Key Questions

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Is There Turmoil Lurking Beneath the Surface of US Treasuries?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

A combination of conditions has led to liquidity concerns in the Treasury market; the situation needs to be closely monitored, but we still believe these US securities are an important part of a diversified portfolio.

The Federal Reserve (the Fed) has been increasing interest rates rapidly this year, attempting to cool rising inflation. Not too long after the rate-hiking cycle began, however, cracks in the Treasury market, the largest and most liquid part of the US bond market, began to emerge.

Since then, market experts, from Treasury analysts to Treasury Secretary Janet Yellen, and now the Fed in its latest financial stability report, have reported about a looming problem – evaporating liquidity in the Treasury market.

If this market were to seize up, the global economy and the financial system may have a bigger problem to deal with than elevated inflation.

The Importance of Liquidity Conditions in Financial Markets

Market liquidity – the ease of buying and selling an asset – is a key indicator of how well markets are functioning. Low liquidity can amplify the volatility of asset prices in response to shocks and, in some extreme cases, can lead to situations where market participants are unable to trade without incurring significant costs.

The Treasury market is a giant with over $23 trillion in outstanding securities. Liquidity conditions in the markets for Treasury securities are particularly important due to the key role these securities play in the global financial system. Not only are Treasury securities a primary source of funding for the US government, but they also underpin borrowing costs for a variety of assets around the globe.

What Are We Seeing in the Treasury Market?

The Treasury market has continued to function smoothly to date, but there have been some indicators that point to liquidity appearing to be less resilient than what is typical. Treasury liquidity as measured by the Bloomberg US Government Securities Liquidity Index – a gauge of deviations in yields from a fair value model – has worsened to levels last seen at the peak financial market disruption during the pandemic. At that time, the government stepped in to buy securities, injecting liquidity into the market, which helped stabilize market functions but also significantly grew its balance sheet.

We have also begun to see an unusual development of off-the-run Treasury securities starting to trade cheap, offering more yield compared to the newly issued on-the-run securities. On-the-run securities are the most recently issued Treasury bonds or notes and are the more commonly traded form of Treasury security making on-the-run securities more liquid than their counterparts, off-the-run treasuries, the older issued but still outstanding notes and bonds.

Markets are generally very efficient, so any meaningful price differences between on-the-run and off-the-run securities are normally neutralized quickly. However, this spread between old and new has widened, further highlighting concerns over liquidity conditions.

Another symptom of poor liquidity in the Treasury market is the deteriorating demand at US debt auctions. Lower overall demand, from both domestic and foreign buyers, results in the US government ultimately paying more to borrow.

What Is Causing This Lack of Liquidity?

There is no single cause, but some factors stand out. First, let us consider the size of the Treasury market and how quickly it has grown. Following the onset of the pandemic and worsening market conditions, the Fed was buying an incredible $75 billion of Treasury securities per day in March 2020 to provide liquidity to markets, eventually buying at a pace of $80 billion per month beginning in June 2020 and extending throughout 2021.

Treasury debt outstanding has risen an astounding 42% since the end of 2019, climbing nearly $7 trillion. While the Treasury market was growing at a rapid pace, the balance-sheet capacity of big financial institutions that engage in Treasury market making had not expanded in line with the increase in the overall supply of Treasuries.

In fact, many traditional larger participants such as US commercial banks, foreign governments and life insurers are not showing the same level of demand as the result of a year of interest-rate increases and steep losses in bond prices.

A market maker's role is to provide liquidity to a particular marketplace for buyers and sellers of those particular securities. Another reason big financial institutions have not been as willing to serve as market makers is because of regulatory capital requirements. One such burden has become the Supplementary Leverage Ratio (SLR). The SLR rule requires broker-dealers to hold capital against all their assets, regardless of perceived riskiness, which includes Treasury securities.

Finally, we look to the Fed's Quantitative Tightening (QT), also known as balance sheet normalization, a process that started back in June. To shrink the balance sheet, the Fed is letting $60 billion a month in Treasuries roll off. In other words, it is letting them mature and removing them from its cash balance. QT removes liquidity from the financial markets.

What Can Be Done to Restore Liquidity?

There are some changes that can be made to help overall liquidity in the Treasury market. Some analysts have argued that a change to the SLR calculation may help. Banks' Treasury holdings have declined since early August of this year, but this trend could be reversed if there are some changes to the SLR. Excluding Treasuries from the SLR calculation would more directly allow broker-dealers to play a larger intermediary role in Treasury markets. The exclusion of Treasuries from the SLR calculation was experimented with briefly during the COVID-19 crisis, but that exemption expired in March 2021.

The US Treasury is also exploring whether a buyback program of off-the-run Treasury securities and replacing those with larger current issues would alleviate some pains. A buyback program was instituted between 2000 and 2002, when the federal government was running a budget surplus, to keep issuance primarily in on-the-run securities. This time around, the goal behind buybacks would be to improve market functioning and liquidity.

Key Takeaways

Economic uncertainty, elevated interest-rate volatility, QT, and weakening demand from major market participants have led to liquidity concerns in the Treasury market. Options are being explored to restore liquidity, but these solutions may take time to show results. Nevertheless, while we believe this is something that should not be ignored and needs to be monitored, Treasury securities still play an important part in a high-quality, diversified, fixed-income portfolio.

For more information, please contact your advisor.

About the Author

Jeffrey Wolosz is a Portfolio Manager and member of the Taxable Fixed Income Team since 2019. He brings experience as a KPB Portfolio Manager and Credit Research Analyst where his focus was evaluation and surveillance of internally managed strategies and investments. Jeff's current responsibilities include portfolio management of model strategies, common trust funds and individual fixed income portfolios, as well as the Structured Cash and Money Market strategies.

Jeffrey holds a bachelor's degree in Business Administration and Master of Arts in Economics from Cleveland State University. He is also certified as an MSRB Municipal Advisor Principal.