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Bond Swings So Extreme Even BlackRock Rewrites Risk Measures

by Eshe Nelson

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With $4.8 trillion in assets -- or about the size of Japan's economy -- no one manages more money than BlackRock Inc. So, it's worth paying attention when the firm says it's time to cast aside its trusted models for assessing risk in bonds.

The gyrations gripping the world's fixed-income market are so great that it's almost impossible to make sense of them on a historical basis. In Germany, for example, yields on 10-year securities have surged from almost nothing in late April to about 1 percent last week -- a move so swift that some strategists are likening it to a once-in-a-generation event.

"The German bund market is incalculably volatile," said Scott Thiel, BlackRock's deputy chief investment officer for fundamental fixed income in London. "It doesn't make sense to measure it in traditional respects."

Across Europe, investors are ripping up their old models to analyze the $100 trillion global bond market that dictates how much consumers and companies pay to borrow. Volatility is soaring as central-bank policies diverge, whiffs of inflation emerge and new regulations cause big banks to back away from their traditional role facilitating buying and selling.

The moves have led to losses of $640 billion in sovereign debt worldwide since the end of April, raising concerns about contagion given the bond market's explosion in size since the credit crisis. The amount of debt in Bank of America Merrill Lynch's Global Broad Market Index has ballooned to more than $41 trillion from about $26 trillion at the end of 2007. Citigroup Inc. now sees more risk in European government bonds than when Lehman Brothers Holdings Inc. collapsed in 2008.

BlackRock Models

BlackRock is testing how risky its holdings are by running them through new worst-case scenarios that assume more volatility and varying correlation among asset classes. And strategists at JPMorgan Chase & Co., the world's biggest debt underwriter, now see the need to calculate a "liquidity premium" for top-rated, longer-maturity government bonds in Europe, a new wrinkle for benchmark securities that are considered the safest assets available because of their deep markets.

The selloff is "questioning what is the right price given the current illiquidity in these asset classes," said Nandini Srivastava, a global market strategist at JPMorgan in London. The difficulty in assessing the amount of risk "exacerbates the problem as you have investors on the sidelines thinking 'Are these really the right prices and yield levels?'"

Volatility Surge

Yield volatility on 10-year bunds has climbed to nine-times its average during the past 15 years, giving traders a taste of the turbulence European Central Bank President Mario Draghi said June 3 they should get used to as the byproduct of record monetary stimulus.

A measure of 30-day volatility on bunds surged to 300 percent in May. It hadn't gone above 100 before this year, in data compiled by Bloomberg going back to the middle of 2005. The market's gyrations are being magnified by record-low yields: In the week of Draghi's remarks, yields soared 0.36 percentage point, the biggest jump since 1998. The yield was at 0.82 percent on Monday at 6:19 a.m. in New York, up from a record of 0.049 percent on April 17.

"Investors should be pricing in more risk," said Grant Peterkin, a money manager at Lombard Odier Investment Managers, which oversees 161 billion Swiss francs ($172 billion). "Given bonds steadily rallied for a long period of time, the low volatility suggested they were low risk, which potentially forced investors to buy more of them."

The danger is that this kind of instability may seep into other assets, he said. This could pressure companies as well as governments with rising borrowing costs. Yields on junk bonds around the world have collapsed to about 6.6 percent, versus their average of 9.7 percent since the end of 1997, according to Bank of America Merrill Lynch index data.

Risk Measure

Citigroup strategists are recommending investors measure their vulnerability by placing more emphasis on duration -- a gauge of a bond's sensitivity to interest-rate changes -- and the amount a country has borrowed, in addition to volatility, according to Alessandro Tentori, head of international rates strategy.

BlackRock is testing how its holdings would perform in scenarios like the dislocation in peripheral debt in 2011 and 2013's taper tantrum. It's also looking at how they'd react to sharp moves in the Standard & Poor's 500 Index.

"It's challenging, particularly when the correlations change, that's the most difficult thing," Thiel said.

Smaller Trades

Allianz Global Investors is running potential investments through Armageddon scenarios to find positions that will hold up if markets turn, according to Mauro Vittorangeli, a senior fixed-income money manager in Paris. The firm is increasing its use of options and is short duration to tackle volatility. Additionally, it is buying European peripheral bonds as the ECB keeps pumping stimulus into the region's economy.

JPMorgan Asset Management is putting on smaller positions in response to the recent price swings to lower risk, said David Tan, the London-based head of rates at the asset-manager, which oversees $1.7 trillion. Should the selloff persist, other areas of the fixed-income market could get nervous and we could see a "taper tantrum-type reaction," he said.

"If you have more volatility, you have to be more careful when it comes to sizing trades and you do not want to be over your skis," said Tan. "We need to have our eyes wide open that there is now two-way risk in markets."