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Market Facts

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A Review of Leverage Measures in the Bond Market

*Prices in financial markets have already adjusted in anticipation of a significant amount of policy tightening, engendering additional alteration of balance sheets in recent months. An unwinding of carry trades--that is, market positions premised on low short-term financing costs--seems to be under way, at least judging from a pronounced shift in the trading portfolios of primary dealers. In addition, investors classified as non-commercial have established net short positions in ten-year Treasury note futures in recent months. Indeed, the swing toward a net short position on ten-year Treasury note futures **has** been the largest since the inception of the contract in the 1980s, likely offsetting a significant portion of the interest rate exposure of previously established carry trade positions. – Alan Greenspan, 7/21/04*

As the quote above highlights, Chairman Greenspan believes that the carry trade is behind us.

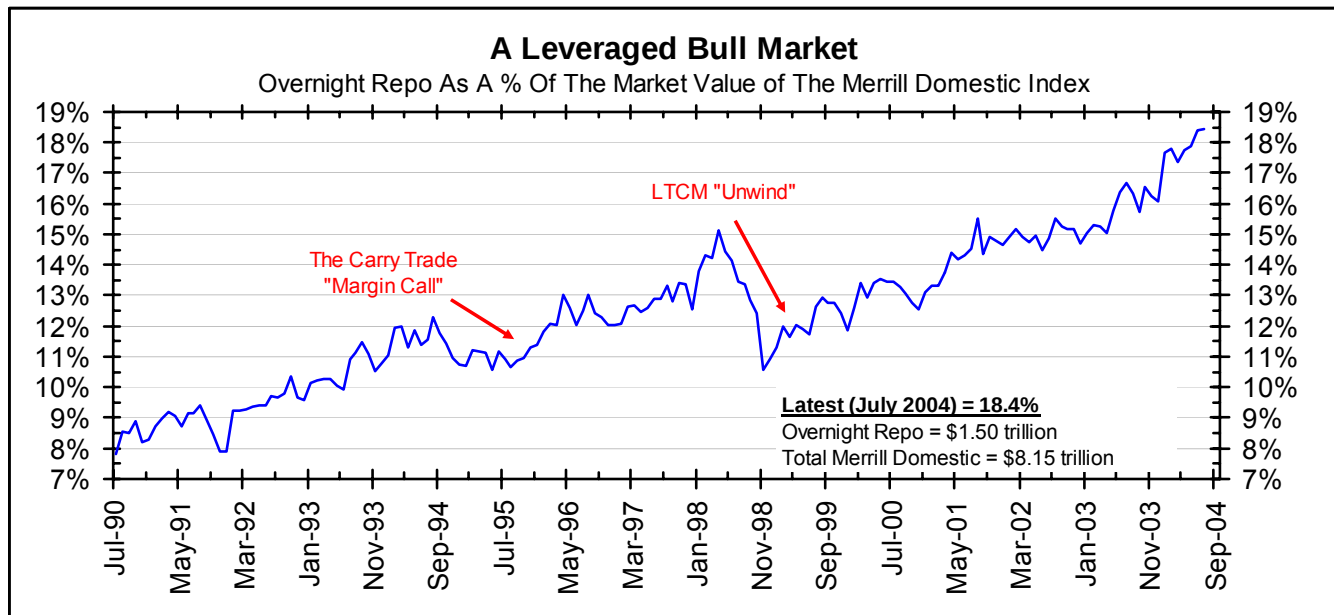
The indicators that we have constructed to track the general level of leverage in the marketplace leave us less convinced. The following is a review of how abnormally low interest rates have been affecting leverage in the bond market.

