Investment Strategy Update

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com
Christofer.Langner@bankfab.com

FAB First Abu Dhabi Bank

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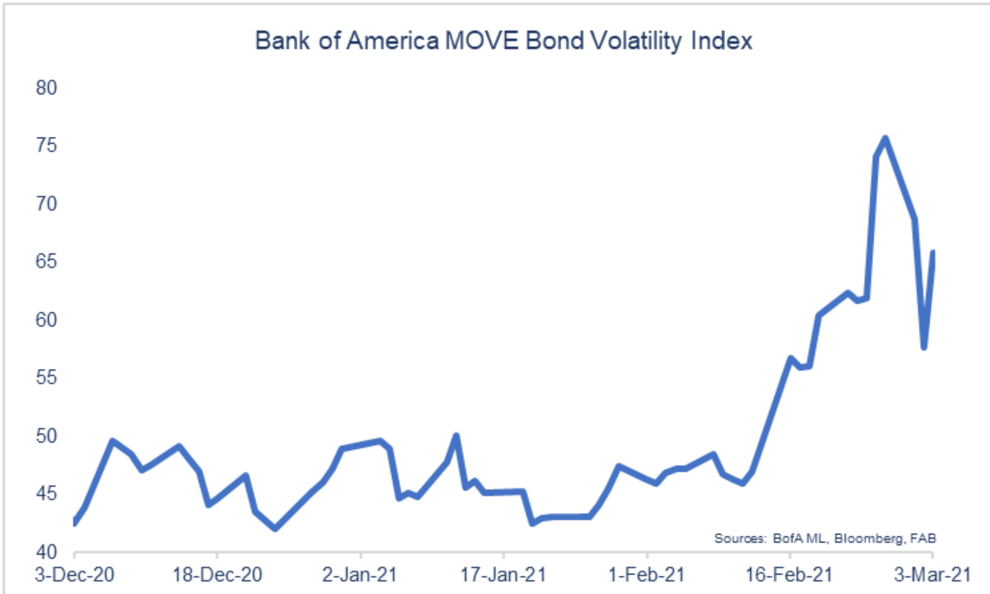
The last time bond markets were this volatile the Fed stepped in

♦ **Lack of liquidity and uncertainty about the expiration of some bond-buying exemptions for US banks are prompting a rise in Treasury volatility.**

♦ **Excluding the market meltdown of March last year, bond volatility is at the highest since 2019, when repo market issues prompted the Federal Reserve to intervene in funding markets.**

♦ **While Fed officials may continue to indicate that the levels of long-term Treasury yields express confidence in the economic outlook, they could indicate concern about the pace at which rates are rising.**

♦ **The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight in alternatives.**



Volatility in the bond market is often overlooked, because it rarely is very high. However, when it does rise, it can cause turmoil across the investment world, and this is happening right now.

The technology-heavy NASDAQ 100 has dropped 8.14% since its most recent record on 12 February, almost the same date when bond volatility as measured by the Bank of America Merrill Lynch MOVE index began to rise. On 16 February, the first trading day after the NASDAQ record, the MOVE index jumped almost 10 points to 56.78, the highest level since a late October market sell-off.

The rise in bond volatility continued and so did the drop in technology stocks as well as in long-term Treasuries. In the same period, the yield on 10-year Treasuries increased 28 basis points to 1.48%.

Excluding the mid-March period of 2020, when the market collapsed amid the global lockdowns, the recent bond volatility has been the highest since the fourth quarter of 2019. That, happens to be the time when the Federal Reserve revived some of its repo operations to normalize conditions in funding markets.

Back then, a sudden demand for Treasuries and regulatory restrictions incentives to hoard them caused liquidity in the market to collapse and volatility to spike. That, in its turn, translated into higher stock market volatility as well.

A similar dynamic seems to be unfolding now. Almost exactly one year ago, the Fed allowed large banks to exclude Treasuries and deposits at the Fed from a measure of capital relative to assets. The exemptions, set to expire 31 March, were meant to free up resources for more loans. If the measure is not extended, banks are likely to hoard Treasuries, sapping the market liquidity and spurring volatility.

Excluding last year's meltdown, bond volatility is at the highest since 2019

The market action in the past three weeks shows signs of this. Bid-offer spreads in the Treasury markets are near the highest in a year. The Secured Overnight Financing Rate (a short-term financing measure) also doubled last night.

All of this will gain new significance in a 10-year bond auction next week. A poorly-attended seven-year auction last week accelerated the Treasury sell off.

If the bond volatility worsens, the Federal Reserve will probably step in. The biggest risk here is that, after tomorrow, Fed officials cannot speak publicly until the next FOMC meeting, on 17 March. The bottom line, however, is that this volatility will pass, and the current sell-off may prove to have been an opportunity.

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