Wednesday, October 18th

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Risk Parity or Risk Party?

UST30-year
Courtesy: Bloomberg
Though everyone is eager to call the end of the three-decade bull Market in bonds, it hasn't happened yet…
100.0%(10.2200)
61.8%(7.1183)
50.0%(6.1602)
38.2%(5.2020)
0.0%(2.1003)
100.0%(6.7470)
61.8%(4.9720)
50.0%(4.4237)
38.2%(3.8753)
15.0%(2.7973)
0.0%(2.1003)
10.0000
9.0000
8.0000
7.0000
6.0000
5.0000
4.0000
3.0000
2.8050
2.0000
1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017

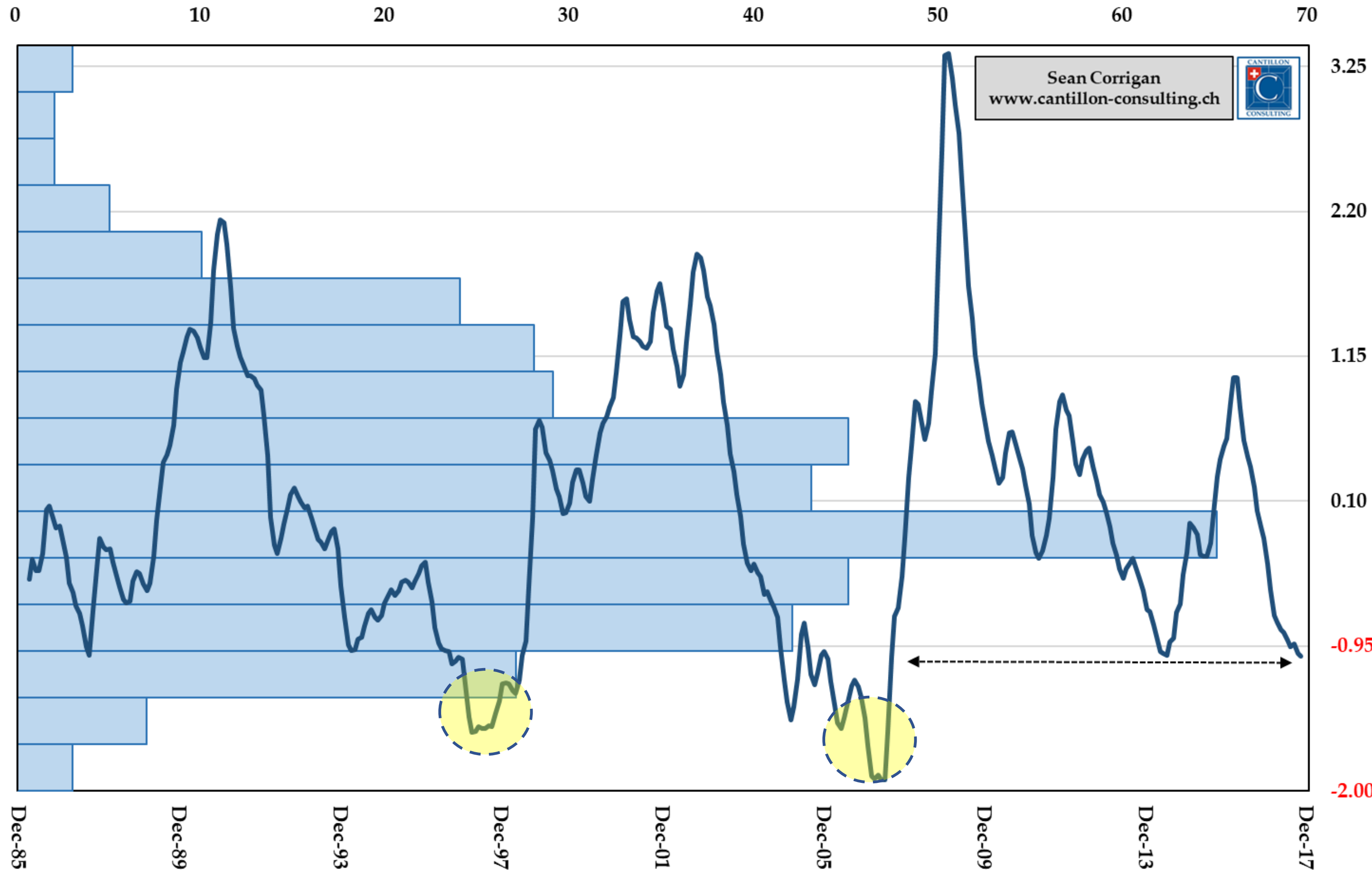
Implied *real* yields are also still unconscionably low and furthermore are becoming ever narrower in range – often a sign of turbulence ahead
Courtesy: Bloomberg
US 10-yr TIPS
100.0%(4.4000)
85.0%(3.6011)
61.8%(2.3651)
50.0%(1.7365)
38.2%(1.1080)
15.0%(-0.1279)
0.0%(-0.9269)
4.0000
3.0000
2.0000
1.0000
0.4135
0.0000
-1.000
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017

All part of the general story of a falling sense of both macro and market risk.

