US Treasury bonds

‘Humbling’ week in bond markets leads to fears of paradigm shift

Investors question whether a lasting and destabilising rise in yields is at hand

Bonds remain strong in historic terms, but for the typically staid and steady US government debt market, this scale of move is rare © FT montage

Colby Smith, **Joe Rennison**, **Katie Martin** and **Robin Wigglesworth** FEBRUARY 26 2021

For prominent US government bond bulls, it has been a tough week, after a gentle decline in prices abruptly became a rush.

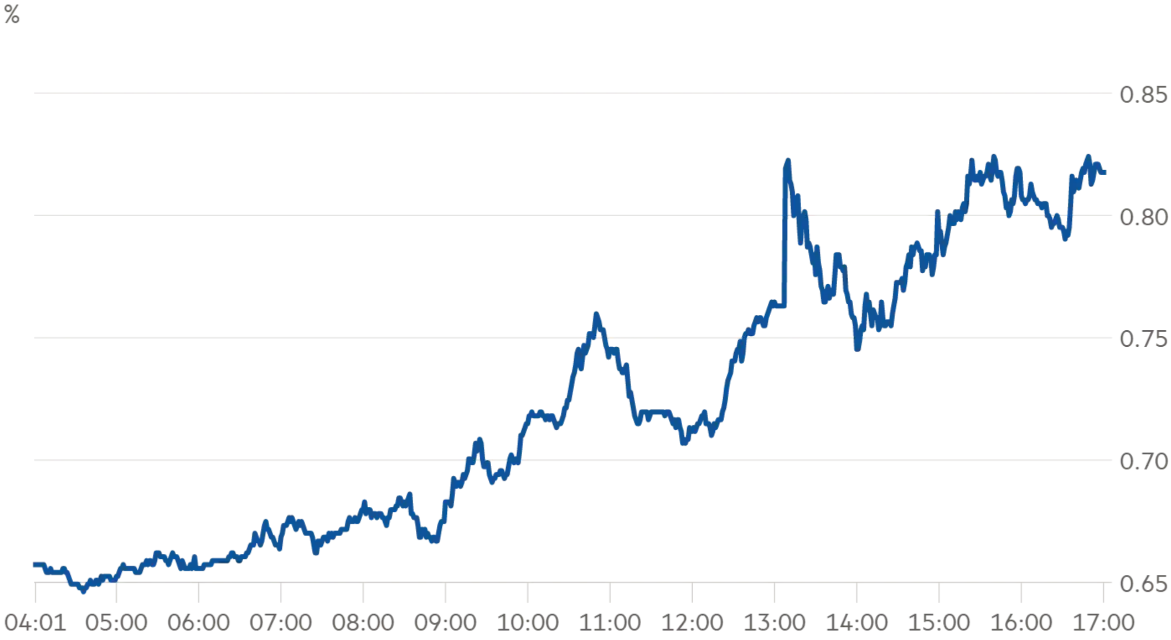
With expectations for rising inflation building, prices on Treasuries had been sinking for most of this month, pushing yields to their highest point since the coronavirus crisis struck markets a year ago. But on Thursday, a shaky US government debt auction caused 10-year yields to spike as high as 1.61 per cent, ending the day with a gain of 0.14 percentage points.

“We are eating humble pie, after the bond market served up a lesson in humility,” said HSBC’s head of bond research, Steven Major. “The probability of lower bond yields has fallen because of much larger US fiscal stimulus than we had expected, and the development of a number of effective vaccines.”

Bonds remain strong in historic terms. But for the typically staid and steady US government debt market, that scale of move is rare. The incident has rekindled memories of chaotic scenes in Treasuries just under one year ago, and led investors to question whether a lasting and destabilising rise in yields is at hand.

"Are we at a paradigm shift? That's what people are worried about, that history isn't much of a guide for us now," said Joyce Chang, chair of global research at JPMorgan.

Five-year US Treasury yields jump in hectic trading



February 25 (New York time)
Source: FactSet
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What just happened?

US sovereign bonds are considered to be the deepest, most liquid market in the world. But on Thursday, that market wobbled. "It was big," wrote analysts at Rabobank. "It was almost as if a dam broke."

The pick-up in yields accelerated after what strategists at BMO Capital Markets described as an "extraordinarily weak" $62bn auction of seven-year Treasury notes. The bid-to-cover ratio, which tracks the value of bids received relative to the amount accepted, fell to a record low.

"Rather than catching the proverbial falling knife, several large auction participants may simply have opted to remain on the sidelines this month," they said.

