FINANCIAL TIMES

WEDNESDAY 30 MARCH 2022

FT.COM

US Treasury bonds

Strains in $23tn US government debt market intensify as Fed tightens monetary policy

Treasuries set to post worst quarter of returns since at least 1973 on inflation and rate rise fears

KATE DUGUID – NEW YORK

Investors' ability to trade US government debt has deteriorated to its lowest point since the ructions of March 2020, deepening worries about the world's most important bond market as the Federal Reserve tightens monetary policy.

Liquidity, or the ease of buying and selling, in US government securities has dropped since the beginning of this year, reaching levels not seen since the first months of the coronavirus crisis, according to an index compiled by Bloomberg.

The deteriorating trading con-ditions have exacerbated this month's price swings, with investors increasingly concerned about how well the market will function as the Fed starts reducing the size of its $9tn balance sheet.

Treasuries are already on course to post their worst quarter since at least 1973 after the Fed raised interest rates for the first time since 2018 this month in its attempt to battle inflation, which is running at its highest level in 40 years. It has also halted its crisis-era bond-buying programme.

At the same time, war in Ukraine has prompted several jolts of volatility in Treasuries in recent weeks. Such intense volatility is unusual and concerning in the $23tn market, widely considered the deepest in global finance, traders and investors say.

"Liquidity and market function challenges moved to the background when the Fed stepped into the market with an enormous asset purchase programme [in March 2020]," said Gregory Whiteley, a portfolio manager at DoubleLine. "Now, with market support from the Fed's operations ended and the Fed's balance sheet due to start shrinking anew, we're seeing the return of market function concerns."

The Treasury market forms a bedrock of international finance, so price movements there ricochet across other markets, affecting everything from mortgage rates to stock prices. The severe global market turmoil at the start of the pandemic in March 2020 was made significantly worse by sharp price moves in US government bonds.

Treasuries typically rally during times of rising market jitters as traders stash their cash in the safest assets, but prices tumbled in 2020 as a jolt of risk aversion sent participants racing out of US government debt. The Fed was forced to intervene to steady the market by pledging to buy unlimited quantities of government bonds and taking measures to boost the corporate debt market for the first time ever.

With the Fed now unwinding the stimulus measures it launched in the depths of the pandemic, investors are worried that long-term problems with Treasury market functioning could again leave it vulnerable.

Primary dealers — the 24 financial institutions that are the traditional market makers in Treasuries — have pulled back from that role since stricter capital requirements were implemented after the 2007-09 financial crisis. Hedge funds and high-frequency trading firms have stepped in to fill the void but often pull back from markets during periods of tumult, a factor that some analysts say heightens volatility.

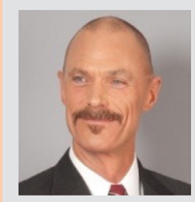
"Liquidity and market function challenges moved to the background when the Fed stepped into the market with an enormous asset purchase programme."

Gregory Whiteley

New rules proposed on Monday by the Securities and Exchange Commission kick off the process of fixing some of these structural issues but progress has been, and is expected to continue to be, slow.

Big price moves in recent days that have come without an apparent trigger present a warning of what may come, according to Mark Cabana, head of US rates strategy at Bank of America. "When I see moves like that happening for really no good reason —against a backdrop of already fragile Treasury market functioning, and even before [the Fed starts selling bonds] — it just makes me concerned," he said.

Cabana added that further volatility could tighten financial conditions, making it harder for companies and consumers to obtain financing, which "could slow the economy quite meaningfully".



Gregory Whiteley
Portfolio Manager, U.S. Government Securities
DoubleLine Capital

Mr. Whiteley joined DoubleLine in 2009. He is a Portfolio Manager on the U.S. Government Securities team, responsible for managing and trading U.S. Government securities, municipal bonds and derivatives. Prior to DoubleLine, Mr. Whiteley was a Senior Vice President and Portfolio Manager at TCW for fourteen years. He joined TCW when they acquired Continental Asset Management (CAM) in 1995, where he had been employed since 1990. At CAM, Mr. Whiteley served as Vice President and Portfolio Manager, Taxable Fixed Income Investments, initially specializing in mortgage-backed securities and later in government securities. Previous to that, he was a Fixed Income Portfolio Analyst with Salomon Brothers, Inc. Mr. Whiteley holds a BA in Economics from the University of Washington and an MBA in Finance from Columbia University.

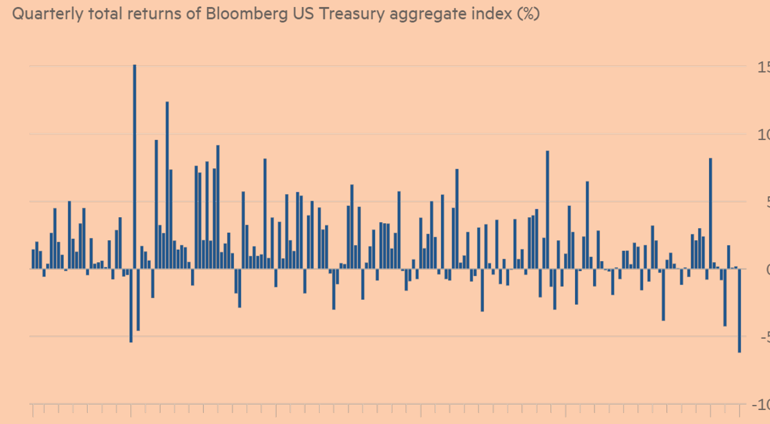
Treasury market liquidity has been worsening

Bloomberg US government securities liquidity index

© FT

US bonds in historic sell-off

Quarterly total returns of Bloomberg US Treasury aggregate index (%)



First quarter of 2022 is through March 28.
© FT