



MOVE Index Signals Rate Cut

Bond volatility gauge provides Fed insight, analysis shows.

June 2019

KEY INSIGHTS

- Based on analysis of historical data, the Merrill Lynch Option Volatility Estimate (MOVE) Index indicates that a Fed rate cut has been likely since late May.
- The key question is whether the first cut will be an insurance cut or the start of a new easing cycle aimed at mitigating the impact of an imminent recession.
- Around historical insurance cuts, the MOVE peaked just before or shortly after the initial Fed move and then trended lower.

The Merrill Lynch Option Volatility Estimate (MOVE) Index indicates that a Federal Reserve rate cut has been likely since late May. Of course, this outlook has become priced into the market as the trade war with China has escalated, weighing on U.S. economic growth. More meaningfully, the MOVE can also provide insight about whether the first rate cut is an “insurance” cut meant to boost confidence and extend the economic cycle or is the beginning of an easing cycle as the economy falls into a recession.

The MOVE Index is essentially the fixed income market’s version of the better-known Cboe Volatility Index (VIX) for equities. The MOVE Index calculates the future volatility in U.S. Treasury yields implied by current prices of options on Treasuries of various maturities. Implied volatility can be seen as a measure of the cost to insure against outsized interest rate moves,

either upward or downward. In addition to the MOVE, we also monitor data such as the difference in yield between three-month and 10-year Treasuries, trends in initial jobless claims, and the Institute for Supply Management’s manufacturing index level for clues about the direction of the Fed’s monetary policy.

Historical Analysis of MOVE and Fed Funds

A T. Rowe Price analysis of historical data for these variables and the federal funds rate showed that the MOVE has historically provided strong signals about the Fed’s monetary policy path. We examined levels of the MOVE before and after the five most recent occasions when the Fed cut rates for the first time following a pause in a tightening cycle: June 1989, July 1995, September 1998, January 2001, and September 2007. (Historical data for the MOVE extend only to the late 1980s.) The analysis



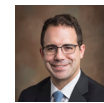
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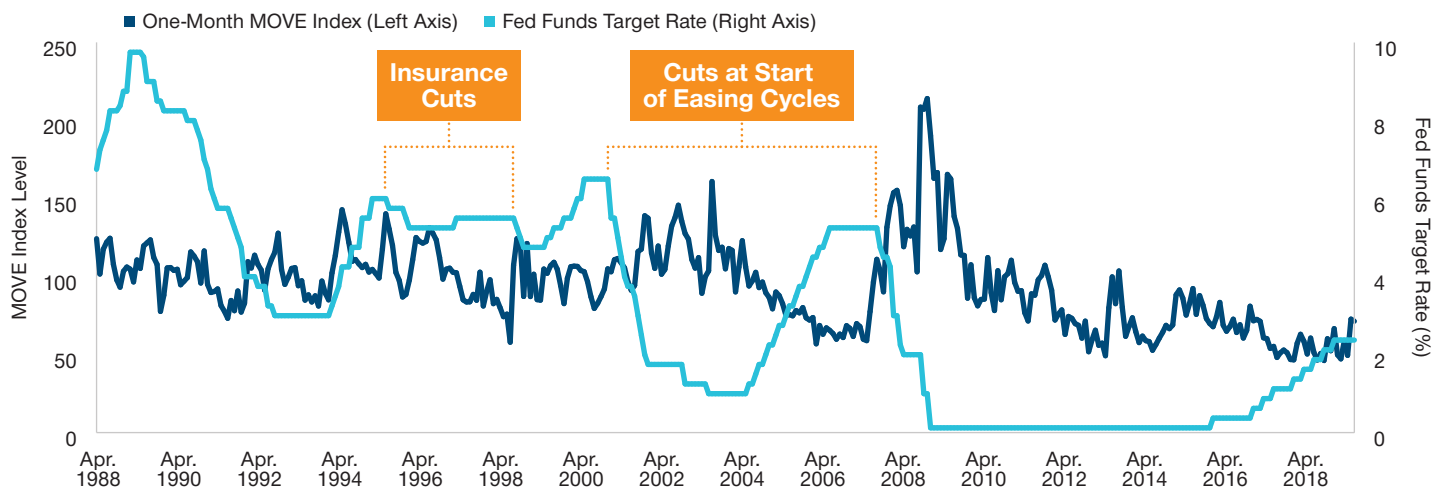


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(Fig. 1) MOVE Bottoms Two Months Before First Cut

MOVE Index and fed funds rate since MOVE inception
As of June 19, 2019



Sources: Bloomberg Finance, L.P.; Bank of America Merrill Lynch; and U.S. Federal Reserve.

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indicated that the MOVE typically hits a cycle low around the same time that the three-month/10-year yield curve inverts. The Fed typically cuts rates, on average, two months after the MOVE reaches a bottom.

The current cycle appears consistent with the historical behavior of the MOVE just before a Fed rate cut. The MOVE hit its lowest-ever level on March 20, indicating that a rate cut could be imminent from the Fed as early as its June policy meeting, given that the April/May meeting ended on May 1. Several other indicators corroborated that we had entered a rate-cutting environment. While the Fed did not lower rates at the June meeting, its policy statement indicated that it was ready to ease if the economy continued to slow.

Insurance Cut or Start of Easing Cycle?

Immediately following the June Fed meeting, fed funds futures contract prices showed that markets saw a first rate cut at the July Fed policy meeting as a near certainty, with the potential for more to follow. The key question is whether that first easing step would be

a short-lived insurance cut designed to extend the economic cycle as opposed to the start of a new easing cycle aimed at mitigating the impact of an imminent recession.

The Fed’s rate reductions in 1995 and 1998 proved to be insurance cuts. In 1995 and early 1996, the central bank lowered rates three times and managed to prevent a slowdown in growth from becoming a recession. In the second half of 1998, the Fed cut rates three times to successfully prevent contagion from the meltdown of the Long-Term Capital Management hedge fund and financial crises in international markets.

MOVE Reaction to Inform Portfolio Positioning

Around historical insurance cuts, the MOVE peaked just before or shortly after the initial Fed move and then trended lower—indicating that the cut had delivered its desired calming effect. In contrast, the MOVE remained elevated for an extended period after the first rate reduction in an easing cycle that led into a recession, such as in 2001 and 2007. Given the

information value of this indicator in past cycles, we will closely monitor the MOVE following the first rate cut

this year to inform the interest rate and overall risk positioning in our core taxable bond portfolios.



WHAT WE'RE WATCHING NEXT

We will continue to track the direction of the economic and yield curve indicators listed above for information about the reaction of the economy and Treasury market to the Fed's first easing steps. In addition, we will be watching for signals of a quick resolution or a further escalation in tensions surrounding the ongoing trade war with China. Either of these outcomes would likely change the central bank's view of the economy and its monetary policy outlook.

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