Hello Market Volatility!

by Steve Brown

Perhaps we had all become a little complacent over the past few months. Equity markets were setting new highs almost every month and while Treasury yields have been trending lower, mostly the move has been gradual and explainable. Market volatility has been low for quite some time and so the activity of the last couple of weeks has certainly made folks sit up in their chairs. The gyrations, as measured by the CBOE Volatility Index (VIX), were not as large as those that came with the debt ceiling crisis of 2011, but since that time, market volatility has been close to non-existent. When the VIX doubled between Oct 8 and Oct 15 and reached its highest level since the fall of 2011, we heard various reasoning from the yammering heads on financial television, but we still scratched our heads.

During this period, there were also statements from several members of the Fed. James Bullard of the St Louis Fed said that the FOMC might need to reconsider whether to end its QE3 bond buying at its next meeting. Others like Dallas Fed president Fisher opined that there is no reason to delay the end of QE3. This is strange when you consider that just two weeks ago, any question as to whether the Fed will end QE3 this month would have been considered preposterous. We will know soon as the FOMC will release its latest policy statement today around 2PM ET. When they do, our bet is that they will announce the end of QE3 as planned.

The question that continues, though, is what do the gyrations of the markets mean for the economy longer term and for community banks? A number of factors have contributed to the big market moves. Slowing economic growth in Europe and China is ongoing and worsening, and there was media-driven panic about the possible spread of Ebola in the US. There were also a number of domestic economic reports that came in on the weak side, including a larger than expected drop in retail sales. Was this enough to merit an intraday drop of more than 350 points on the DJIA and cause the yield on the 10Y Treasury to momentarily drop more than 30bps to 1.83%? There are very real concerns about the global economy and equity markets that have been very high based on marginal economic growth. The 10Y Treasury yield falling below 2% even momentarily is a little shocking.

Since this odd period, equity markets have recovered much of their big drop and the DJIA yesterday closed above 17,000. Treasury yields have risen though the 10Y is still at a surprisingly low level at around 2.29%. It is worth noting that this is 73bps below where we began the year. Yields across the curve are quite low for an economy that has been growing for more than 5Ys, so investor angst remains.

Some other factors that are putting downward pressure on Treasury yields include projections that the economic recovery may be getting long in the tooth by most historical measures. This, and some slowing economic reports, has at least a few pundits concerned that a recession could be imminent. In addition to that, investors looking for safe-haven investments tend to look toward sovereign bonds of countries with strong credit quality. Current Treasury yields look like a bargain compared to most others around the world. The Japanese 10Y government bond is yielding around 46bs. In Europe the 10Y German Bund is yielding around 0.88%. Even in Italy with its wobbly economy and deficits, 10Y government bonds are yielding 2.53%. Treasury yields are attractive by comparison, with the economic strength of the US and its credit quality.

All indications from the Fed still point to policy tightening and a rising Fed Funds rate sometime around mid-2015. How high rates will go remains a question though. Given the drop in longer term interest rates, banks should be prepared for a number of scenarios: higher rates overall (what most banks have been anticipating for some time), higher short term rates but a flatter yield curve, or just a continuation of the current environment. If your ALM models are based on simple shocks, it is time to broaden your analysis of what could be coming down the road. We are approaching yet another time of change and recent market volatility is simply an expression of concern. Make sure your bank is prepared for whatever may occur by taking a robust look from a number of directions.

BANK NEWS

Economic Damage

The Wall Street Journal reports on an economic study by a John Hopkins University professor using data from 23 countries. The study found that countries were hit hardest by the recession also saw the greatest long term damage to their economies. According to his calculations, potential growth for the U.S. was hit by 4.7% vs. a whopping 30% for Greece.

Job Interview

Online job search company Glassdoor finds 33% of companies will put potential new hires in front of a group when interviewing them for an open position.

Video Interview

Workforce consulting company Right Management finds 20% of job candidates sat through a video interview vs. about 10% the prior year.

Rich People

Forbes reports about 50% of global wealth is controlled by 1% of the population.

Budget

The Congressional Budget Office (CBO) projects the US deficit will decline to $492B in 2014, but then rise to $1T by 2022. The large increase is expected to be driven by an aging population, rising health care costs, expanding federal subsidies for health insurance and rising interest payments on federal debt.