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What's behind the U.S. Treasury market's roller coaster ride?

In the Loop

Key Insights

- The U.S. Treasury market has experienced abrupt moves in the aftermath of the tariff announcement.
- There is unlikely to be a major policy response unless there is an outright breakdown in market structure.
- Treasury auctions are critical to watch going forward for signs of whether demand is faltering.

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Recent abrupt shifts in the multi-trillion-dollar U.S. Treasury market have garnered significant attention. In this Q&A, we explore the factors driving the moves, the potential for policy responses, and the key factors to watch out for next.

What has been going on in U.S. Treasury markets?

U.S. Treasuries have been on a roller coaster ride. The initial rally following the April 2 tariff announcement gave way to a dramatic sell-off in a liquidity-strained market that prompted some calls for policy action to help alleviate the pressures. Although the April 9 90-day pause in additional tariffs on countries has helped restore some calm to the world's biggest bond market, it's important to understand the factors behind the sell-off and how developments could evolve from here.

In a nutshell, the combination of poor liquidity and rapidly shifting narratives driving sentiment caused outsized yield moves in U.S. Treasuries. Some of these narratives involved hedge funds unwinding trades designed to profit from small price differences between cash Treasuries and futures contracts, as well as foreign holders of Treasuries selling their positions.

But the real reason that Treasury yields have been so volatile is that the Treasury Department issued approximately USD 2.3 trillion in new debt annually from 2020 through 2024. At the same time, regulators have not allowed bond dealers to expand their balance sheet market-making capacity. This has created a situation that is the rough equivalent of funneling the traffic on a busy four-lane highway into only one lane.

For now, it appears that the worst of the situation may have passed, but volatility in Treasury markets is here to stay. Taking a step back, it's important to understand the interconnection between the U.S. trade deficit and the financial account surplus. For the past four to five decades, the global economic order was structured so that the U.S. imported cheap goods, meaning that dollars were being exported globally.

These dollars served as the basis for the majority of trade transactions, global central bank reserves, and financial transactions globally, which underpinned the U.S. dollar's reserve currency status. This was further supported by the rule of law and the sheer depth and breadth of U.S. financial markets. These dollars were then recycled back into the U.S. in the form of a financial account surplus.

Consequently, the U.S. announcement about curbing its current account deficit has the super-secular potential to partially unwind the financial surplus that the U.S. has benefited from. We are monitoring this closely as it could have broad long-term implications for all U.S. assets. The U.S. Treasury market, where almost a third is held by investors outside the U.S., could be meaningfully affected over the secular horizon.

Could heightened volatility prompt a policy response?

The Federal Reserve can make tweaks to help market functioning, but the central bank is unlikely to start buying Treasuries through quantitative easing—as it did in March 2020—unless there is an outright breakdown in market structure. These relatively minor adjustments are likely to include changes to the dynamics of the standing repo facility (SRF), which serves as a backstop when bank counterparties are unwilling to lend to help manage short-term interest rates. Changes could include widening the timing or collateral acceptance to help ease funding issues.

Keep in mind that the Fed also needs to maintain its independence from politics in dealing with the ramifications of the Trump administration's tariffs.

What indicators are you monitoring for signs of further liquidity deterioration or bank funding stress?

Treasury auctions are critical to watch for signs of faltering demand, and we agree that problems selling new issues—even with meaningful yield concession—would be a negative signal.

Looking beyond the Treasury market, credit markets have been relatively orderly as of early April, although new corporate bond issuance has almost ground to a halt. We're closely watching data on outflows from credit exchange-traded funds (ETFs) and institutional credit funds. A rush to exit these products could drive a liquidity freeze in credit markets that could then lead to even more selling pressure on Treasuries to raise cash.

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