Still the World’s Safe Haven?
Redesigning U.S. Treasury Markets After the Covid19 Crisis

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Covid forced central banks to rescue their bond markets

1. In March 2020, Covid news triggered a “dash for cash.”

2. Most bond trades by investors are handled by large bank-affiliated dealers, whose balance sheets are constrained by post-GFC capital regulation.

3. The bond market choked on huge investor trade demands.

4. Central banks responded with huge bond purchase programs.
   - Fed: $3,200 billion in purchases for 2020, 14.9% of GDP.
   - ECB’s PEPP: €1,350 billion, 11.9% of GDP.
   - Bank of England: £300 billion program, 13.6% of GDP.
Fed purchases of Treasuries during the Covid Crisis

Typical two-tiered bond markets
Figure: Marketable treasuries outstanding, including projections from 2020 from deficit of Committee for a Responsible Federal Budget, April 13, 2020. Total assets of the holding companies of Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, Bear Stearns, Bank of America, JP Morgan Chase, Citigroup, and Wells Fargo. Data: FRED, CRFB, 10K disclosures.
Treasuries will overwhelm dealer balance sheet space

Record foreign gross sales of Treasuries to U.S. dealers

Figure: U.S. treasury bid-offer spreads, indexed to 100 at January 2, 2020. This figure by Lorie Logan, Manager of the System Open Market Account and Head of the Open Market Trading Desk, Federal Reserve Bank of New York, was published with her speech of April 14, 2020. The underlying data source is Bloomberg Financial LP. Bloomberg publishes dealer bid and offer prices in the dealer-to-customer market.
Bid-Offer Spreads: Gilts, Bunds, Treasuries

Figure: Percentage increases in bid-offer spreads in the interdealer markets for Gilts, Bunds, and Treasuries, from February 24. Figure source: Bank of America Securities, Data and Innovation Group.
Market depth

Figure: Treasury market depth on Brokertec, in millions of dollars. The market depth shown is the average of the largest three amounts bid or offered on Brokertec's interdealer central limit order book market (New York, London, and Tokyo, respectively) for on-the-run 10-year U.S. treasuries between 8:30am and 10:30am EST. The figure was obtained from JP Morgan, US Fixed Income Strategy, Joshua Younger and Henry St. John, April 2, 2020.
Figure: Total treasury market volumes, dealer-to-customer and interdealer (including ATS), for weeks ending on the indicated dates, and primary dealer volumes (which double counts trades between primary dealers). Data sources: FRBNY and TRACE (FINRA).
Central clearing of Treasury transactions is still limited

Figure: Data gathered by Treasury Market Practices Group (2018) implies that a firm faces a CCP on about 22% of Treasury transactions.
A rule requiring the central clearing of transactions of firms actively trading Treasuries, or engaging in Treasury repos, would relieve some of the need to warehouse trade flows on dealer balance sheets. Dealers would be better able to net their buy and sell trades with central counterparties (CCPs). Central clearing is a pre-requisite to all-to-all trade. With a broad-market CCP, some treasury transactions could flow directly from ultimate sellers to ultimate buyers, without necessarily impinging on dealer balance sheet space.
One-day settlement risk: SPDR SP500 versus 10-year note

Figure: Estimated market-total one-day gross settlement risk, on-the-run 10-year U.S. treasury notes and SPDR SP 500 ETF. One-day gross settlement risk is estimated as the dollar market value of the volume of trade multiplied by the option-implied standard deviation of daily returns. Treasuries trades normally settle in one day (T+1), whereas exchange-traded equities such as the SPDR SP500 ETF settle in two days (T+2). Underlying data sources: FINRA, U.S. Treasury Department, CBOE, NYSE-Arca.
Figure: Settlement fails in treasury securities transactions involving primary dealers, and centrally cleared settlement fails at FICC. Data sources: Federal Reserve Bank of New York and FICC.
Appendix charts
Financing of primary-dealer treasury inventories

Figure: Total of all treasury positions for which primary dealers received financing with repurchase agreements and securities lending, January to May, 2020. Data source: Federal Reserve Bank of New York.
Yield Curve Noise and Volatility

Figure: Implied volatility of the 10-year treasury note and the Hu-Pan-Wang measure of yield curve noise, in basis points. The implied volatility measure is from CBOE TYVIX data, based on options on the 10-year treasury note. The Hu-Pan-Wang (2013) noise measure of treasury market illiquidity is the square root of the mean squared error (RMSE) obtained when fitting the prices of treasury securities to a smooth model of the yield curve. Figure source: Professor Jun Pan.
We estimate that ECB programmes will have close to €980bn of net purchasing power by the end of June 2021, assuming full utilization of remaining purchasing power in all programmes and an APP net target of €20bn/month.

Source: ECB, Haver Analytics, Morgan Stanley Research

Exhibit 3:

Weekly PEPP and PSPP purchases

APP/PEPP – split by programme

€800bn of the €1,350bn PEPP envelope in 2020.

At the current pace, the ECB is likely to utilise between €750bn and €800bn of the €1,350bn PEPP envelope in 2020.

Between March and September, PEPP purchases accounted for 70% of total Eurosystem net purchases, with 66% of September purchases conducted in PEPP.

The summer decline in the weekly pace of PEPP purchases persisted through September, with the average pace of purchases over the past four weeks at €14.8bn.

Source: ECB, Haver Analytics, Morgan Stanley Research

Exhibit 4:

PEPP and PSPP purchases by country in August

Source: ECB, Morgan Stanley Research; Note: August PEPP purchases assume capital key

Figure source: Morgan Stanley Research.
Figure: The ratio of the stock of outstanding marketable treasuries to the total of treasury positions for which primary dealers received financing with repurchase agreements and securities lending. Data sources: FRED and Federal Reserve Bank of New York.
Figure: The difference, in percent, between (a) the repo rate implied by selling treasury futures, purchasing the cheapest-to-deliver underlying treasury note, and closing the futures contract at maturity by delivering the treasury note, and (b) the actual market general-collateral one-month repo rate. The data shown in the figure were provided to the author by Andreas Schrimpf, Hyun Song Shin, and Vladyslav Sushko, from Graph 3 of their paper “Leverage and Margin Spirals in Fixed Income Markets During the Covid-19 Crisis,” BIS Bulletin, Number 2, April 2, 2020.
1. What is the primary purpose of central-bank asset-purchase programs? (a) restoring market functionality, (b) controlling risk-free interest rates, or (c) lowering borrower credit spreads through direct purchases of risky assets.

2. On March 23, the Fed merely said it would buy corporate bonds. Credit spreads plunged.

3. Similarly, the ECB’s March 18 PEPP announcement, alone, narrowed Euro area sovereign bond credit spreads (by 72 bps for BTP-Bund).
Balance-sheet space is expensive: The USD-JPY CIP basis

Figure 7: Illustration of Quarter-End Dynamics for the Term Structure of CIP Deviations: In both figures, the blue shaded area denotes the dates for which the settlement and maturity of a one-week contract spans two quarters. The grey shaded area denotes the dates for which the settlement and maturity dates of a one-month contract span two quarters, and excludes the dates in the blue shaded area. The top figure plots one-week, one-month and three-month CIP Libor CIP deviations for the yen in red, green and orange, respectively. The bottom figure plots the difference between 3-month and 1-month Libor CIP deviation for the yen in green and between 1-month and 1-week Libor CIP deviation for the yen in red.

Source: Du, Tepper, and Verdelhan (2016).