US Treasuries 2y v 10y, Divergence from 1981-2017 Mean: *Source - FRED*

The extra return to be had for accepting maturity risk has fallen to decadal lows…

PS: For those who insist on appealing blindly to this gauge as some sort of recession probability warning, without considering what message it is supposed to be sending about economic conditions at the turn of the cycle, this is still a *l-o-n-g* way from the danger zone.



In fact, everywhere we look, the rewards for accepting extra risk are falling.

With regard to credit quality, junk is now trading at the lowest spread since the Crisis and is thus heading back into the danger territory of the Asian Contagion/LTCM episode of the mid-90s and, beyond that, to the pre-LEH excesses of a decade ago

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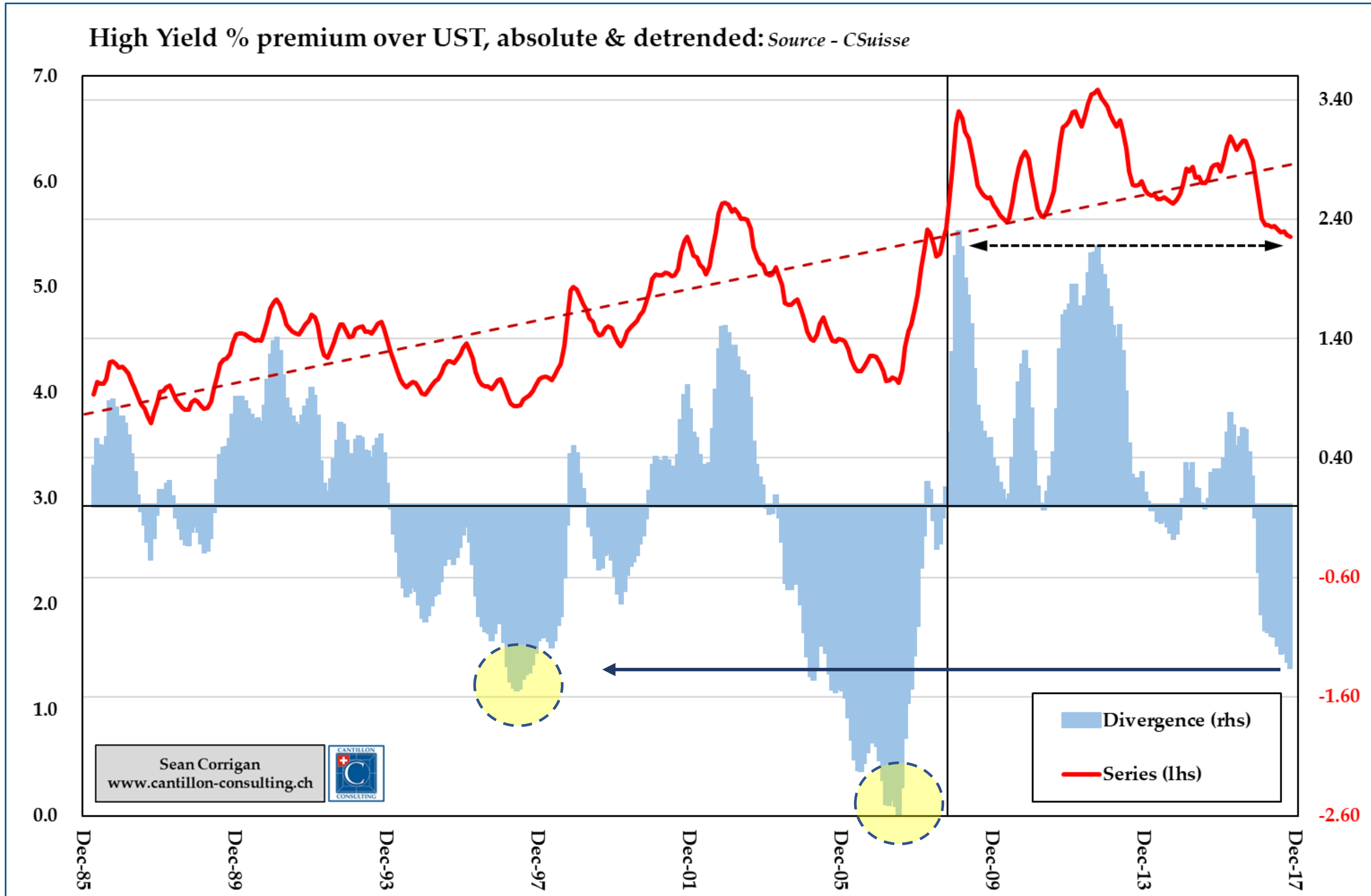
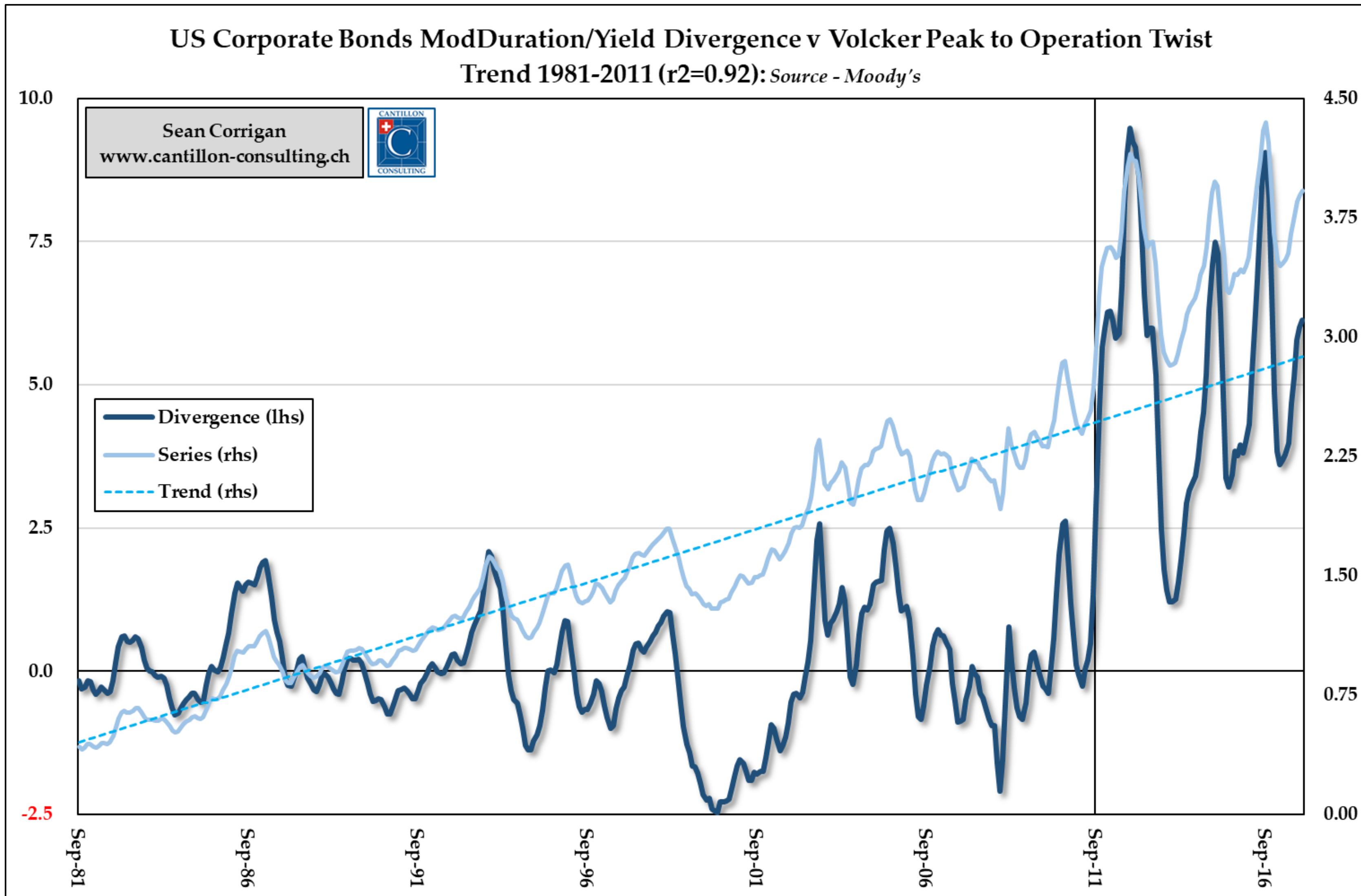


