A YEAR WITHIN A DAY FOR FIXED INCOME MARKETS

MARCH 19, 2020

GUY LEBAS
Chief Fixed Income Strategist

Financial markets are not broken.

We have in the past five trading days seen unprecedented price swings in nearly every asset class, including moves in major foreign currency prices that, statistically speaking, should only happen every few millennia, and seemingly conflicting valuations across theoretically identical groups of securities.

Okay, perhaps financial markets are a little broken. But more saliently, the capital normally deployed to “right” otherwise divergent financial relationships is simply missing. Nowhere is this more evident than in fixed income markets. We’ll take a moment to review some of the incredible price swings, provide a thesis for some of the underlying causes, and share thoughts on how this market dysfunction resolves.

PRICE SWINGS

Perhaps the most obviously divergent move in financial markets has been the surprising correlation between stock prices and U.S. Treasury prices. On Tuesday, March 17, the S&P 500 rose in price +6%, while the 30-year Treasury bond fell in price -9%. On Wednesday, March 18, the S&P 500 fell in price -7%, while the 30-year Treasury bond fell in price -3%. In “normal” markets, when there is an extreme decline in equities, high-quality bonds such as Treasuries typically perform well and rise in price, not fall.

This relationship is a key component of portfolio construction (a recent Janney Investment Strategy Group report titled The Role of Fixed Income in a Diversified Portfolio covers the topic), since owning high-quality bonds typically cushions the movement in a portfolio mostly comprised of equities. Lower volatility leads to better risk-adjusted long-run returns. Now, two rough trading days should not upend what is meant to be a long-term relationship, but the unexpected convergence in stock and bond performance suggests something much rarer is afoot in the global financial markets.

MARKET MAKERS MAKE MOVES

It appears market makers have significantly withdrawn capital from financial markets. The description “market makers” is another way of saying financial intermediaries. It includes the category of banks that have broker/dealer subsidiaries, non-bank broker/dealers, and even a few large hedge funds and hedge fund-like entities, such as Citadel.
These entities have, over the past decade, been a huge provider of capital to financial markets and have helped to ensure stability of financial relationships. As a simple example, the yield of a 10-year Treasury note and the yield implied by 10-year Treasury futures prices should be approximately equal. When the two became even slightly misaligned, this group of market makers would appear to right the relationship.

When it comes to less-liquid fixed income instruments, such as investment-grade corporate bonds or municipal bonds, these same market makers had a similar role to play. They sought to ensure that values of similar securities traded at similar prices and yields. Since these markets contain a wide variety of securities, the relationships were approximate rather than precise. Generally speaking, however, bonds from similar issuers of similar quality and similar maturities should trade similarly. For example, a triple-B railroad five-year bond should trade reasonably close in yield to another triple-B railroad bond. A 10-year New York general obligation muni bond should trade reasonably close in yield to another 10-year New York GO. A corporate bond exchange-traded fund (ETF) should be approximately equal to the value of the bonds in that fund. A range of bank and non-bank market makers offered to buy and sell bonds (and ETFs) to make sure these relationships held, roughly so, at least. But buying and selling bonds, owning and shorting bonds requires capital. Apparently, there is a today shortfall of market maker capital in the U.S. domestic financial system.

**DYSFUNCTION DETAILS**

Over the past two weeks, the capital shortfall became painfully evident.

As we wrote in *Fixed Income Market Dysfunction*, corporations and individuals, faced with an impending cash shortfall, began to draw down their lines of credit. On the corporate side, these drawdowns entailed multi-billion dollar announcements; on the retail side, the size is just as large in millions of credit card balances.

Banks needed to add to their capital to support these draws, and given the rapid timeframe, the options were limited. Bank treasurers opted to withdraw capital for market making activities. Non-bank market makers simply were not large enough to fill the gap. With no capital available to normalize the relationship between financial instruments (the Treasury vs futures, railroad bond, and GO bond examples above), these relationships became severely unhinged. The unhinging generated massive losses across the hedge fund and non-bank dealer community, and contributed to forced selling of all sorts of assets in recent days.

**FED’S ROLE**

The Federal Reserve has a role of “lender of last resort.” In 2008 into 2009, they fulfilled that function. As the U.S. financial system has moved away from loans and towards securities in the subsequent decade, the Federal Reserve has a function as the broker/dealer of last resort.

Over the past week, the Fed have started to fulfill that function with the launch of the Commercial Paper Funding Facility (through which they will effectively buy short-term bonds directly from issuers) and the Primary Dealer Credit Facility (through which they will lend to broker/dealers). The final leg of the tripod is quantitative easing (QE), through which the Fed will be taking bonds off of banks’ balance sheets. Through these three mechanisms, the Fed is slowly freeing up capital in the banking system, which will eventually go to market making activities.

**WHAT’S NEXT**

Even with knowledge of the pathway, it is impossible to know when these capital mechanisms will provide support for financial markets. Much depends on whether big bank treasurers respond quickly by deploying capital back into the broker/dealers. Another hurdle is nonbank dealers may be hesitant to deploy capital themselves. One of the first signals market participants will notice in the return of capital to the financial markets is that bonds start trading more “normally.” Normalcy will likely appear first in low-risk bonds such as Treasuries before slowly spreading to other facets of the financial markets. Look for reduced volatility, narrower differences between bids and offers, and directionally “correct” trading in Treasuries relative to stocks as a good first step.

---

**Performance of Bond ETFs and Indexes They Track Diverged; Capital Necessary to Correct Absent from Markets**

(Source: Janney Investment Strategy Group; Bloomberg/Barclays Indices)
Disclaimer

Past performance is no guarantee of future performance and future returns are not guaranteed. There are risks associated with investing in stocks such as a loss of original capital or a decrease in the value of your investment.

This report is provided for informational purposes only and shall in no event be construed as an offer to sell or a solicitation of an offer to buy any securities. The information described herein is taken from sources which we believe to be reliable, but the accuracy and completeness of such information is not guaranteed by us. The opinions expressed herein may be given only such weight as opinions warrant. This Firm, its officers, directors, employees, or members of their families may have positions in the securities mentioned and may make purchases or sales of such securities from time to time in the open market or otherwise and may sell to or buy from customers such securities on a principal basis.