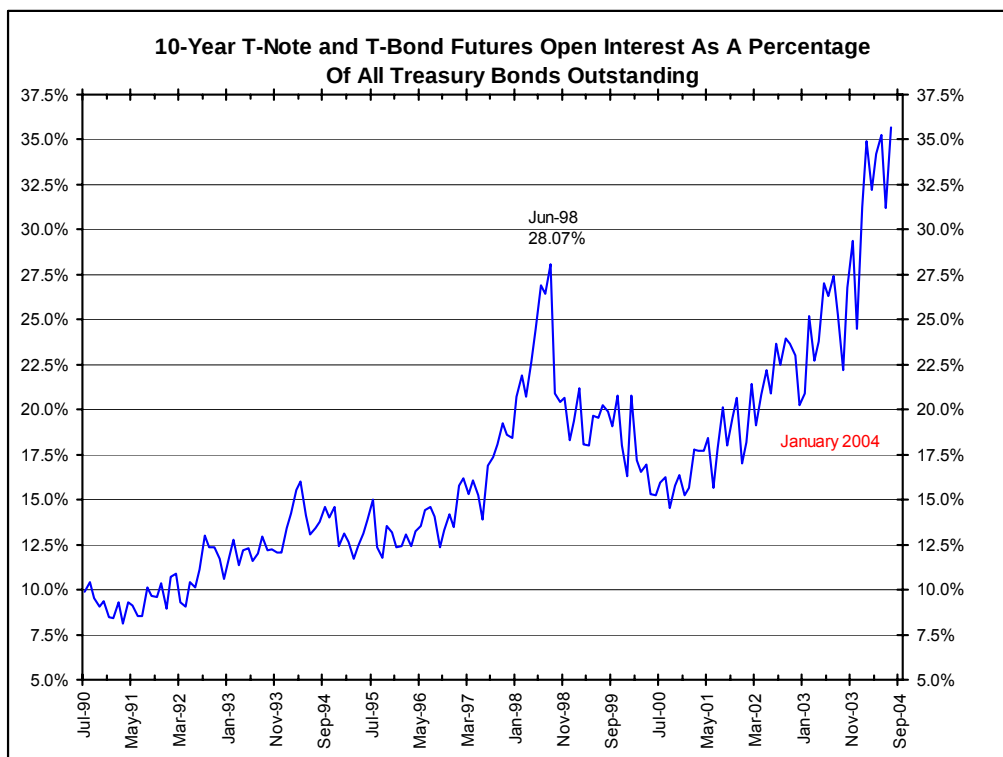
Just How Leveraged Is The Bond Market?

The first part of Greenspan's quote above mentions a pronounced shift in the trading portfolios of primary dealers. For this reason, we have created the chart

below, which shows the total amount of overnight repurchase agreements outstanding as a percentage of the market value of the Merrill Domestic Master Index (a broad measure of the size of the fixed-income market). You may think of this as the most comprehensive measure of leverage in the bond market.

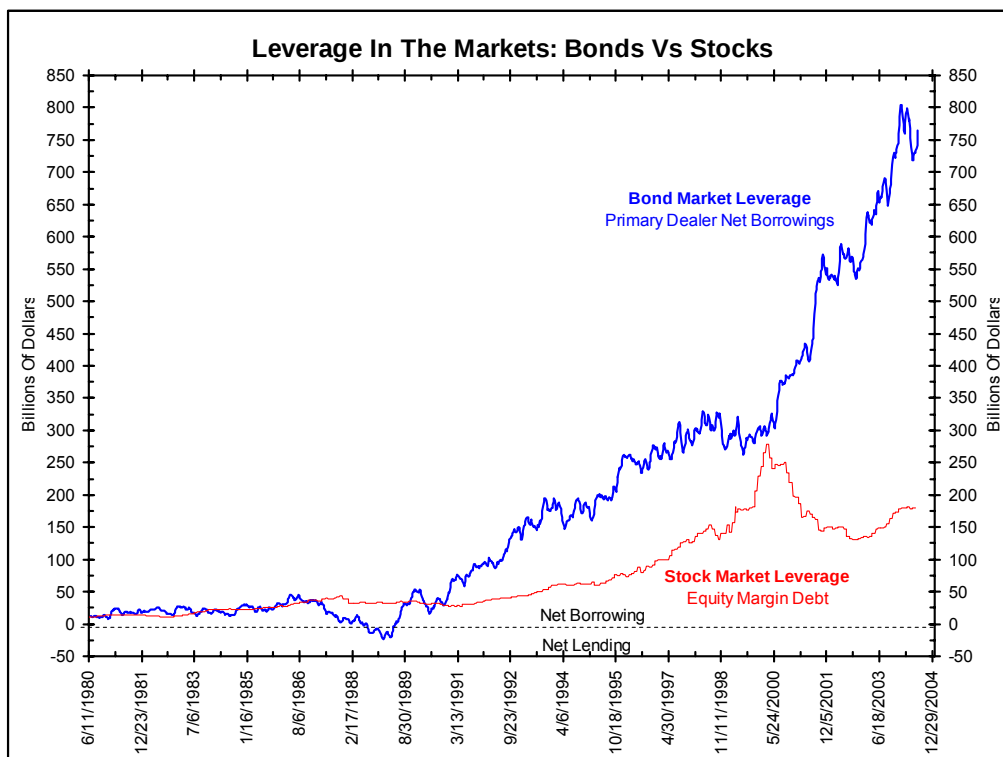
By this measure, **bond investors have not significantly reduced their leverage** through July 31. Are there alternative measures of leverage that confirm or deny this first observation?





