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The Week That Was

Author:
Sean Fallon, CFA
Senior VP

Mr. Fallon joined Stephens in July of 2012 to Head the Municipal Taxable efforts and to trade CMBS, Agency CMBS, and ABS. He has 19 years of experience managing and trading fixed income assets. Mr. Fallon holds a Bachelor of Arts in Political Science from St. Mary's College and both an MS in International Management and MBA from University of Maryland. He also holds the Charter Financial Analyst and Chartered Market Technician designations.

sean.fallon@stephens.com

Stephens Inc.
111 Center Street
Little Rock, AR 72201

501.377.3466
800.643.9691

www.stephens.com

Member NYSE, SIPC

If a tree falls in a forest and no one is around to hear it, does it make a sound? For centuries philosophers have challenged our understanding of reality with this question to get us to ask the more important one: Without some modicum of sensory input does anything exist? If you can see, touch, or smell the tree then logic would dictate that the tree is real. But devoid of these stimuli you are merely relegated to a circuitous exercise in philosophical questioning.

Logic would seem to dictate that if we know the characteristics of a tree we could deduce what sound it would make if it did in fact fall. After all, based on past experiences there should be some level of predictability around the sensory output whether we observe the tree falling or not. The challenge to this riddle resides in producing evidence that the tree did in fact make a sound--and without any sensory proof you cannot.

As I watched the markets this week I was reminded of the puzzle of the tree. The financial markets have a seemingly endless series of data points that would seem to prove that they exist. However, just because you can see a price level does that mean is it real? Moreover, given the lack of volume that we have seen in recent trading sessions, can we say that any of the levels are real?

With financial instruments, logic would dictate that if any pricing is real it should be stable. However, investors are witnessing price swings that would seem to be at odds with this presupposition. As an example, in U.S. rate trading this week, 30-year Treasuries had a 25-basis-point range, marking the third week in a row that we have seen a range in excess of 20 basis points. Why are we seeing these large swings? Primarily it would appear to be a lack of buyers. Trading volumes have fallen by 7% since the start of the year and are down in excess of 10% vs. levels seen a year ago.

But the lack of liquidity and the associated large swings in price levels is not just a domestic phenomenon. European rates have seen similar moves and over the last 30 days the German 10-year Bund has seen its yield rise by 60 basis points. 10-year Bunds finished the week at 0.62%, which was the highest close for the 10-year since December 2014.

In addition to waning volume, the other element that is driving volatility is central bank stimulus. European rates fell to the extent that they did tie to European Central Bank purchases just as they did domestically. Conversely, once their buying ebbed the market quickly began an exercise in re-pricing itself.

In looking at the overall fixed-income market this week most sovereign credits finished the week higher as yields dropped by 5 to 10-plus basis points. This was a sharp reversal from the recent sell-off that caught many investors off sides. In the corporate credit markets yields on investment-grade names rallied by 1 to 2 basis points, while high-yield names finished the week 1 to 2 basis points wider.

Domestically, U.S. rates put in a solid performance as yields overcame an early week sell-off to finish the week lower. The one exception was the 30-year Treasury, which finished the week at 2.91%--roughly 2 basis points higher on a week. However, the long bond's finish was nonetheless impressive as its close was 22 basis points off of its intraweek highs in yield. The middle of the curve put in the best performance of the week, with yields in the 3- to 5-year segment falling by 3 to 4 basis points.

With the long-end's underperformance the curve finished the week steeper as most relationships widened by 2-plus basis points. The spread between 5-year and 30-year Treasuries was the biggest mover of the week as the relationship widened by 6 basis points, finishing the week at 141. Down the curve the steepening was more muted as the spread between 2-year and 10-year Treasuries widened by only 2 basis points, finishing the week at 157.

As we close the week, we are seeing investors being forced to reassess their assumptions tied to both pricing and market stability. After all, stable liquid markets do not see 4- to 5-point price swings during the normal course of trading. The historically unprecedented levels of stimulus have completely skewed both risk and return, and when combined with the waning volumes, a very unstable backdrop is being created.

The riddle about the falling tree forces you to question your perceptions and need for sensory inputs to determine what is real. I believe that investors are being given a similar riddle by the markets--one where despite the sensory inputs (data), the reality of the perceptions based on those inputs must be questioned.