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The Day Ahead: Fed and Bank of Japan on Wednesday

The past several years have marked a historically low level of a volatility in interest rates. People define volatility in different ways, so let's just agree that the gaps between the highs and the lows have been smaller over the past few years than they were any time before that. This will be **easy enough to see** in today's first chart.

The root cause of this phenomenon is a bit more open to debate, but there are **2 good possibilities** that jump to mind (my mind, anyway). The first is that rates will naturally grow less volatile as they asymptotically approach zero. This assumes, of course, that rates are indeed asymptotically approaching zero as the global economy matures, productivity levels-off, birth rates decline, and exponential drivers of growth (like the industrial revolution, the tech boom, the wheel, and fire) become fewer and farther between.

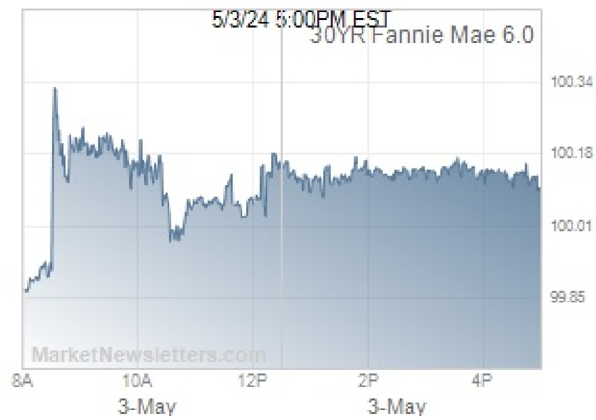
Even if you don't believe in that kooky narrative, it's easier to say that the Fed seems to be engineering a certain sort of **chaos** that is more and more **controlled**. In other words, the Fed is taking market reactions around the world into consideration before pulling the trigger on policy changes. When rates have been at their lows, the Fed has been more likely to talk about things like tapering (in late 2012 and early 2013) and hiking rates (in early 2015).

But what if volatility was able (or allowed) to return to historical norms? It's interesting to consider that by the end of the year, levels such as 2.5% or 0.5% would be within the **"normal"** range of volatility for 10yr yields--a jump of a full point from the current linear regression point (yellow line) of 1.5 in the following chart. Yet most of us will probably be surprised if we see even half that.

MBS & Treasury Market Data

	Price / Yield	Change
MBS UMBS 6.0	100.09	+0.31
MBS GNMA 6.0	101.03	+0.29
10 YR Treasury	4.5138	-0.0657
30 YR Treasury	4.6711	-0.0579

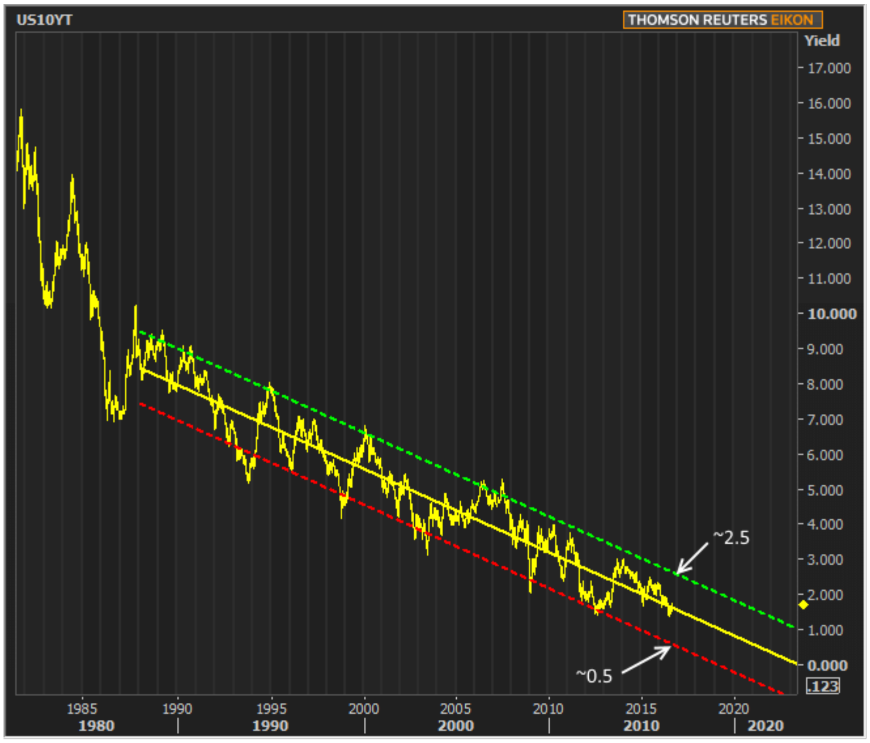
Pricing as of: 5/3 5:04PM EST



Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.28%	-0.09	0.00
15 Yr. Fixed	6.75%	-0.07	0.00
30 Yr. FHA	6.70%	-0.12	0.00
30 Yr. Jumbo	7.48%	-0.07	0.00
5/1 ARM	7.35%	-0.07	0.00
Freddie Mac			
30 Yr. Fixed	7.22%	-0.22	0.00
15 Yr. Fixed	6.47%	-0.29	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	7.24%	+0.11	0.66
15 Yr. Fixed	6.75%	+0.11	0.64
30 Yr. FHA	7.01%	+0.11	0.94
30 Yr. Jumbo	7.45%	+0.05	0.56
5/1 ARM	6.64%	+0.12	0.87

Rates as of: 5/3



While the Fed isn't likely to come out and say "you're on your own" and let rates take their natural course, they do stand at least some small chance of surprising markets with a hike this week. To be sure, this is NOT at all likely based on Fed Funds Futures, although polls of economists place the probability **closer to 50%**. If the Fed does hike, it could contribute to a scenario that makes recent market movements continue to roughly follow the pattern seen in 2011-2013, the last time rates hit long-term lows and then came to terms with the need to move higher.

Granted, 2013 relied on something of a **rude awaking** in the form of the taper tantrum, so it might not seem like we have anything quite so big at stake this time. That's probably a safe assumption, but not because the Fed is buying assets that it might stop buying. Rather, the risk is that other central banks--namely, Europe's (ECB) and Japan's (BOJ), might be on the verge of making the same sort of hints that the Fed made in late 2012 and early 2013, before the taper tantrum hit.

With that in mind, Wednesday's **Bank of Japan announcement** is just as important as the Fed announcement. The BOJ isn't expected to suddenly end its stimulus efforts, but they may shift their focus toward rate policy as opposed to asset purchases, and that could cause a good amount of volatility before the Fed announcement hits.

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