The chart above illustrates the total notional value of open interest in 10-year notes and long bonds as a percentage of the total value of all Treasuries with a maturity greater than 10 years. While institutional fixed income investors can and do operate at greater

leverage than available in the futures market, futures markets are open to other classes of traders. The growing level of open interest is not consistent with de-leveraging in the bond market. Where does this leverage stand in relation to other markets?



The second chart on the previous page compares the current level of bond market leverage to that of equities. Bond leverage is represented by primary dealer net borrowings, total primary dealer repo less reverse repos outstanding (thick blue line), which currently stand near \$774 billion. Equity leverage is represented by margin debt (thin red line). These two measures were similar at the stock market's peak in March 2000, but have moved in opposite directions since.

The strong growth of bond market leverage over the past four years has **not** started to reverse despite Chairman Greenspan's comment.

Commitment of Traders Data

Let us now turn our attention to the second part of the opening quotation, which referred to the recent move to a net short position in 10-year note futures by non-commercial traders.

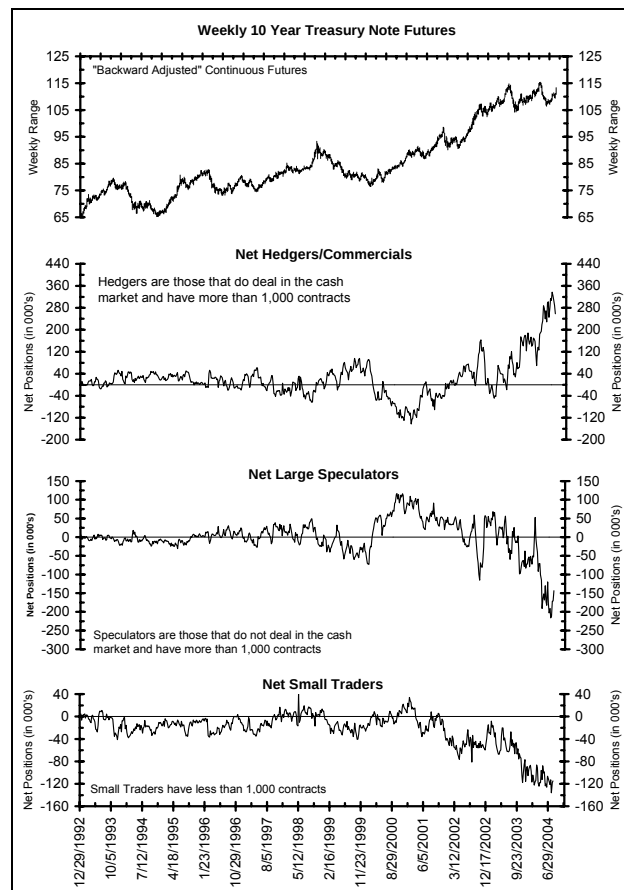
Non-commercial investors can be separated into two groups – the Large Speculators (third panel below) and the Small Traders (fourth panel below). We regularly cover this data in our [Commitment of Traders Update/Analysis](#).

Both of these groups are near net short extremes, and we concur with Greenspan's assessment on

this count. However, he further states that these net short positions are "likely offsetting a significant portion of the interest rate exposure of previously established carry trade positions." Here we disagree.

The extent, if any, to which Large Speculators are involved with offsetting cash market positions cannot be ascertained. If anything, the more favorable margin and position size treatment afforded to self-declared Hedgers by the exchanges mitigates such exposure. While it is possible for the extreme Large Speculator positions seen to be involved in hedging various cash market positions in non-Treasury instruments – hedging Treasuries is inefficient compared to closing the position – the open interest is more likely to represent a leveraged directional bet.

If the 10-year Treasury future market were to unwind its leverage, the net positions of both the Net Hedger/Commercial and the non-Commercial trader groups should converge to zero. The fact that the non-Commercial traders currently hold near-extreme net short positions shows that these opposing groups are still making considerable bets in the 10-year futures market.



Conclusion

All of the measures of bond market leverage discussed above suggest the same answer: The bond market **still** has a record amount of leverage. The size of the repo and futures markets are still near their record highs, and the Commitment of Traders data shows Commercial and non-Commercial traders at opposite net extremes.

The common thread driving leverage has been an abnormally low funds rate and the Fed offering a timeline on how long this source of cheap financing

will last. Terms such as “considerable period”, “patience”, and “measured” have changed behavior.

Given all of this leverage, it is reasonable to expect the bond market to react violently to anything that may change the outlook for this cheap financing. While some investors have undoubtedly exited their leveraged positions, the bond market is still highly leveraged.

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