

Treasurys Trading Is A Brand New World WSJ, September 18, 2003

NEW YORK -- Being nailed to a seat for a solid nine hours every day is one of the few things that hasn't changed for traders of Treasurys over the past few years.

But many other aspects of trading U.S. government bonds have fundamentally altered at a time when fixed-income returns at big banks have never been so profitable. These range from the drastically larger average size of trades to the prevalence of electronic trading.

Chief among the changes has been the startling growth of the nearly \$5 trillion mortgage-backed securities market, which frequently uses the \$3.3 trillion pool of outstanding Treasurys to manage interest-rate risk.

"The heightened awareness among Treasury traders of what drives the mortgage market is the biggest change we have seen in the marketplace for a long time," said Brian Edmonds, global head of U.S. Treasury Trading at Banc of America Securities in New York. "It wasn't on my radar screen a few years ago when the mortgage market was smaller than the Treasury market."

While the mortgage market and, indeed, the \$4.1 trillion corporate-bond market, the \$34.4 trillion U.S. interest-rate swap market and the \$2.4 trillion agency-debt market are sizable entities themselves, they are built on the foundation provided by the status of Treasurys as the ultimate safe-haven asset.

"Treasurys are ultimately the clearinghouse for interest-rate risk," said Robert Lunder, head of government trading at Bear Stearns in New York.

As a result, the rapid expansion of diverse fixed-income products in recent years has forced trading floors to become far more integrated, with Treasurys as the lubricant that helps investors and dealers price, value and hedge mortgage bonds, swaps, and agency- and corporate-debt positions.

Whereas a decade ago, a Treasurys trader needed to pay attention only to the government-bond market, that narrow horizon has greatly expanded to include a broad array of interest-rate products. Given the increasingly interlinked nature of both U.S. and global fixed-income markets, this has become an essential part of trading Treasurys.

Moreover, the recent growth of fixed-income markets has naturally facilitated a surge in the size of trades. This is partly because investors in the massive mortgage-backed securities market sell or buy Treasurys to rebalance portfolios and counter an unwanted extension of duration, or average life expectancy, as rates rise or fall. Thus, a \$500 million trade in five-year Treasurys "is no longer considered an exceptional size, whereas five or 10 years ago, that was the case," Mr. Edmonds said.

But it isn't just the boom in mortgage portfolios behind bigger trades. Hedge funds have adopted higher tolerance levels for risk, and, as a result, are trading Treasurys in large volumes. Even some banks have followed this approach, setting up internal proprietary-trading desks.

"One of the big changes or reversals is now you have a customer base, or portion of the customer base, that is a lot bigger and has a larger risk tolerance" than the primary dealers, said J.P. Marra, head of government-bond trading at Lehman Brothers. "The net of it is, the market is bigger than the dealerships right now," and some leveraged accounts "have the ability to move the market" simply by the sheer size of their trades, he said.

Some longer-term investors also have become more of a force in the market. "There's a slow evolution for real-money accounts to trade the market more frequently than they have in the past," said Jim Caron, a market strategist and former trader at Merrill Lynch, referring to long-term investors.

This enhanced trading presence has also been encouraged and often rewarded by the most aggressive easing of the federal-funds rate in history by the Federal Reserve. From its January 2001 level of 6.5%, the fed-funds rate had bottomed out at 1% by June 2003. Each slice in rates has duly ignited renewed bull runs in Treasuries that have whetted the appetites of interest-rate investors.

The arrival of such a large customer base using Treasuries also has been spurred by the erosion of the market power once held by primary dealers, those banks that deal directly with the Fed and underwrite Treasury auctions.

The breaching of the wall between primary dealers and the rest of the market began with the steady evolution to electronic trading systems. Scott Gewirtz, co-head of U.S. government trading at Deutsche Bank in New York, said that electronic trading systems have made the Treasuries market "more transparent" in nature, and that the greater depth of participants with access to prices and liquidity has generated an environment of "rapid-fire trading."

The changes aren't without a downside. A whole language built around voice-brokering is dying, leading veteran traders to lament what they call the "sterilization" of the trading floor. The roar that once would envelop fixed-income desks after an economic-data release and fuel a collective adrenaline rush has diminished substantially as electronic trading often confines volume to beeps and clicks. One bond salesman said, "Sometimes economic data comes and goes without a blip of noise."

The advent of online trading has democratized trading, blunting the edge large banks once had when the wide spread between a bid and an offer gave them a clear edge, effectively creating a much more level playing field.