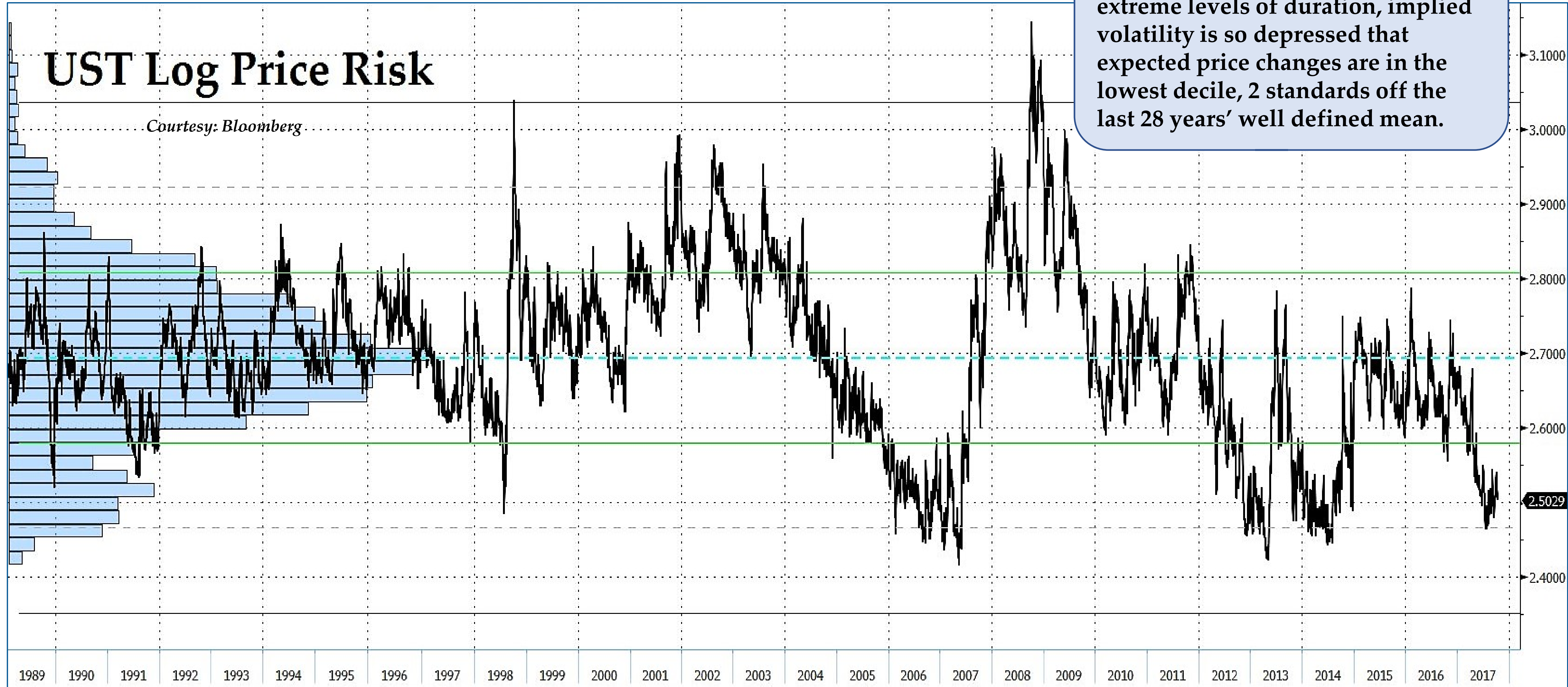
…something equally evident if we look at the percentage premium on offer, not just at the arithmetical difference.

NB, the last three recessions have seen spreads blow out to the classic 'distressed' threshold of 1000bps over: today they stand at barely 400.

Be warned!



Meanwhile, the length of holding time needed to make up for an adverse yield change – approximated by the dividend of the modified duration and the YTM – has been pushed by central bank intervention to multi-sigma extremes, even *after* allowance is made for the rising secular bull market trend