Primary dealers, financial companies that underwrite US bond sales, accounted for almost 40 per cent of the auction, the highest share in seven years, Jefferies data show — a sign of tepid demand from investors.

The market is selling off for the right reasons . . . what the market is sniffing out is that there is a chance QE is tapered sooner

Bob Miller, head of Americas fundamental fixed income at BlackRock

Greg Peters, a senior fund manager at PGIM Fixed Income, drew parallels to the turmoil that gripped the Treasury market in March — a period marked by extreme price gyrations and pockets of illiquidity that spread to other corners of the financial system.

"That is how it all started in March 2020," he said. "I'm not saying we have the same broad economic and market shock of a lockdown . . . [but the market] is definitely breaking apart here."

Other government bond markets have felt the pain too. In Australia — a likely beneficiary of China's early and fast economic rebound — 10-year yields rushed almost to 2 per cent, the highest in two years.

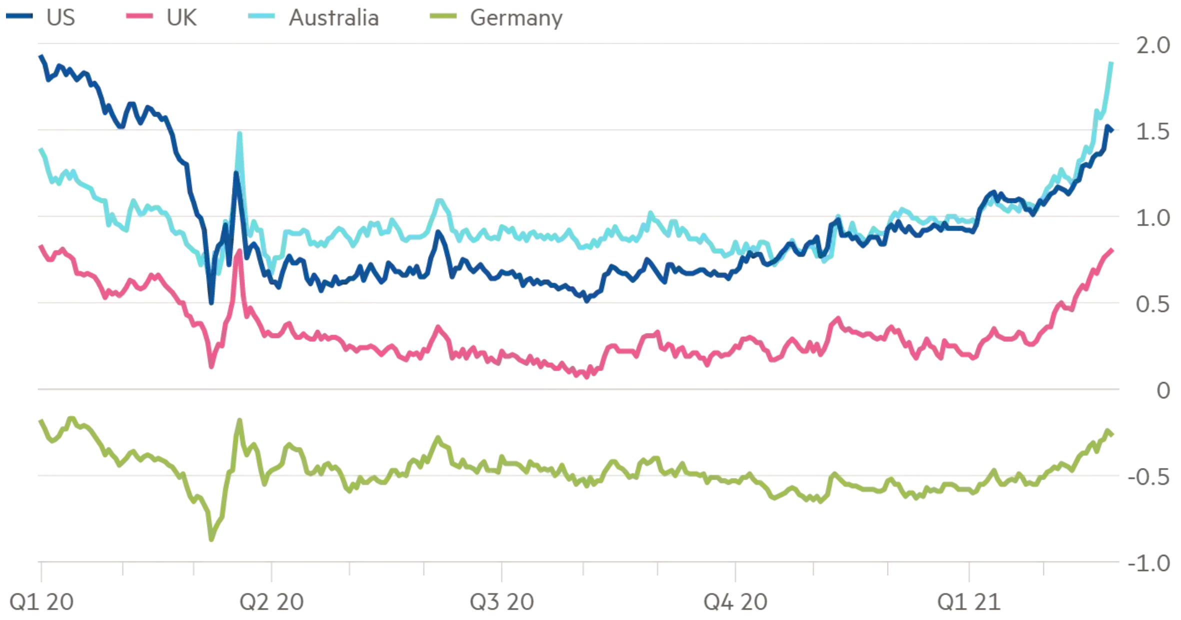
Are debt markets overreacting?

In 2013, global bond markets fell sharply after the US Federal Reserve hinted at an intention to start withdrawing post-2008 stimulus, in a shock known as the "taper tantrum". This time, we have "a tantrum, without any taper", wrote Johanna Chua at Citi.

Nonetheless, the theme is the same: investors are beginning to price in the possibility of the Fed pulling back from its emergency measures introduced to temper the effects of the pandemic. In theory, the central bank would do that only if the US economy were starting to recover. It has already promised to shrug off a rise in inflation above its 2 per cent target. And inflation is stuck well below that level, at 1.5 per cent. But investors are testing the Fed.

Global bond yields rise after dropping during Covid crisis

10-year yield (%)



Source: FactSet

“The market is selling off for the right reasons,” said Bob Miller, head of Americas fundamental fixed income at BlackRock. “I think what the market is sniffing out is that there is a chance QE is tapered sooner.”

