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Bond-Market Volatility Triggers Alarms

U.K.'s debt agency chief raises prospect that swings could cause investors to balk at buying bonds at auction

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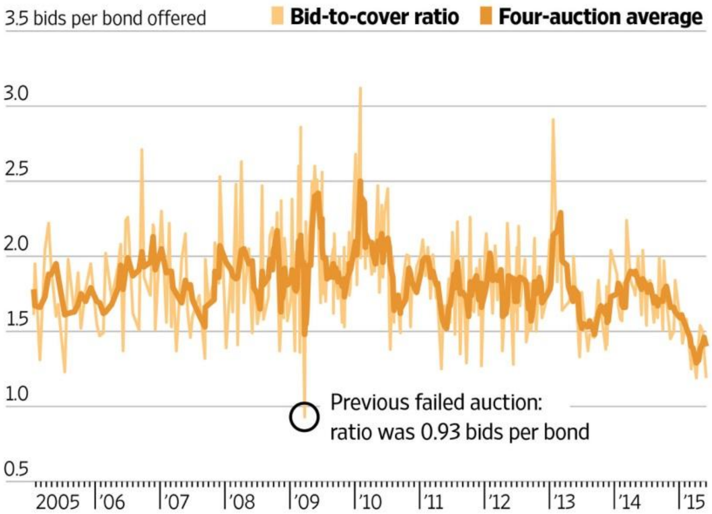
Gilt Edge

The ratio of bids submitted by banks to bonds offered at U.K. auctions has slipped; bond-market volatility could cause an auction to fail.



Note: Results don't include auctions of government bonds linked to inflation.
Source: U.K. Debt Management Office
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Regulators and government officials are becoming increasingly worried about rising volatility in government bond markets.

Federal Reserve and European Central Bank officials have publicly discussed the issue in recent weeks, and the head of the U.K.'s Debt Management Office raised the prospect that the swings could one day cause investors to balk at buying its bonds at auction.

Government-bond markets across the globe have seen sharp price swings over the past few weeks, led by German bonds, known as bunds. The 10-year bund yield was 0.89% Monday, compared with 0.49% a week ago. U.K. bonds, known as gilts, haven't been immune from the turmoil. Ten-year yields have risen from 1.81% to 2.05% over the same period. In the U.S., the 10-year note yield has climbed to 2.38% from 2.19%. Bond yields rise as prices fall.

Officials have voiced concerns that new regulations prompting banks to cut back their bondholdings are driving big swings in the bond market, exposing investors to losses and raising red flags about the rising role of algorithmic-trading firms.

Meanwhile, volatility has increased by the twin forces driving global markets: soft global demand for goods and services and a wave of cash from expansive central-bank policies meant to reignite growth. Markets have moved sharply as investors reposition themselves for shifts in the global economy.

The head of the U.K.'s Debt Management Office said in an interview that unusual market swings mean a British government-bond auction may soon fail to sell all bonds on offer for the first time since 2009. The U.K.'s next auction is scheduled for Tuesday.

'We have had worries about the impact of regulation on banks' willingness to hold government bonds on their balance sheets for some time,' said Robert Stheeman, CEO of the U.K. Debt Management Office, pictured in 2012.*PHOTO: BLOOMBERG NEWS*

"This higher-volatility environment is a concern," said Debt Management Office Chief Executive Robert Stheeman. "I wouldn't be surprised if we had a failed bond auction at some point in the not-too-distant future."

The prospect of a rare U.K.-bond auction failure—there have been only three out of 535 since 1998, according to the debt agency—comes just weeks after some traders blamed lack of demand at an auction of French debt in early May for a sharp selloff in eurozone bonds.

Failure to sell all the U.K. bonds on offer wouldn't necessarily mean buyers, mostly banks, are worried about financing the U.K. But it would reflect concerns about buying large amounts of bonds when prices are swinging wildly.

Mr. Stheeman's comments refer to big banks' ability buy large chunks of bonds when the debt is auctioned, and the remarks come at a time when officials on Wall Street and in Washington are worried about challenges trading large sizes of debt in the secondary market, where bonds change hands after they have been issued.

Volatile trading in government-bond markets has drawn scrutiny from the International Monetary Fund, the Bank of England, the Fed and the U.S. Treasury Department.

