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# Broken

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**Risk sentiment remains fragile and equally worrisome is that market functioning has become impaired. We believe aggressive and more permanent measures are needed to improve market functioning. Still, absent fiscal measures, fundamental uncertainty about the economic backdrop is likely to remain elevated, thus keeping a lid on yields.**

Global safe haven yields rallied again as sentiment and liquidity conditions continue to worsen but less than expected amid a worsening funding backdrop. Global equities have sold off sharply; US and European equities are down 20-25pp in just the last five days, while VIX has shot up to levels not seen since 2008. Credit spreads have widened sharply, with CDX HY and IG at 670bp and 140bp respectively. Figure 1 shows that long end government bonds have rallied about 20-30bp. Canadian rates have rallied much more as the Bank of Canada cut rates by 50bp, which was more than the market expected. Bank of England also cut 50bp, whereas the ECB focused on liquidity measures. It boosted QE by 120bn euros through year end, added new long-term refinancing operations but left the deposit rate unchanged. Central banks are acting in a coordinated fashion with whatever policy space they have; however, they are failing to stem the worsening in sentiment as investors likely see fiscal measures as necessary at this point.

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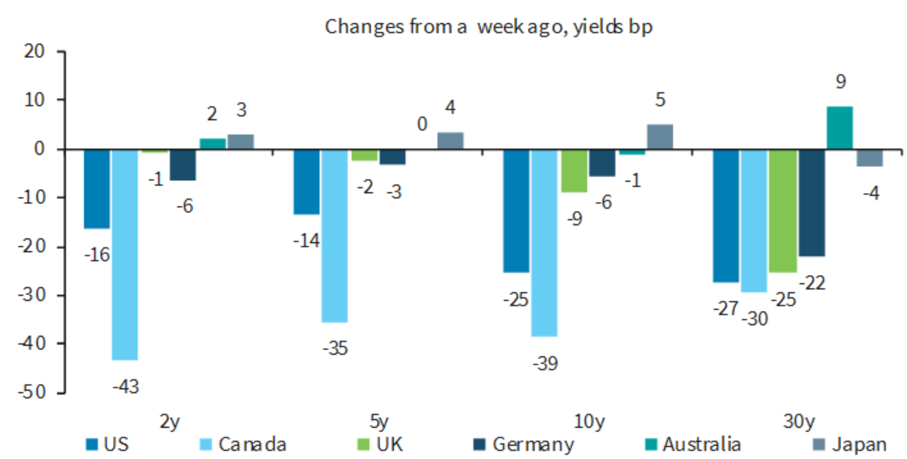
Equally worrisome is that market functioning has become impaired and relative value relationships in the rates market have gone haywire. For instance, Treasury futures have richened significantly versus the underlying CTDs, resulting in a sharp increase in implied repo (Figure 2). In other words, the expected return in long basis positions (long Treasuries financed in the repo market and being short Treasury futures) has risen sharply, pointing to a sharp increase in expected financing rates. While overnight funding conditions have worsened somewhat, the implied repo is now well above the levels even during the September repo spike. In our view, this reflects stop-outs of long basis positions amid fears of balance sheet availability. 30y swap spreads have tightened 30bp over the last week to -60bp reflecting similar dynamics. On-the-run Treasury premia has increased sharply as well, suggesting an increased preference for liquid securities (or decrease for less liquid securities, Figure 3). Our measure of market liquidity, which looks at rate moves relative to the amount of DV01 trading in the market, has also worsened (Figure 4). Overall, relative value

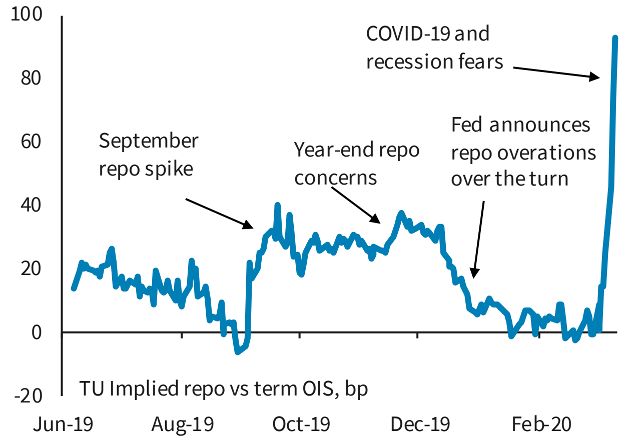
FIGURE 1
**Safe havens have rallied but less than expected given the worsening funding backdrop**