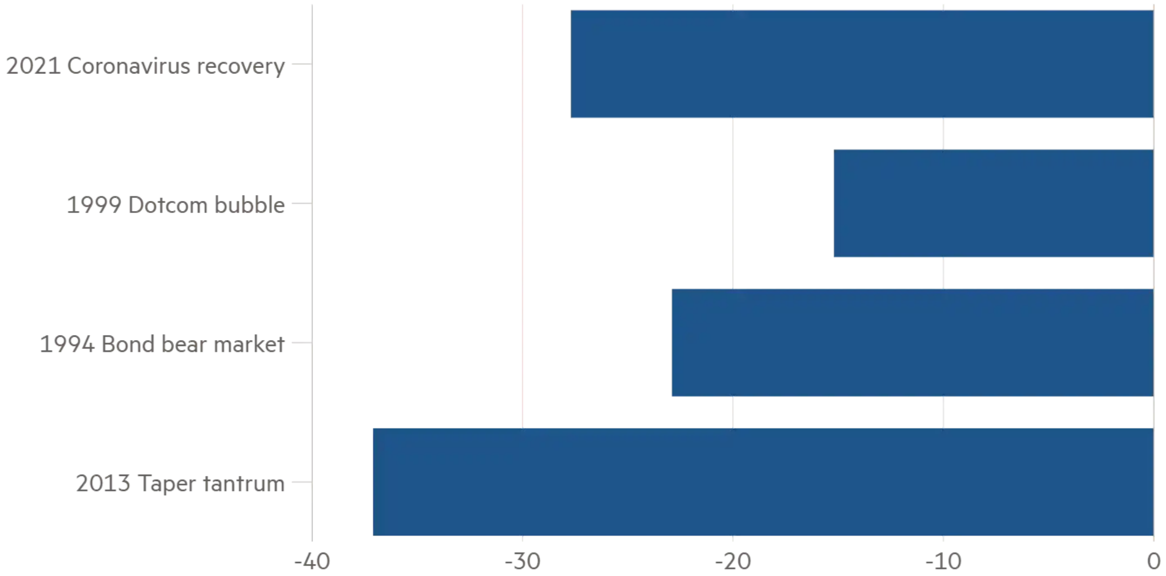
What technicalities are at play?

Treasury yields are crucial to mortgage rates. When they rise, homeowners are less likely to refinance their mortgage because they have already locked in a lower borrowing cost. The Mortgage Bankers Association notes that mortgage refinancing declined 11 per cent in the week of February 19 from the one prior.

That means mortgage investors are probably going to have to wait longer to get their money back. The delayed payouts increase the risk these investors face from rises in interest rates, something known as duration. To hedge against the increased duration, investors sell Treasuries that mature well into the future exacerbating the rise in yields.

How the 2021 bond drop compares with previous episodes

US 10-year Treasury returns during previous fixed income sell-offs (%)



Source: Bank of America

The number of "convexity hedging" investors has declined over time. But they can still make a difference in periods of high volatility, and analysts say that has been the case this week.

Should investors in other asset classes be worried?

Even before Thursday's shake-out, investors were trying to calculate when the push higher in yields would pose a threat to credit and equities.

Stock markets are flying high in large part because interest rates have been so low. If bond investors are right that growth and inflation are strong enough to hint at lighter monetary support, then stocks, particularly in high-growth sectors like technology, are likely to be vulnerable. The pick-up in yields has already left a dent in emerging-market assets and currencies.

What, if anything, will central banks do?

Krishna Guha, vice-chairman of Evercore ISI, said the Fed's leadership held some "responsibility" for the "disorderly" move in inflation-adjusted Treasury yields seen this week. The 10-year real yield, which also serves as a barometer of expectations for future Fed rate moves, has risen sharply to negative 0.6 per cent, well off its all-time lows of over negative 1 per cent and back to levels last seen in June.

"The absence of any indication of concern or [central banker] carefulness around the move in yields . . . has been read in markets as a green light to ramp real yields higher," Guha said. "A change of tone at least seems warranted in our view — and possibly more."

That "more" could entail adjustments to the Fed's $120bn-a-month asset purchase programme.

Some investors are also beginning to speculate that the Fed could revert to yield curve control — a policy it last used during the second world war — with specific targets for bond yields, and buying and selling as many securities as necessary to maintain those levels.

Fed officials are split on the benefits of wading even deeper into the fabric of financial markets, but according to Nick Maroutsos, head of global bonds at Janus Henderson, it is one of many tools that could soon shift back into the limelight.

"They are probably trying to pick and choose their spots and wondering at what point they will potentially intervene," he said.

Elsewhere, the European Central Bank's president Christine Lagarde and chief economist Philip Lane have made it clear they are watching yields closely.