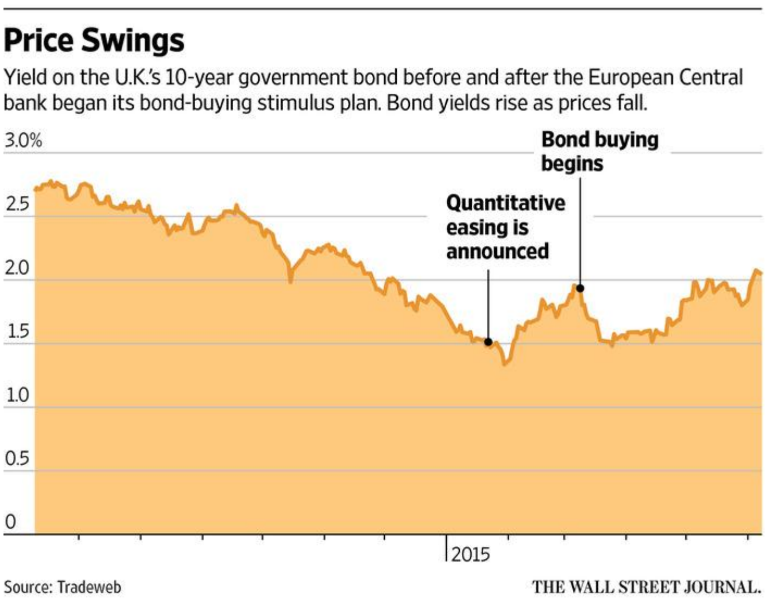
When Treasury yields on Oct. 15 tumbled to their biggest one-day decline since 2009, market watchers were quick to highlight the increasing role of high-frequency trading firms in government bonds and how recent movements may have been exaggerated by those firms' tendency to step away from the market during periods of stress.

Comments last week by ECB President [Mario Draghi] that the central bank's bond-buying program could be increased also seemed to fuel the recent volatility.

More broadly, better economic and inflation data in the eurozone appeared to have driven the broader selloff and the accompanying volatility.

Some market supervisors and regulators, as well as large banks and money managers, are raising alarms because the volatility in the bond market comes at a time when fund managers, not banks, are loaded up with the debt securities. The Fed is poised to raise short-term interest rates in the coming months for the first time in nearly a decade. Higher rates could dent the attractiveness of existing bonds issued at lower yields.

The minutes from the Fed's April meeting noted that the "tendency for bond prices to exhibit volatility may be greater than it had been in the past, in view of the increased role of high-frequency traders, decreased inventories of bonds held by broker-dealers, and elevated assets of bond funds."



That view was echoed last week by Mr. Draghi, who also warned that investors should "get used to periods of higher volatility."

In the U.K., Mr. Stheeman said the gilt market is fundamentally sound, but that banks aren't willing to hold as many bonds as they were a few years ago, particularly when markets are so volatile.

"When volatility dies down, we would expect auctions to go back to normal," he said.

The U.K. issues debt by asking its 21 regular primary dealers, predominantly banks, to submit bids for a set amount of bonds at regular auctions. The debt agency can reject bids it deems too low. The dealers then sell the bonds to investors in the secondary market.

An auction fails if there aren't enough valid bids to buy the bonds on sale.

"We have had worries about the impact of regulation on banks' willingness to hold government bonds on their balance sheets for some time," Mr. Stheeman said. If an auction fails to sell some bonds, the U.K. government would wait at least three days before trying to sell them again.

Last Tuesday, there were barely enough bank bids to cover an auction of 10-year gilts. The ratio of bids to debt for sale was 1.19 times. The average ratio over the past year is 1.9, said Moyeen Islam, a rates strategist at Barclays PLC.

“The market could take it badly and sell off further” if there is a failed auction on a day when bonds are already weakening, said Anthony O’Brien, co-head of European rates strategy at Morgan Stanley. “But it’s worth remembering things are different from 2009. Now, there is a reduced threat to the U.K’s credit rating and the country’s fiscal position is on a sounder footing.”

The U.K.’s finances deteriorated following the 2008 financial crisis as taxpayer money was used to bail out banks and a deep economic slump set in. Matters have improved since then. This year, the International Monetary Fund projects, the U.K. will have inflation-adjusted economic growth of 2.7%.

Mr. Islam said there would be “some noise and excitable commentary” if there was a failed auction. “But overall, the gilt market fundamentals are solid enough, and the market mature enough, to be able to take an uncovered auction in its stride,” he said.

Moreover, he said, the U.K. debt agency is good at reacting to market conditions by either reducing auction sizes or even postponing an auction.

On Tuesday, the U.K. is scheduled to sell £900 million ($1.37 billion) of inflation-linked bonds maturing in 2024.

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