FINANCIAL TIMES

July 29, 2015 10:00 am

US Treasuries market faces liquidity concerns

Joe Rennison in New York

Bond funds face spike in redemptions as rates increase

©AFP

Investors are asking themselves a question that until recently had never been up for debate; how "liquid" are US Treasuries?

With $12.6tn of debt outstanding and more than $500bn changing hands every day, US Treasuries are considered the bedrock of global finance, but concerns about liquidity — or the ability to buy and sell an asset in large size without affecting its price — are now widespread.

For many, the wake up call came on October 15 last year, when the yield on the 10-year US Treasury bond, which moves inversely to price, plummeted 34 basis points in early morning trading. Banks and other trading firms pulled back from quoting prices during the most extreme moments of turmoil, leaving investors with little ability to transact cash bonds.

It did not last long. Yields rebounded sharply, finishing the day not far from where they started, but it was a sign of what can happen and sights have since turned to the potential for a repeat event, particularly as the Federal Reserve prepares to raise interest rates.

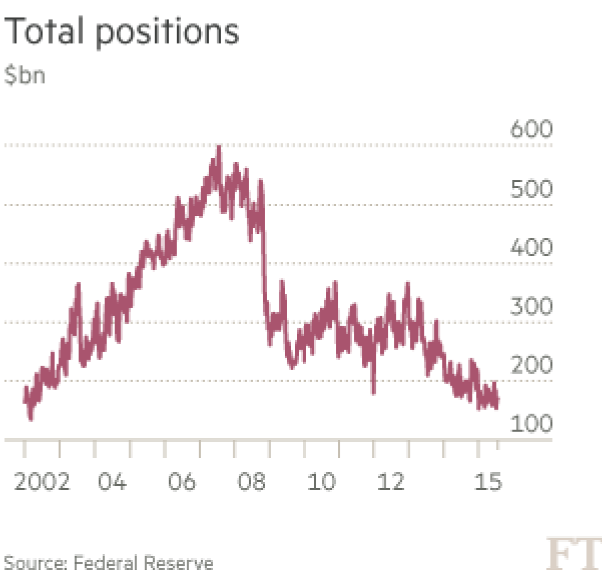
"There will be discontinuous pricing," says Richie Prager, head of trading and liquidity strategies at BlackRock, the largest asset manager in the world. "Anyone who doesn't expect some sort of discontinuous pricing as interest rates normalise, as volatility returns, is really just not realistic."

Some fear that bond funds will be at the mercy of their clients, facing severe redemptions as rates increase, forcing them to liquidate portfolios to return clients' cash. Most hold a float of liquid assets, such as US Treasury bills and other types of short-term debt, for this purpose. But a stampede for the exit could see many asset managers needing to sell at the same time, leading to volatile movements in prices.

"You have a bucket of Treasuries that is presumed to be liquid and then suddenly it isn't," says Henry Peabody, portfolio manager at Eaton Vance. "That shakes the whole institution of Treasury trading and you have to start factoring that in."

It's a paradigm shift for investors that have long accepted low returns for buying the US government's debt on the assumption that it was a "safe" asset. For the time being, investor demand remains strong, with mutual funds holding around 10 per cent of all Treasury securities outstanding. But sentiment suggests that without the guarantee of liquidity, or a higher rate of return, the asset becomes less desirable.

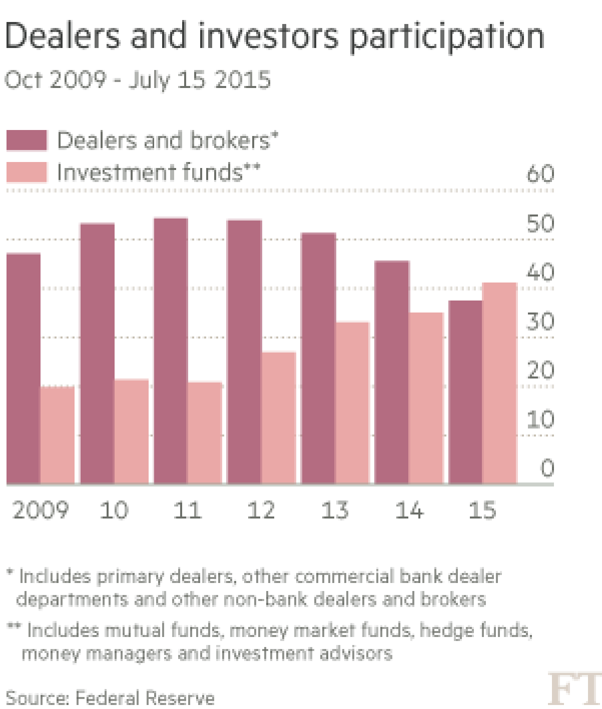
Some investors say that they have already begun to price in a "liquidity premium" for holding Treasuries — a concept previously reserved for corporate debt.



"It has reduced the appeal because the risk has increased," says Jennifer Vail, head of fixed income strategy at US Bank wealth management.

At the centre of the rapid evolution taking hold is the retrenchment by banks across fixed income, altering the traditional relationship between dealers and their clients.

Primary dealer holdings of high-grade debt, including Treasuries, mortgage-backed securities and corporate bonds, has fallen from $524bn at the end of 2007 to $170bn today, according to data from the Federal Reserve.



Anecdotally, traders say they used to step in during volatile price swings to help clients, with the aim of securing more business for when markets were calm. It was part of the client relationship. As banks have reduced balance sheets and declining fixed income revenues, the incentive to step in during market turmoil has been reduced.

"Why do I want to step in and lose money when I'm not making money the rest of the time," says a fixed income head at a European bank. "There are just fewer people willing to stand up and make a market these days."

Unlike corporate bonds, which have seen a growth in alternative execution venues, trading in Treasuries remains primarily dealer to client, whether it is over the phone or on electronic platforms like Bloomberg, or Tradeweb. Investors have noticed the decline and it is forcing a shift in behaviour.

Some have chosen to go directly to the regular US Treasury auctions, rather than rely on banks, to purchase bonds. Dealer participation in auctions for new Treasury securities has fallen from an average of 53 per cent in 2010 to 37 per cent so far this year, according to the data. Investment funds have increased participation from 21 per cent to 41 per cent in the same period. At the most recent 10-year Treasury auction this month, investors walked away with $9.5bn of the $21bn on offer.

It is also possible to avoid a liquidity squeeze by simply holding more cash. Fund managers' cash holdings are at their highest level since December 2008, according to research from Bank of America Merrill Lynch. But holding large buffers tends to have a negative effect on performance for the fund, which could be investing that cash in higher yielding assets.

A similar effect can be achieved by increasing the credit lines available from banks, like BlackRock and Aberdeen Asset Management have done.

It represents a shift away from a "decades long assumption" in Treasury markets, adds Mr Peabody. "It requires a level of vigilance that hasn't been required in the past."