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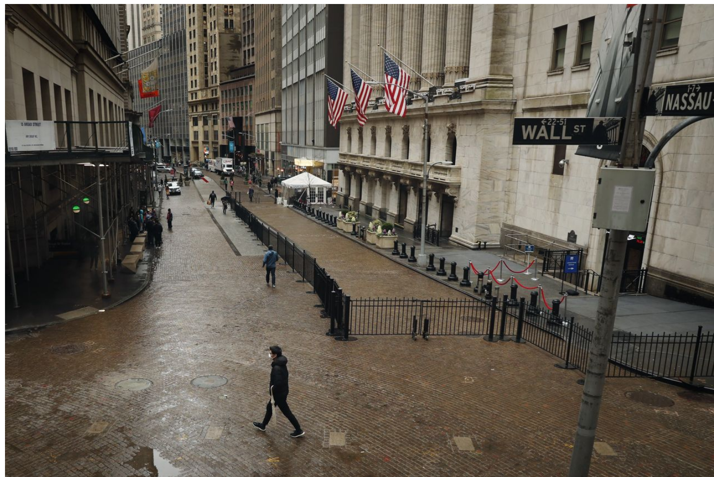
MARKETS

Federal Reserve Accelerates Treasury Purchases to Address Market Strains

Central bank cites 'highly unusual disruptions' in Treasury market as pandemic pressures grow



Volatile market activity this week has prompted the Federal Reserve to act.

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By Nick Timiraos and Julia-Ambra Verlaine

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The Federal Reserve accelerated previously announced purchases of Treasury securities on Friday in a bid to prevent strains in financial markets from worsening.

The Fed took the unusual step after offers to provide vast sums of short-term loans a day earlier were met with tepid demand, indicating ongoing challenges in restoring smooth functioning in the market for U.S. government debt.

Stocks rallied Friday, in part on signs of progress in Congress toward passing government measures to support the economy. But Wall Street faced beneath-the-radar pressure as financial firms scrambled to exit complex bond market trades that pushed up long-term U.S. Treasury borrowing rates, which typically go down in a crisis.

The Fed announced Friday morning that it would purchase later in the day roughly half of some $80 billion in Treasury securities that it had said Thursday would be purchased over the next month.

The Treasury market has faced "highly unusual disruptions...associated with the coronavirus outbreak," the New York Fed, which conducts market operations for the central bank, said Friday. The Fed said it stood ready to accelerate other planned purchases as needed.

"The Treasury market is the foundation, the building blocks for the rest of the market, and the foundation is cracked," said Rick Rieder, chief investment officer of global fixed-income at BlackRock Inc. "What the Fed did was right in every regard."

Disruptions to funding that first appeared Wednesday and continued Friday suggested the Fed's promise on Thursday to provide essentially unlimited amounts of short-term loans secured by government debt hadn't fully resolved issues plaguing the Treasury market.

Friday's decision by the Fed to accelerate purchases of short- and long-term government securities "increases the odds that we will see a formal and potentially larger" bond-buying program soon, said Roberto Perli, an analyst at research firm Cornerstone Macro.

The Fed's rate-setting committee is set to meet on Tuesday and Wednesday. Many Wall Street analysts expect the Fed will follow the prior week's emergency half-point rate cut—which took the benchmark federal-funds rate to between 1% and 1.25%—with another cut that takes the rate to near zero.

This week's actions occurred during the central bank's customary pre-meeting quiet period, limiting how much the Fed said publicly about its actions.

"I think they're just trying to hold down the fort until next Wednesday," said Jim Vogel, interest-rate strategist at FHN Financial. "There's a corner of my heart that has sympathy for all the Fed folks trying to come up with the best recommendations. I hope it leads them to do more than they think they need to do."

Fed Chairman Jerome Powell has signaled the central bank will do as much as it can to support market functioning and the broader economy during what could be a wrenching slowdown in activity intended to prevent the spread of the coronavirus.

But Fed officials have also acknowledged there are limits to how much monetary policy can help stabilize confidence, and analysts have warned that markets could remain volatile until public testing for the coronavirus has revealed the full extent of its spread in the U.S.

Rising market volatility reflects a constellation of challenges. They include business continuity plans by Wall Street banks that have led trading teams to work from multiple sites or remotely; post-crisis regulations that have made individual large banks more resilient but restricted their ability to quickly warehouse assets being sold by financial firms; and hedge funds caught up in bond trades that became extremely unprofitable when volatility soared, leading to more volatility as those trades unwind.

On Thursday afternoon, the Fed attempted to alleviate strains by offering up to $1.5 trillion in short-term loans called repurchase agreements, or repo, to financial institutions. Those offerings saw comparatively tepid demand, with the Fed ultimately extending $119.5 billion.

Fixed-income traders at large banks have described the Fed's recent actions as positive, but say they fall short of resolving the fundamental issues: balance sheet constraints and archaic financial plumbing that prevents a rapid, efficient transfer of cash to those that need it, including hedge funds and other investors.

"The repo patch applied by the Fed midday yesterday will take several days to work through the system," said Mr. Vogel. "Like last Tuesday's intermeeting rate cut, it's designed to make things less worse rather than better."

The Fed also plans to revamp its scheduled purchases of $80 billion in Treasury securities over the next month. Since October, the Fed has been buying $20 billion in securities of varying maturities and $60 billion concentrated in bills, which have maturities of one year or less. On Thursday, the Fed announced it would try to ease funding strains by shifting all $80 billion toward securities across varying maturities.

Readjusting the Fed's planned purchases "just one day after they released the original calendar is a sign that they are trying to get it right, but they have not yet figured out what is the right thing to do," said Lou Brien, a market strategist at DRW Trading.

Liquidity in longer-term Treasurys and those issued some time ago is particularly poor because there is already less demand for those bonds, traders say. The prices of longer-term bonds also go up and down more for any given amount of change in their yield, making them riskier to hold.

Michael Lorizio, a senior trader at Manulife Investment Management, said the price gap between what dealers were willing to buy longer-term Treasurys for and what they were billing to sell them for had only increased Friday morning.

Mr. Lorizio said he had tried to sell some older bonds with near 30-year maturities and found the price dealers were willing to buy them for was lower than what was indicated on his computer screen, a sign of market illiquidity.

Many funds that include a mix of riskier assets, like investment-grade bonds or stocks, along with Treasurys are experiencing large outflows. In response, some managers appear to be selling Treasurys because, even under these circumstances, they are still easier to off load than those other assets.

Recent volatility has put special pressure on so-called relative value traders, which seek to profit from small differences in prices of two very similar assets. Those traders have also helped the U.S. government digest a large supply of Treasury securities amid ballooning budget deficits.

The upshot is that a messy unwinding of those trades could amplify market volatility, put some hedge funds and other traders in significant stress, and explain this week's unusual dislocations in the Treasury market.

—Sam Goldfarb and Gregory Zuckerman contributed to this article.

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