Bond market nervousness continues

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Last week, the US Federal Reserve upgraded its forecast for growth in the US economy, in the course of 2021, to 6.5 percent from December's estimate of 4.2 percent.

The reaction on financial markets to this supposedly "good" news underscores the extent of the transformation that has taken place, in both the basic economy and the financial system, as a result of the provision of trillions of dollars of ultra-cheap money by the Fed, and other major central banks, over the past decade and more.

One of the main factors behind the increased growth forecast is the expected impact of the Biden administration's $1.9 trillion stimulus package. But because it is being financed entirely by an increase in government debt, there are concerns it will trigger a rise in interest rates, as a result either of the Fed tightening its monetary policy because of inflation, or the operation of market forces.

In order to finance the debt, the government must issue more Treasury bonds. This increase in supply tends to lower their price and increase their yield (the two have an inverse relationship). The yield, or interest rate, on the 10-year Treasury bond, is the baseline for interest rates throughout the financial system, and so any increase will extend more broadly.

With the US financial system and the economy as a whole so dependent on the continuation of ultra-low interest rates, the fear is that an upward move in Treasury yields, produced by a sell-off, will create financial turbulence, threatening the "recovery."

So far this year, the shift by investors out of government debt has already seen the 10-year Treasury yield rise from 0.9 percent at the start of the year, to more than 1.7 percent, with further rises expected to come.

Following the meeting of its policy-making body last week, the Fed issued further reassurances that even if inflation were to rise over the next year to above its target of 2 percent, and the official unemployment rate continued to fall, it would not increase its base interest rate, now at virtually zero, until 2024 at the earliest. It also pledged to continue buying Treasury bonds and mortgage-backed securities, at the rate of $120 billion a month, or $1.44 trillion a year.

In other words, ultra-loose monetary policy, which was further developed last March when the $21 trillion Treasury market froze, would continue.

But as the *Financial Times* noted in an editorial, "market participants do not quite believe him, and are clearly minded to test the Fed's resolve to keep monetary policy loose. Bond yields keep rising."

Speaking at a conference over the weekend, the head of the Bridgewater hedge fund, Ray Dalio, said the fiscal package announced by Biden would result in more bond sales to finance the spending. This would worsen the "supply-demand problem for the bonds, which will exert upward pressure on rates," he said.

The Fed would "have to buy more, which will exhibit downward pressure on the dollar."

The Treasury bond market was delivered a shock on February 25, when a $68 billion auction for seven-year bonds was undersubscribed by 40 percent, meaning the underwriters had to step in to make up the gap. The event was a chilling reminder of what happened in March of 2020, when the Treasury market, the most liquid in the world, froze, as bonds were sold off in a dash for cash.

Speaking before the Fed's meeting last week, Steven Oh, the global head of credit and fixed-income at PineBridge Investments, told the *Financial Times* that Fed Chair Jerome Powell needed to "show a bit more concern about the rise in yields." He continued, "What you don't want to do in the recovery phase is to counteract the fiscal stimulus with monetary tightening."

But Powell gave no commitment to intervene, saying the Fed would see an issue with the bond sell-off only if it were accompanied by “disorderly conditions in markets or persistent tightening of financial conditions that threaten the achievement of our goals.”

In other words, the Fed has not ruled out intervening, but not yet.

The next market test will come later this week, when there will be an auction for $62 billion worth of seven-year Treasury bonds. *Bloomberg* noted that the market was haunted by the ghost of what it called the “horrific” auction last month.

One financial strategist told the news agency that this week’s auction would reveal whether the seven-year auction last month was so poorly sponsored “because of the volatility of that day, or whether it’s a continuing theme.” He added, “There’s just a lot of volatility now and questions about whether higher rates are going to impact equities.”

The market may also be impacted by a move by the Fed to end an emergency regulation, introduced as a result of the March 2020 freeze, which allowed banks to exclude Treasury bonds from their asset holdings for the purpose of calculating their reserve ratios. The aim of the measure was to encourage the holding of Treasuries in a bid to boost the market. But the removal of the exemption could lead banks to sell off some of their holdings, further increasing bond yields.

Whatever the outcome of this week’s auction, market nervousness will continue, as more bonds come onto the market to finance its growing debt. So far, the Fed has said it does not want to directly target the yield curve in order to keep interest rates down.

But, as one financial analyst told the *Financial Times*, if rates were to go up by another 0.5 or 1 percentage points, “that could really slow things down,” and the “blowback in equity and credit markets could also be severe enough to prompt verbal intervention from the Fed, or even a shift towards the Fed buying more longer-term debt.”

The turbulence in the bond market has underscored the changes in the functioning of both the real economy and the financial system, as a result of the massive trillion-dollar interventions by the Fed. If growth is low, the “solution” is supposedly the provision of still more money. But if growth starts to rise, then still more money is needed to keep yield down, in order to maintain stability in the financial system.