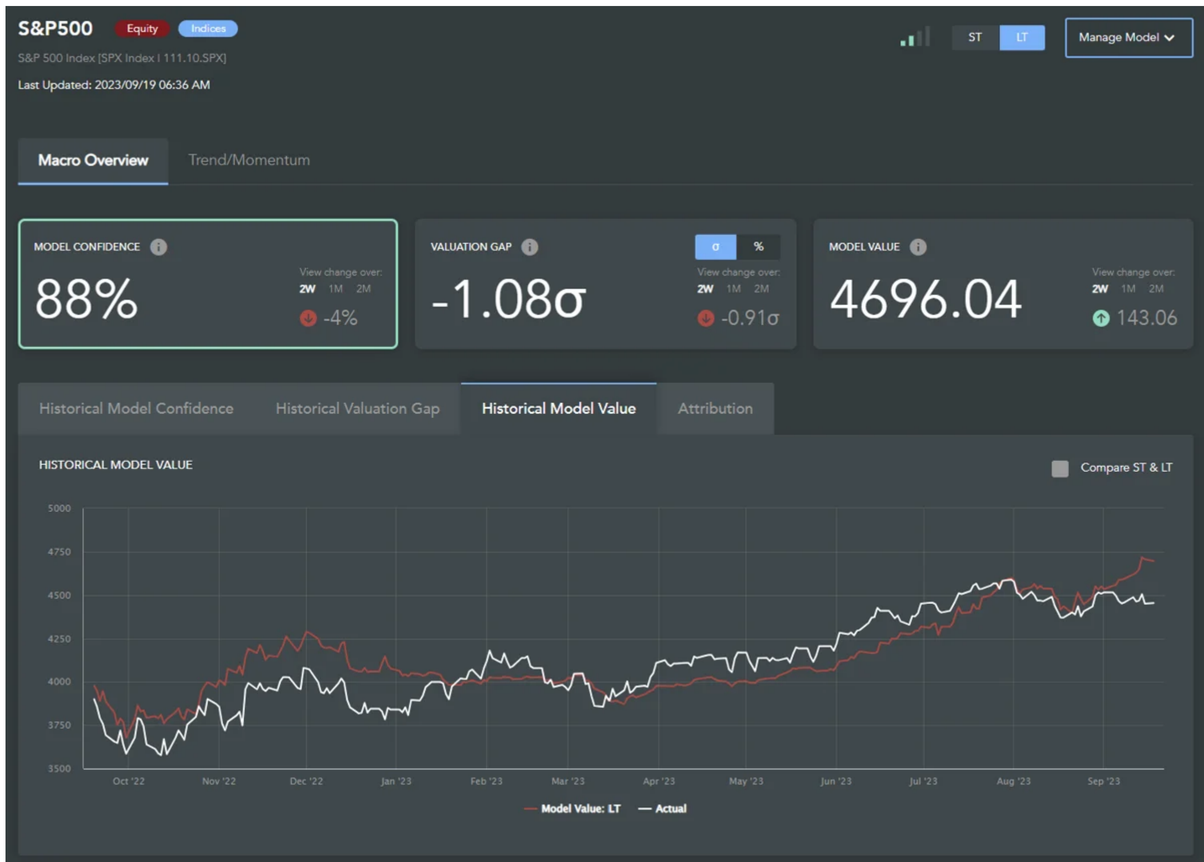
At its peak, a one standard deviation rise in real yields equated to a 1% fall in the S&P500. Today sensitivity is close to zero.

Meanwhile in 2023 the story has been the **rising importance of interest rate vol** which Qi labels 'FED QT Expectations'. It has moved in the opposite direction. S&P500 sensitivity was effectively zero over H2 2022, but factor leadership has changed and it has become a highly prominent driver.



That can also be seen in the attribution chart above. Other bond market signals like the level of real yields or shape of the yield curve have had little effect on S&P500 model value over the last month.

Instead low rate vol, tight credit spreads and the rally in crude oil have been instrumental in moving macro-warranted model value for the S&P500 up 5.24% over the last month.



That improvement in macro conditions has not been mirrored by the market. Hence the S&P500 now screens as over one standard deviation cheap on our metrics.

The case for lagged policy effects and a recession haven't gone away. Indeed, there are mounting signs that economists are capitulating on recession forecasts just as deeper cracks open up.

It is still all about **Goldilocks or Bust**. But, for now, Goldilocks still has the edge.

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