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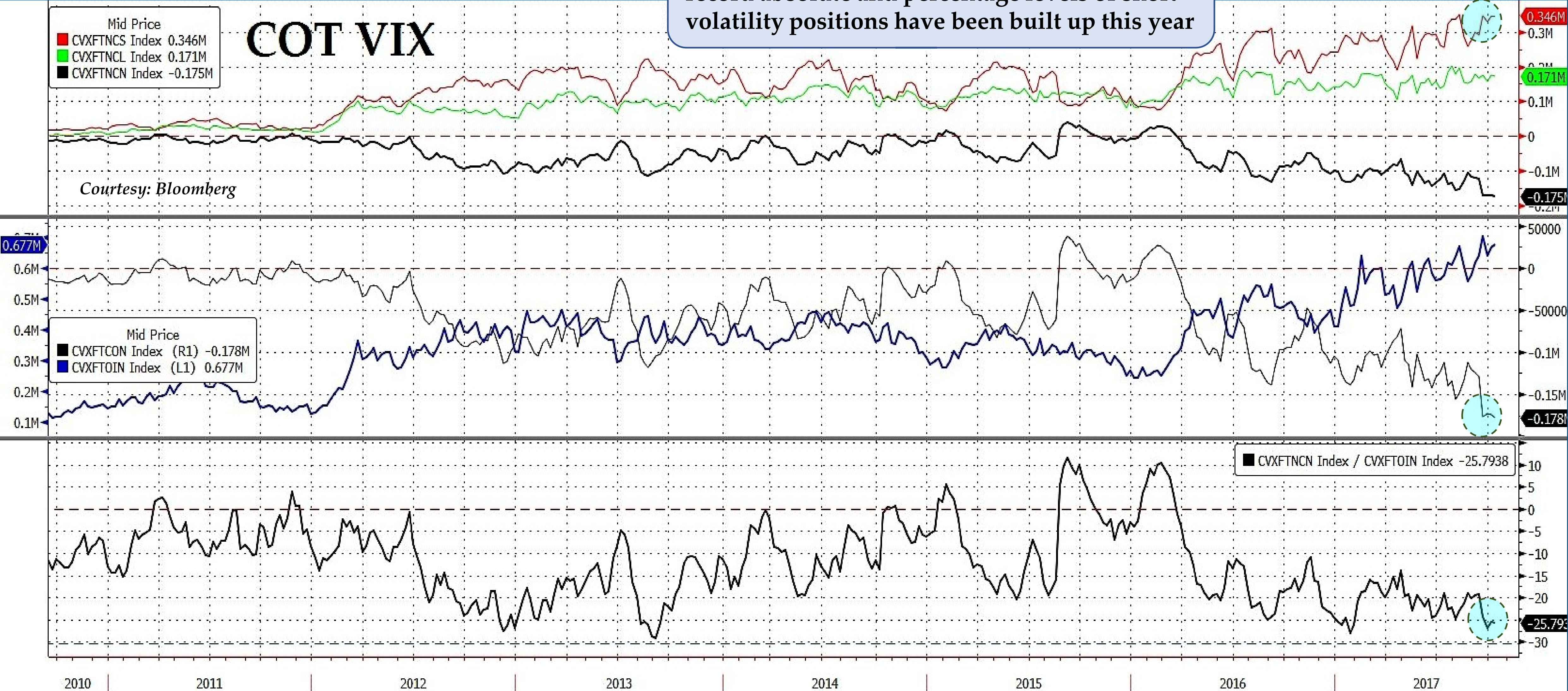
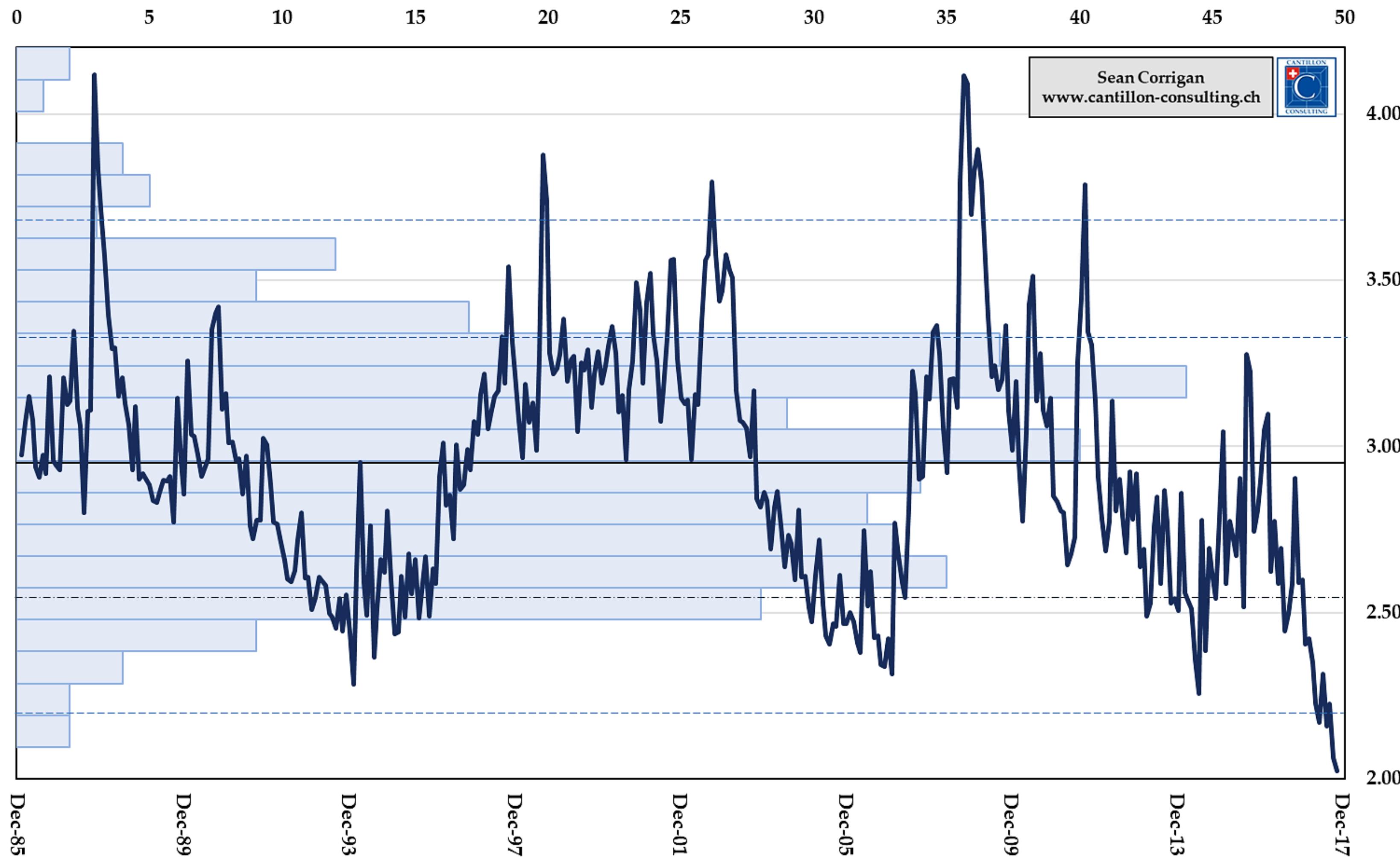
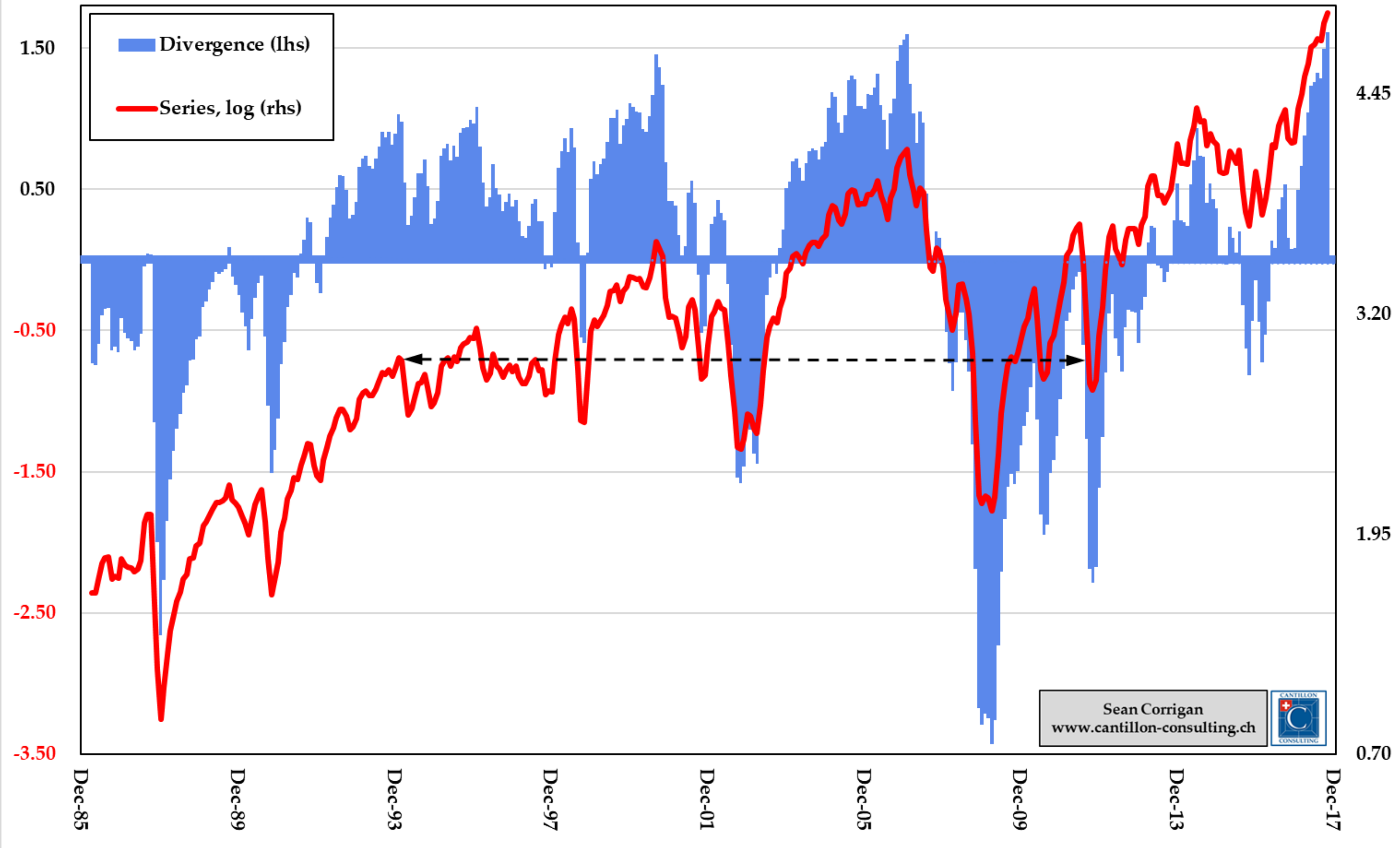
Much the same dynamic applies to stocks as record absolute and percentage levels of short volatility positions have been built up this year





