Remarks on Uncertainty and Financial Markets

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The Economic Implications of Heightened Uncertainty
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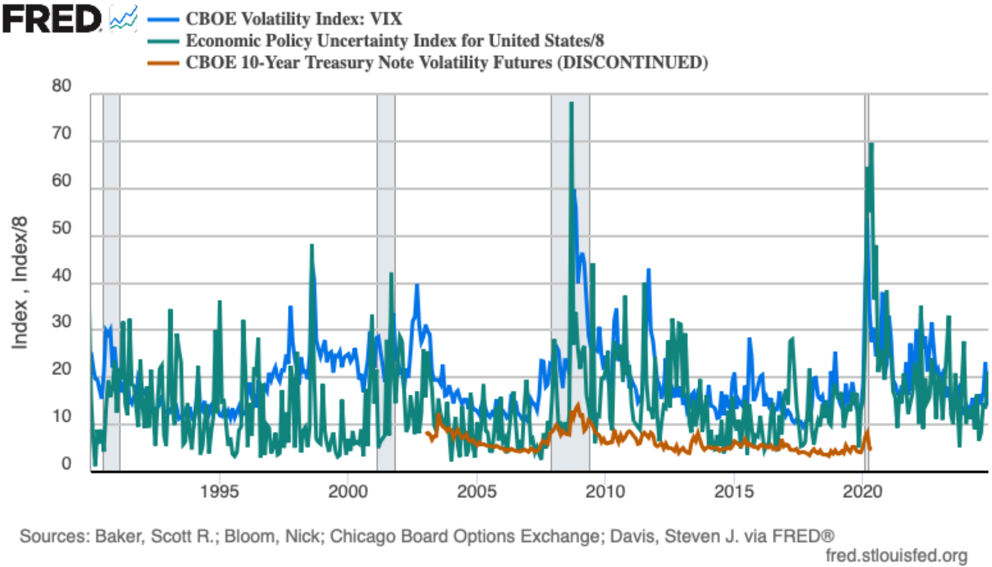
The missing financial uncertainty

- An unusual behavior
- Potential causes
- Hidden fragility

VIX, Bond Volatility, and Economic Policy Uncertainty



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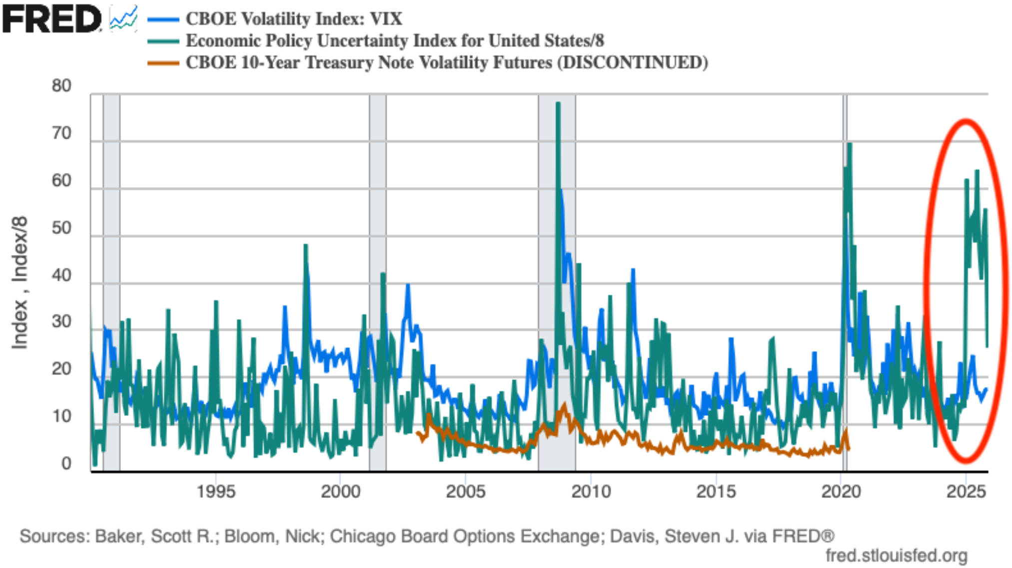


The Missing Financial Uncertainty

Despite elevated policy uncertainty and concerns about Treasury/Dollar role:

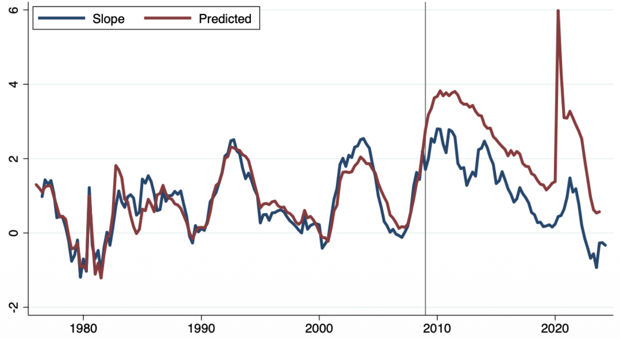
- Low market volatility (VIX $\approx$ 20%)
- Booming stock market (S&P500 +15%)
- **Low and stable term premium** (10yr - 2yr $\approx$ 50bps)

Explanation 1: Promises of Stabilization

- Systematic asset purchases in downturns
- Since introduction, long yields have been lower and more stable
- Interventions removed much of the downside risk priced in options

Markets perceive that the Fed follows implicitly an "asset purchase rule" and will intervene when necessary
$\Rightarrow$ *permanently enhances the stability of Treasuries*

(Haddad Moreira Muir 2025)



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- In 2025 context:
  - Slow down taper or even expand balance sheet if start of Treasury sell-off
  - Market-functioning or liquidity interventions for plumbing issues
- Interventions are infrequent and powerful ... but must follow through on perceived commitments
  - Taper tantrum 2013, Lagarde speech 2020
- Potential buildup of risk-taking
  - Highly levered players, harder to contain extreme events
- Potential disconnect between market signals and underlying economic conditions

Explanation 2: Financial Dominance

- **Financial dominance**: government policy actions disciplined by bond-market participants (Brunnermeier 2016)
  - Market-based checks and balances

- Potential misalignment between what benefits Wall Street vs. Main Street

- Potential additional instability: markets might inject noise into policy decisions

Explanation 3: AI

- Political uncertainty overshadowed by positive growth news from AI development
  - Already substantial gains, and asset prices are forward-looking

- Unlikely main explanation: technological revolutions typically increase volatility

Summary

- The missing financial uncertainty: markets remain remarkably stable
- Two stabilizing forces:
  - Asset purchase rules: central bank interventions
  - Financial dominance: market-based discipline
- Stabilization can be fragile
  - Policy credibility requires following through on perceived commitments
  - Accumulated risk-taking increases tail risks

References

- **Policy stabilization of financial markets** "Whatever It Takes? The Impact of Conditional Policy Promises" (Haddad Moreira Muir AER 2015), "Asset Purchase Rules: How QE Transformed the Bond Market" (Haddad Moreira Muir WP 2025), "Financial Conditions Targeting" (Caballeo Caravello Simsek WP 2025) **and fragility** "NBFIs in Focus: The Basics of Hedge Funds" (NY Fed Teller Window blog), "Treasury Market Dysfunction and the Role of the Central Bank" (Kashyap Stein Wallen Younger BPEA 2025)

- **Financial dominance** "Financial Dominance" (Brunnermeier book 2016)

- **AI and bond market** "Do Markets Believe in Transformative AI?" (Andrews Farboodi WP 2025)