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Managing Fixed Income Trading Costs Through Political and Economic Uncertainty

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World events introduced significant volatility into fixed income markets over the last several weeks. Russia's invasion of Ukraine initially drove investors to safe-haven assets such as Treasuries as they tried to avoid the uncertainty of riskier assets. However, renewed inflation fears are again driving rates markets lower, with Treasuries and European government bonds selling off significantly. Trading costs can increase dramatically during periods of high volatility such as this, so it is essential for managers and owners to use TCA to monitor execution costs as they reposition portfolios.

Backdrop

Russia announced its formal recognition of the sovereignty of Luhansk People's Republic and Donetsk People's Republic on February 21, 2022 and launched an invasion of Ukraine shortly after on the morning of February 24. In response, Western nations imposed a series of sanctions, roiling markets and culminating in the removal of several Russian banks from the SWIFT messaging system on February 26, 2022.[1] Shortly after that, Euroclear and Clearstream shut down the settlement of rouble-denominated transactions.[2] The impact on trading in Russian sovereign debt was immediate, trading volumes dropped significantly on February 23. They collapsed entirely starting on March 1, according to MarketAxess data cited by The Desk.[3]

Predictably, illiquidity also spread to other eastern European bonds with EM and frontier markets becoming increasingly volatile. Unexpectedly, volatility also spread to developed markets with Euro and Sterling-denominated investment grade and high yield being impacted as well. The Desk reported bid-ask spreads are 50% to 100% wider in EUR and GBP rates products and are more than 100% wider in other central Europe and middle eastern markets.[4]

Looking at a broad measure of fixed-income volatility, the ICE MOVE Index (SMOVE1M) hit 140.03 on March 7, its highest level since the onset of COVID-19 in March 2020. Bloomberg also notes that the Bloomberg Aggregate Index is currently 9.9% off its 2021 peak, the most significant drawdown since 2008.[5]

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[1] Brown, C. P. (2022, March 16). Russia's war on Ukraine: A sanctions timeline. PIIE. https://www.piie.com/blogs/realtime-economic-issues-watch/russias-war-ukraine-sanctions-timeline
[2] Watkins, J. (2022, March 2). Euroclear and Clearstream shut down settlement of Russian securities. The TRADE. https://www.thetradenews.com/euroclear-and-clearstream-shut-down-settlement-of-russian-securities/
[3] Barnes, D. (2022, March 3). Market disruption spreads beyond Ukraine and Russia. The DESK. https://www.fi-desk.com/market-disruption-spreads-beyond-ukraine-and-russia/
[4] Barnes (2022)
[5] Matua, C., & Ritchie, G. (2022, March 14). Stagflation fears bringing credit to worst quarter since 2008. Bloomberg News.

Moves in Treasuries since the beginning of the year reflect the opposing dynamics between an escalating conflict in Europe and concerns about domestic inflation. Treasury prices dropped significantly during the first several weeks of 2022, with 10-year yields reaching a high of 2.045% on February 15, reflecting investor concerns about rising prices. Then, Russia's invasion of Ukraine prompted investors to seek the safety of Treasuries, increasing prices and pushing 10-year yields down as low as 1.722% on March 1.[6]

However, yields have again shot up following the Fed's decision to raise interest rates 25 basis points on March 16. 10-year Treasury yields briefly hit 2.24% after the decision, marking the highest point since 2019 before settling around 2.17% at the end of the trading day.[7]

As we approach the end of the month (March 28) the yield curve continues to invert signaling greater potential for a recession. According to Bloomberg, the yield on the 5-year note hit 2.572%, above the 10-year rate and trading briefly above the 30-year rate. This is the first inversion of that part of the curve since 2016.[8] Meanwhile the yield on the 2-year note has shot up 90 bps this month, the largest rise since 1984.[9]

The action has not been limited to rates markets. According to Bloomberg, US investment-grade bonds have also sold off, down 2.7% for the week ending March 11. On a total-return basis, that is the worst week since March 2020. Overall, the debt is down 8% for the year, potentially marking the worst quarter since 2008 if it persists through the end of the month.[10]

What does this mean for institutional Investors?

These developments create a problematic backdrop for investors with few good available options. Many portfolio managers are likely to reposition themselves around changing interest rates and a more unpredictable global environment. It is essential to factor the frictional cost of trading into these decisions and use TCA to carefully monitor market makers to better understand the cost of liquidity across fixed income asset classes. Managers should carefully consider their use of counterparties, electronic trading venues, and trading protocols to ensure they get the best possible price based on their trading objectives.

At the same time, asset owners are likely to see increased trading costs among managers during the first quarter and potentially the second quarter. For example, Abel Noser data shows that trading costs tripled for US Treasury bond trades at the onset of the COVID crisis in March

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[6] Goldfarb, S. (2022, March 15). Yield on Ten-Year Treasury Hits Highest Mark in Years. Bloomberg News.
[7] Yun Li,Tanaya Macheel,Vicky McKeever. (2022, March 16). 10-year treasury yield pares gains after hitting highest level since 2019 following fed rate hike. CNBC. https://www.cnbc.com/2022/03/16/us-bonds-treasury-yields-rise-ahead-of-fed-decision.html
[8] Watts, W. (2022, March 28). Treasury Yield Curve Flattening Accelerates. Bloomberg News.
[9] Crise, C. (2022, March 28). You Can Bet the U.S. Treasury Knows There's an Inflation Issue. Bloomberg News.
[10] Matua and Ritchie (2022)

2020. This is consistent with the findings of the Federal Reserve Bank of New York that Treasury bid-ask spreads widened out 2-6 times prior levels depending on the maturity of the bond.[11]

Asset owners should expect to receive feedback from their managers highlighting the similarity in cost increases to those in the Treasury and credit markets in March 2020 (COVID-19) and be aware that although higher costs are expected, contrasting the costs incurred across different managers may help identify which managers are skilled in trading unpredictable markets. Asset Owner TCA reports can also help track the different repositioning tactics (and quantify the associated costs) made by each manager.

Summation

At this point, it is unclear how the situation in Ukraine will play out or how the Fed will manage increasing inflation. However, we know from our 30+ years of experience that the volatility caused by political instability or economic uncertainty leads to higher trading costs. Managers and owners should leverage TCA to monitor the impact on trading and ultimately portfolio returns to gain a competitive advantage.

[11] Fleming, M., & Ruela, F. (2020, April 17). Treasury market liquidity during the COVID-19 crisis. Liberty Street Economics. https://libertystreeteconomics.newyorkfed.org/2020/04/treasury-market-liquidity-during-the-covid-19-crisis/