…and – guess what? – this has pushed implied vol out through the bottom of the past 30-years' experience



Scaling this by the stock level itself – to give us a rough, inverse measure of the percentage premium people are willing to pay for protection – we are again at new absolute and trend-adjusted highs of insouciance

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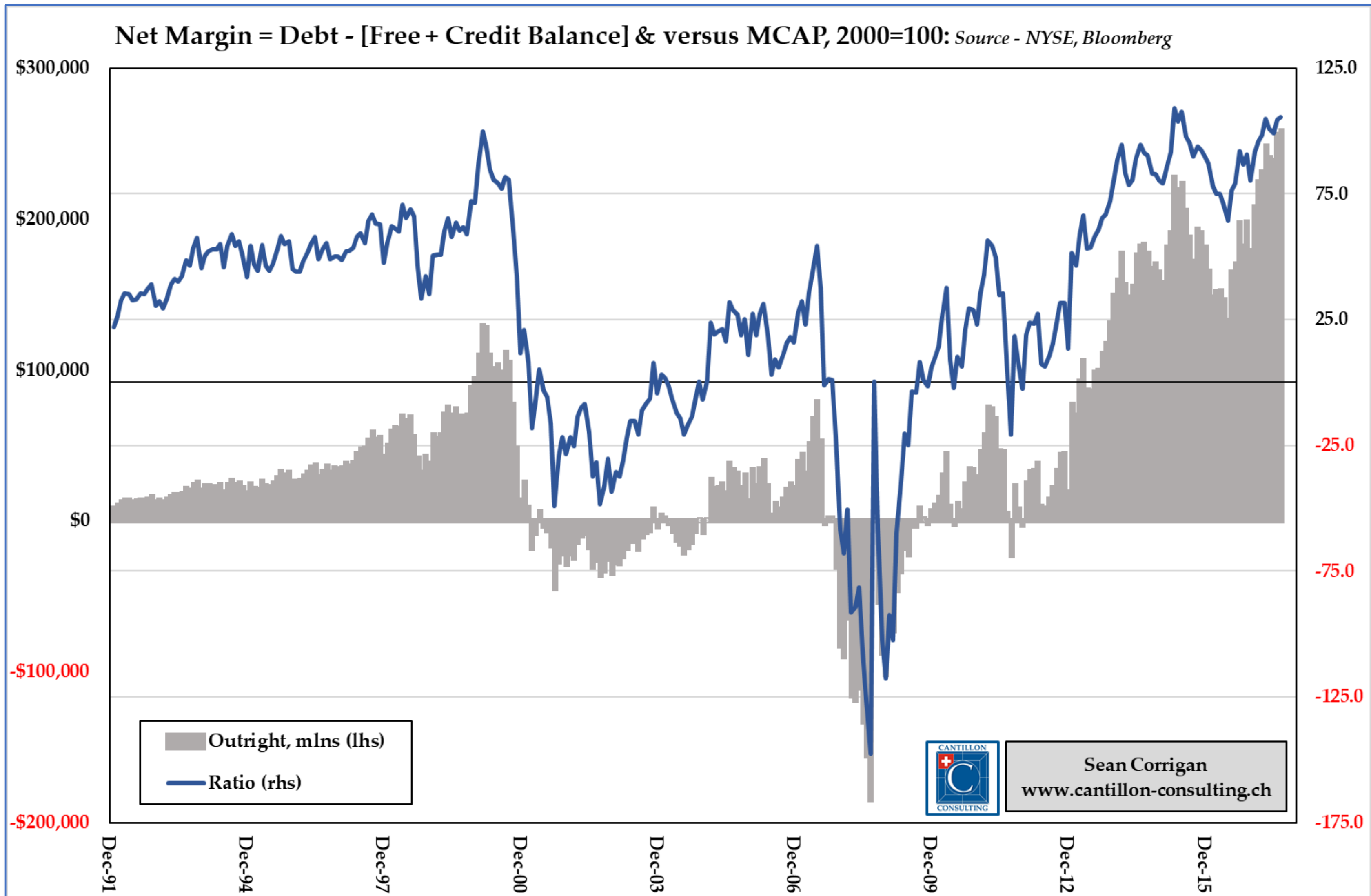

But, if there is no perceived risk, the only way to structure a portfolio is to add leverage, right?

