

## Buttonwood Full tilt

*Why the bond market has become jumpier*

JAMES MADDISON was sure he had scored. As his free kick arced over the wall of Arsenal players, a goal seemed certain. Somehow Arsenal's goalkeeper, Aaron Ramsdale, got a hand to the ball and kept it out. "Best save I've seen for years," said Peter Schmeichel, a former goalie. Others noted a crucial detail. Before the ball was struck, Mr Ramsdale was on his toes, his weight distributed evenly, ready to jump in either direction. By keeping perfectly balanced, he made a wonder-save possible.

Balance (or the lack of it) matters in financial markets, just as in football. A market in which bets are slanted in one direction is vulnerable to a big swing in prices the opposite way. Where positions are lopsided traders can be wrong-footed by even a tiny change in sentiment or in the news. Some of the recent volatility in global bond markets can be put down to skewed positioning. When liquidity is patchy, as in today's Treasury market, the results can be some surprisingly large shifts in bond yields.

To understand all this, imagine you are pondering a trade. You notice that covid-19 infections are rising in Europe and that governments are imposing partial lockdowns. Meanwhile there are signs that America's economy is picking up steam. You conclude that the Federal Reserve will have to raise interest rates sooner than people expect and a lot sooner than the European Central Bank. A way to profit from this analysis might be to sell the euro against the dollar.

Before you go ahead, you would be wise to check how other traders are positioned. America's Commodity Futures Trading Commission publishes regular reports on the positions of traders in currency futures and options. If, say, there were already a lot of euro

shorts, you should feel less gung-ho. After all, if many traders have already sold the euro, there are fewer potential sellers to drive it down in the future. And there are perils when a lot of investors are betting one way. In the event of unexpected news that is positive for the euro, the speculators who are short the currency would be nursing losses. Some would be forced to buy back the euros they had sold. As more traders scrambled to cover their short positions, the euro would appreciate sharply. This is a classic "short squeeze" or "position washout".

That brings us to bond-market volatility. Inferring traders' positions from bond futures is tricky, says Kit Juckes of Société Générale, a bank. The nature of finance is to borrow short and lend long. This "natural positioning" will tend to obscure other speculative bets, says Mr Juckes. Perhaps this is why a lot of the recent discussion of volatility has been focused on liquidity—how easy it is to get in or out of a position quickly. A report this month by a working group drawn from America's Treasury, the Federal Reserve and other regulatory



bodies provides an example. It blames evanescent liquidity for the dramatic jumps in bond yields in, for instance, March 2020 and in February this year. It puts this down to a change in market structure. New regulations in the aftermath of the global financial crisis of 2007-09 made it costlier for banks to hold large inventories of bonds to facilitate client trading. A small group of electronic high-frequency traders has since supplanted the banks. These firms keep the market super-liquid most of the time. But they are thinly capitalised, and cannot hold a lot of bonds for long. In volatile markets, they are forced to take less risk. So when liquidity is most needed, it tends to vanish.

These and other changes in market structure have tended to make positions more extreme. Bond-buyers are less heterogeneous, says George Papamarkakis of North Asset Management. Funds are bigger. Information flows more quickly. And momentum trading, the buying of recent winners and selling of recent losers, is a more prevalent feature of bond markets. In the halcyon days before the financial crisis, there were marketmakers who were willing and able to lean against momentum, to take a view based on fundamentals, and to hold bonds for more than a day (or a few seconds). But not anymore. So positions become crowded. When a piece of news goes against a popular trade, the washout can be quite dramatic.

A market that leans too far one way is eventually forced to reverse. In this regard, the bond market is like a goalkeeper who gambles on where a free kick is going. He shifts his weight to one side of the goal in anticipation. But he is often left flapping in despair as the ball heads for the other corner.

▶ An even more alarming prospect is that Mr Erdogan has decided to test his conviction, which turns basic economic thinking on its head, that cutting rates is the way to tackle inflation. As the central bank dances to his tune, the strategy risks plunging Turks into poverty. Many blue-collar workers, students and pensioners are no longer able to buy meat or basic household necessities. Attempts by the pro-government media to put a positive spin on this sound like cruel jokes. A television pundit recently celebrated the impact of the crisis on the minimum wage, which had sunk from the

equivalent of around \$380 monthly at the start of the year to \$220, as a chance for foreign companies to move production to Turkey. One ruling-party parliamentarian helpfully suggested Turks should eat less.

For middle-class Turks, holidays abroad and scores of imported goods are out of reach. Many young professionals say they no longer see a future in Turkey. Since the start of last year, some 3,000 doctors are believed to have moved, mostly to Germany. Another 8,000 are planning to join them. Newlyweds Taner and Busra, he a physician and she a paramedic, both in

their late 20s, say they can no longer dream of buying an apartment or a new car. "We're getting poorer each day," Taner says. They are starting to take German classes.

Turkey has confronted currency collapse before. On a few occasions, most recently late last year, Mr Erdogan eventually gave in and let the central bank raise rates. This time he seems determined to hold out. Ordinary Turks will continue to pay the price. "Interest is the cause and inflation is the result," Mr Erdogan likes to say. The true cause is the president, and the result is a broken economy. ■