Source: Bloomberg, Barclays Research

FIGURE 2

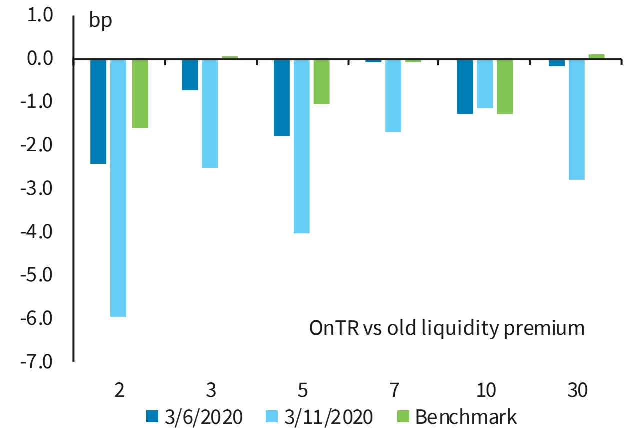
**Treasury futures Implied repo rate has risen sharply**




Source: Bloomberg, Barclays Research

FIGURE 3

**On-the-run premium has sharply risen as well**




Source: Barclays Research

relationships which rely on smooth functioning of markets, availability of funding and balance sheet, are completely dislocated (See the US Treasury and Derivatives for details). What can policymakers do to alleviate this situation?

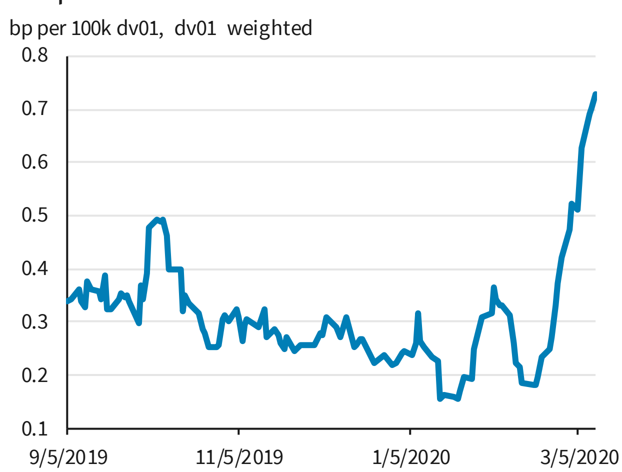
**What can the Fed do?** While the Fed did increase its overnight/term repo operations significantly to ensure availability of funds, it appears that investors are worried about balance sheet constraints instead. The Fed also announced that for the next month, it will spread $60bn purchases across the curve. While that is the step in the right direction as it removes coupon Treasuries from dealer balance sheets, instead of just T-bills, we do not think it is sufficient.

*The Fed needs to move to ongoing large-scale asset purchases (LSAPs) to free up dealer balance sheets on a more permanent basis*

In our view, the Fed needs to move to ongoing large-scale asset purchases (LSAPs) to free up dealer balance sheets on a more permanent basis. In addition, it should also begin reinvesting Agency MBS paydowns back into Agency MBS (currently the Fed reinvests up to $20bn in Treasuries and the remainder, if any, in the Agency MBS market). The mortgage basis has significantly widened and such a move by the Fed could help financing conditions in the housing market (Figure 5). We believe such ongoing asset purchases could go a long

FIGURE 4

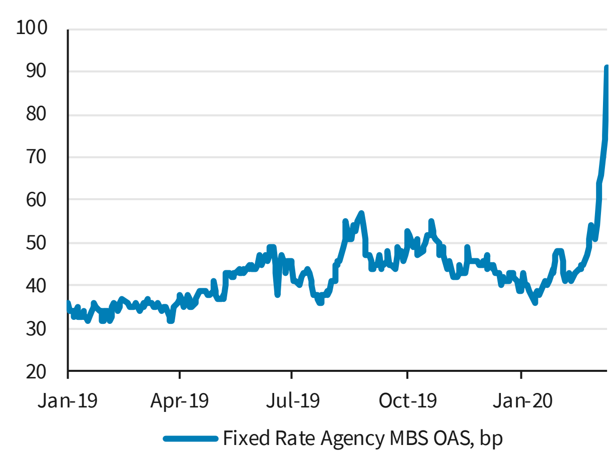
**Our measure of liquidity has deteriorated by several multiples**




Source: Bloomberg, Barclays Research

FIGURE 5

**Mortgage basis has underperformed**




Source: Bloomberg, Barclays Research

way to ensure smooth functioning of the markets. The Fed could also revisit some of the post crisis tools[1], such as TALF, CPFF which involves providing liquidity directly to borrowers in the credit markets under "unusual and exigent circumstances" (see the Money Market section for details)