Net margin debt on the NYSE is therefore hitting absolute and proportional records

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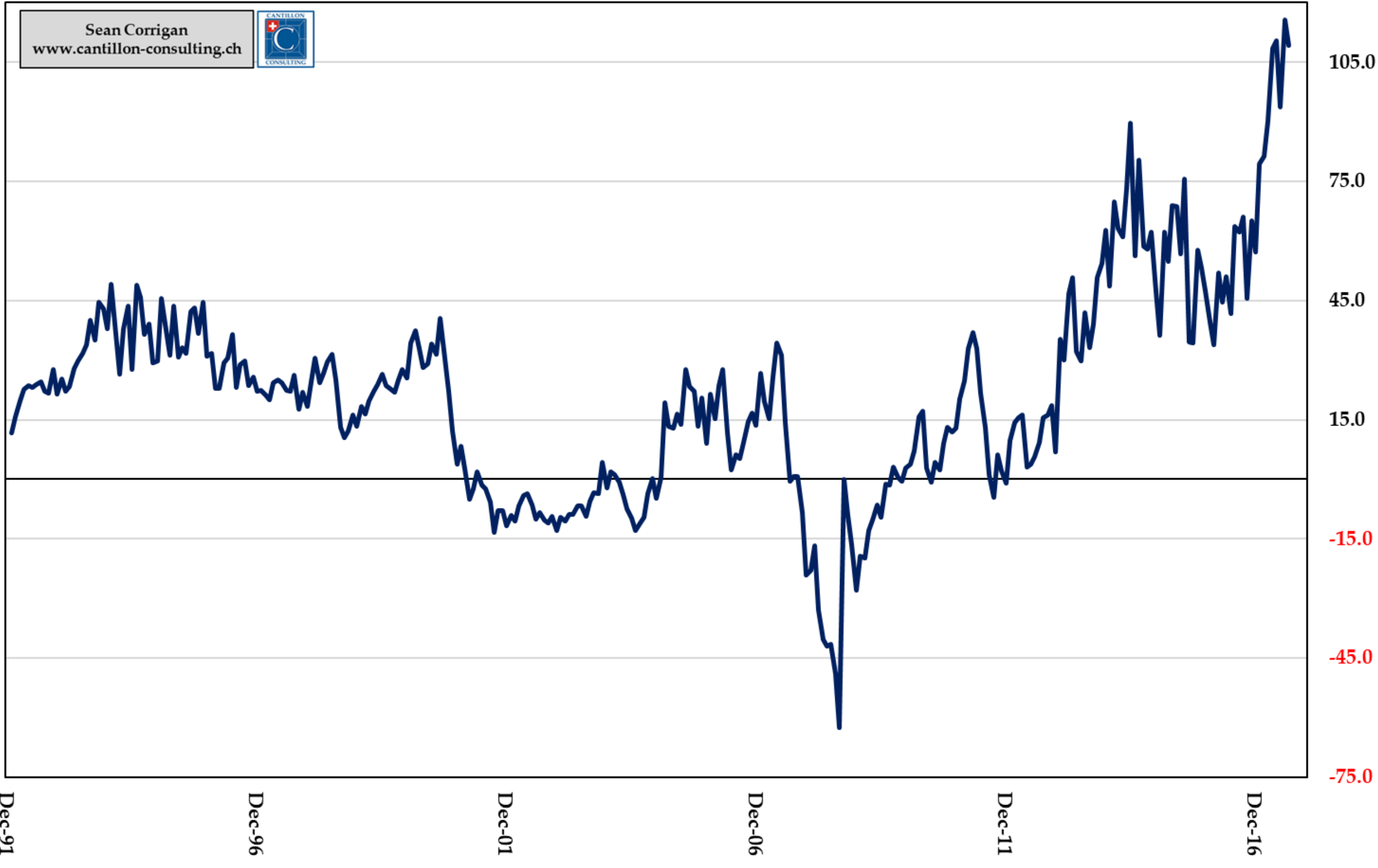

Taking another perspective, by putting the last two graphs together, if we let net margin debt as a percentage of market cap stand in for a measure of leveraged sensitivity - and hence of the potential price changes under conditions of liquidation – it, too, registers an unprecedented multiple of the market's estimate of volatility

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Finally, if we combine our measures of stock and bond risk into a single geometric average, we find ourselves once more falling off the bottom of the chart. UGH!
Combined Stock & Bond Risk
Courtesy: Bloomberg
2.50
2.00
1.50
1.00
0.50
0.3304
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
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2006
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2008
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