The Tell

‘Fragile’ Treasury market is at risk of ‘large scale forced selling’ or surprise that leads to breakdown, BofA says

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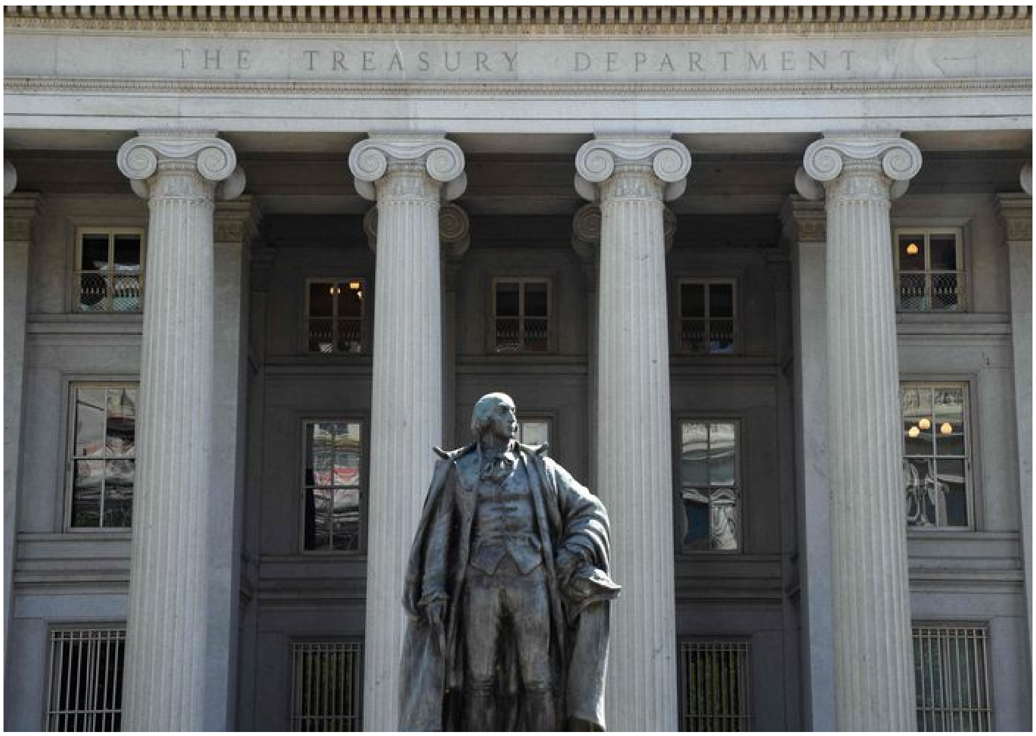

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TMUBMUSD02Y 4.504% DJIA +2.47% ▲ SPX +2.37% ▲ COMP -0.81% ▼

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The world’s deepest and most liquid fixed-income market is in big, big trouble.

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For months, traders, academics, and other analysts have fretted that the $23.7 trillion Treasurys market might be the source of the next financial crisis. Then last week, U.S. Treasury Secretary Janet Yellen acknowledged concerns about a potential breakdown in the trading of government debt and expressed worry about "a loss of adequate liquidity in the market." Now, strategists at BofA Securities have identified a list of reasons why U.S. government bonds are exposed to the risk of "large scale forced selling or an external surprise" at a time when the bond market is in need of a reliable group of big buyers.

"We believe the UST market is fragile and potentially one shock away from functioning challenges" arising from either "large scale forced selling or an external surprise," said BofA strategists Mark Cabana, Ralph Axel and Adarsh Sinha. "A UST breakdown is not our base case, but it is a building tail risk."

In a note released Thursday, they said "we are unsure where this forced selling might come from," though they have some ideas. The analysts said they see risks that could arise from mutual-fund outflows, the unwinding of positions held by hedge funds, and the deleveraging of risk-parity strategies that were put in place to help investors diversify risk across assets.

In addition, the events which could surprise bond investors include acute year-end funding stresses; a Democratic sweep of the midterm elections, which is not currently a consensus expectation; and even a shift in the Bank of Japan's yield curve control policy, according to the BofA strategists.

The BOJ's yield curve control policy, aimed at keeping the 10-year yield on the country's government bonds at around zero, is being pushed to a breaking point because of rising interest rates and yields worldwide. As a result, some expect the BOJ to tweak its policy, which was introduced in 2016 and is seen as increasingly out of line with other central banks.

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Right now, investors are grappling with a cauldron of risks: persistent U.S. and global inflation, accompanied by continued interest rate increases by the Federal Reserve and other central banks, as well as lingering uncertainty about where the world's economy and financial markets are headed. U.S. officials are so concerned about the potential for a repeat of the September volatility which gripped the U.K. bond market, that Fed and White House officials reportedly spent last week asking investors and economists if a similar meltdown could happen here, according to the New York Times.

Illiquidity in the ordinarily smooth-functioning Treasurys market means that government debt can't be easily and quickly bought and sold without significantly impacting the underlying price of bonds — and that type of situation would theoretically translate into trouble for just about every other asset class.

Expectations for a 5% or higher fed-funds rate target have the potential to trigger further bond selloffs, not long after investors finished wrapping their heads around a 4% level for interest rates. As of Friday, traders pulled back on the chances of a fed-funds rate target that gets to at least 5% next year, versus a current level between 3% and 3.25%, though they haven't completely ruled out such a scenario.

Treasury yields finished the New York session mostly lower on Friday, with the policy-sensitive 2-year rate **TMUBMUSD02Y, 4.504%** dropping by the most in three weeks. Meanwhile, all three major U.S. indexes **DJIA, +2.47% SPX, +2.37% COMP, -0.81%** ended higher for the day and the week, after a report by The Wall Street Journal raised investors' hopes that the Fed might back off aggressive rate hikes.

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