**What can the US Treasury do?** One option is conducting buybacks of off-the-run securities from primary dealers. However, since the Treasury is not running a budget surplus the way it did in the early 2000s, it would have to issue more on-the-run securities to fund the buybacks. While buybacks may help liquidity in off-the-runs, they ultimately do not remove Treasuries from market; for instance, if levered investors end up buying the new issue, it would still need to be financed and will therefore use up dealer balance sheet. Hence, the benefit would be less than Fed's LSAPs, but perhaps non-trivial.

*We believe aggressive steps are needed to improve market functioning and help at least partially restore relative value relationships*

Overall, we believe aggressive steps are needed to improve market functioning and help at least partially restore relative value relationships. However, fundamental uncertainty about the economic backdrop is still likely to keep liquidity premium elevated.

Away from market functioning, there is still significant uncertainty about the economic effects of COVID-19 and Treasury yields have rallied significantly over the last few weeks to reflect that (and likely would have rallied even more if not for funding concerns). However, despite the markets essentially priced for the Fed to go to the zero lower bound, financial conditions continue to tighten, driven by lower equities and wider credit spreads. In our view, for Treasury yields to rise, risk sentiment needs to turn and for that to happen, fiscal authorities need to step up. If not, while cases in the US are still rising, it is unlikely that yields will retrace the rally. In fact, we believe the market is priced for too quick a normalization in volatility, and recommend a 3m*10y-1y*10y calendar spread (see Derivatives for details).

Hence, it is worth considering, as we discuss below, should the economic outlook worsen dramatically, can US Treasury yields fall below 0%? Specially, our positioning indices are now suggesting that real money investors are underweight duration, which may exacerbate any adverse news (Figure 6).

## Negative Treasury yields?

Even as some of the major central banks – such as the ECB, SNB and the BOJ – have already implemented negative interest rate policy (NIRP), the Fed has so far resisted the idea. We do

FIGURE 6

**Real money investors are underweight duration**


Source: Barclays Research

FIGURE 7

**Term premium was very negative during 2012 amid QE**


Source: Bloomberg, Barclays Research

[1] https://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm

not expect that to change anytime soon. However, we also do not think that is a prerequisite for longer-term yields to turn negative.

*We also do not think that the Fed adopting NIRP is a prerequisite for longer-term yields to turn negative.*

In our view, in an adverse economic scenario (say, a recession), the expected policy rate could fall below 0% even when the overnight policy rate is above 0%. We envisage this as reflecting the Fed not explicitly ruling out using NIRP, thus allowing for its possibility in the future. In our view, ruling out NIRP would limit the effectiveness of Fed's other policy tools and therefore the Fed is unlikely to do so. Simply allowing this possibility to exist would widen the future distribution of policy rates to the downside, thus exerting downward pressure on longer-term rates in the present. This could push expectations into negative territory should the economic outlook worsen enough.

Alternatively, term premium could become negative enough for yields to fall below 0%, even if the expected policy rate is not. We envisage this as reflecting rising disinflation worries, persistent diversification benefits and potential asset purchases. Investors are clearly concerned about the disinflationary aspects stemming from the demand shock. Continuing worsening risk sentiment is still resulting in flight-to-quality into the Treasury market. In this backdrop, large scale asset purchases could also push term premium lower. Figure 7 shows that term premium fell sharply during 2012/2013 (pre taper-tantrum), to around -25bp to -50bp. Hence, if expected policy rates are close to 0%, negative term premium can push Treasury yields into negative territory.

We have discussed this in detail in *Can Treasury yields go negative?,* March 11.

## Market Views

### Duration

- We are neutral on duration, given the uncertainty about the effect of the virus on the US economy.

### Curve

- We are neutral on curve as at current yield levels, the curve is directional with rates.

### Swap spreads

- We maintain our recommendation to buy 2y swap spread wideners, given the expansion in Fed's repo operations and still fragile risk sentiment.

- We are neutral on back-end swap spreads

### Volatility

- We believe that the market is priced for too quick a normalization in volatility, and recommend a 3m*10y-1y*10y calendar spread.

- We maintain our recommendation to buy 1y*2y-1y*30y ATM+17 bear-steepeners because large sell-offs are likely to be led by the long end.

- We maintain our recommendation to be long 2y*5s30s curve vol given that the changing monetary policy regime means a more volatile curve.

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