Markets volatility

US Treasury bond wobble heightens concerns over health of $21tn market

Latest liquidity shock lifts pressure on American regulators to address market function issues

Regulators are concerned about the stability of the market after yields surged last week © FT montage

Colby Smith and **Eric Platt** in New York, and **Robin Wigglesworth** in Oslo 6 HOURS AGO

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The severity of last week's US government bond sell-off has rekindled concerns about the health of the world's largest and most important debt market, adding urgency to regulators' efforts to address cracks that have emerged during periods of stress.

The $21tn US government debt market started 2021 on the back foot, as investors began pricing in a big economic recovery, the possibility of faster inflation and, in turn, the prospects that the Federal Reserve could begin to raise interest rates earlier than expected. But the sell-off accelerated sharply last week, with Treasury yields soaring as the market's normally easy trading conditions deteriorated markedly.

"You never like to see liquidity dry up like it did. It is always concerning to see that in what is supposed to be the largest and most liquid market," said Mike Gladchun, director of US rates trading at Loomis Sayles. "It is going to amplify attention on Treasury market functioning . . . and amplify those calls for reform."

Market conditions worsened after a grim auction of seven-year Treasuries on Thursday. Primary dealers — the club of big banks that underwrite US bond sales — were forced to pick up nearly 40 per cent of the sale, the highest share in seven years, according to Jefferies.

Source: Bloomberg
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As prices fell, the yield on the benchmark 10-year Treasury note jumped to a one-year high of over 1.6 per cent on February 25, having started the month at about 1.1 per cent. The move was even more pronounced in five-year Treasuries, in what Jay Barry, a rates strategist at JPMorgan, said was akin to a "flash crash". A key measure of expected volatility in the Treasury market, the ICE Bank of America Move index, also climbed sharply.

The tumult following Thursday's auction prompted big Wall Street trading desks to back away from the market, said Ritchie Tuazon, a portfolio manager with Capital Group. It meant that fund managers attempting to sell Treasuries saw big gaps in the prices they were quoted. The volatility and choppy trading conditions were mirrored in Treasury futures, as prices slid dramatically and counterparties to trade with dwindled.

"When the velocity of the movements picked up, dealers started pulling back quite significantly," Tuazon said.

Treasuries have recovered their footing this week, with the 10-year US government bond yield declining to 1.4 per cent. Yet the sense of dysfunctional trading last week has once again stirred concerns over the health of the Treasury market — a reference point for the global financial system, guiding prices of everything from equities to real estate.

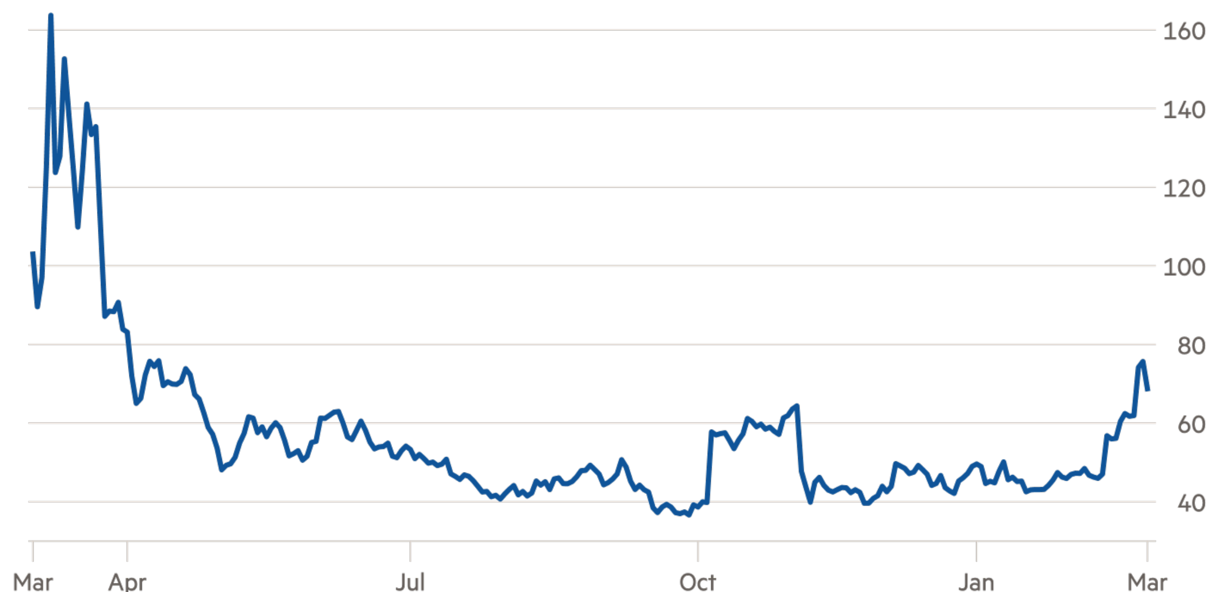
The past year has brought mounting signs of fragility, a worrying development at a time when the US government is borrowing at a rapid pace to dull the effects of the pandemic.

For some investors and analysts, last week revived memories of the turmoil that engulfed Treasuries when the coronavirus crisis caused Treasury trading to seize up in March last year and prompted aggressive intervention from the Federal Reserve to restore order. Regulators have since scrambled to determine what went wrong and how to address weaknesses.

“We are having more of these episodes and there needs to be a response to strengthen the underpinnings of the Treasury market,” Barry said.

Choppy trading in the world's biggest bond market

Move index (implied one-month volatility in the Treasury market)



Source: BofA, Bloomberg

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Traders stressed that last week was not nearly as severe as the turmoil that wracked Treasuries at the peak of the Covid-19 market crash.

Bret Barker, head of government debt at asset manager TCW, highlighted that trading in older Treasury notes — known as off-the-run securities — held up well despite being prone to liquidity droughts.

But Kevin Walter, co-head of global Treasuries trading at Barclays, estimates that the difference in prices between where traders were willing to buy and sell US government debt — known as the 'bid-offer spread' — tripled at the peak of the turbulence on Thursday last week.

Banks often blame bouts of illiquidity on post-crisis regulations constraining their ability to make markets, and the influx of high-speed, algorithmic traders in Treasuries. These firms might keep trading cheaper and more efficient in normal times, but they tend to pull back when turmoil erupts, some asset managers say.

"They make up such a large share of the order book depth that when it is decimated as it was, there is no other conclusion to draw other than the fact that they either pulled back significantly or widened their bid/offers," said Gladchun at Loomis Sayles.

The turbulence has heightened concerns about what may happen if regulators do not extend a Covid-triggered exception for Treasuries and cash reserves when it comes to calculating how much extra capital banks need to hold. A political battle recently escalated over the concessions, which were extended in part to help banks absorb selling pressures and are set to expire this month.

Some experts say that further measures may also be needed to shore up the market that acts as a benchmark for trillions of dollars in assets.

"For the world's so-called risk-free asset — the asset which is supposed to be the one that protects us every single time — the fact that this is happening should be horrifying," said Yesha Yadav, a professor focused on Treasury market reform at Vanderbilt Law School. "Regulators have a lot to do here."

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