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CREDIT MARKETS

Bond-Market Strains Keep Traders on Edge

Many believe Fed intervention will help—while expressing surprise at how quickly functioning unraveled in some markets

The state of Wisconsin has been holding off on a $281 million bond sale that was meant for last week.

PHOTO: LAUREN JUSTICE FOR THE WALL STREET JOURNAL

By Gregory Zuckerman Follow *, Heather Gillers* Follow *and Julia-Ambra Verlaine* Follow

Updated March 20, 2020 6:11 pm ET

The global scramble for cash is putting immense pressure on bond markets, raising concern about whether they are functioning well enough to effectively distribute funds to communities and businesses.

On Friday, the Dow industrials dropped 913.21 points, or 4.55%, to 19173.98, putting it down 33% for the year. Selling was broad-based, with declines in technology shares, financial issues and health-care firms leading the 30-stock index to its fourth weekly decline out of five. U.S. Treasury prices rose Friday, with the yield on the 10-year Treasury note falling to 0.932%. But many traders say trading this month in Treasurys and other debt offers reason for acute concern.

In recent days, long-term Treasury securities have suffered significant price declines alongside large stock-market retreats, an unusual dual downturn that has raised alarm among traders. A stampede into dollars is pushing up the U.S. currency's value overseas, adding to repayment woes for companies and governments that borrowed in dollars.

In the U.S., corporate issuance has been largely off limits to all but the bluest chips. State and local governments are facing sticker shock as steep declines in demand for their securities force rates much higher in some instances, while the market for short-term corporate loans has become surprisingly fragile, some market participants said.

The disruptions have prompted a series of extraordinary Federal Reserve interventions. Many traders express optimism that those fixes will help return markets to normal.

Even so, the events are adding to uncertainty about the outlook for the economy and the price that some borrowers will pay simply to stay afloat at a time when many Wall Street banks are forecasting a sharp decline in U.S. economic output for the second quarter at least.

"Disrupting access to new funding curtails credit to companies, local authorities and others," says Mohamed El-Erian, Allianz SE's chief economic adviser. "This adds another shock to an economy that's reeling" from the spread of the novel coronavirus, the stock market tumble and collapsing oil prices.

The most apparent disruption has come in what is typically the most robust of financial markets: the one for U.S. Treasurys. On Wednesday, the price of the benchmark 10-year Treasury note, which usually climbs amid weakness for stocks, instead fell 2 17/32 points, sending its yield up to 1.259%.

There were signs of improvement in Treasurys on Thursday and Friday, as the 10-year note's price rose more than 3 points. But prices in the municipal market deteriorated sharply at the end of the week, with yields on AAA-rated 10-year bonds rising to 2.79% Friday afternoon from 1.84% Wednesday, even after the Fed moved Friday morning to shore up municipal money-market funds.

The losses came even as the Federal Reserve has committed to make massive purchases to help bolster Treasury markets. Some of the weakness is likely due to an expected surge in new-bond issuance, as well as to the collapse of some trades using borrowed money.

Still, longer-term Treasurys generally have been declining in price since their yield set a record low March 9, setting off alarms about how that market is functioning. Before 2008, both newly issued Treasurys and so-called off-the-runs, or those issued just a bit earlier, traded with the same level of fluidity, as investors got in and out with ease.

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But the level of trading deteriorated in recent years, partly as investment banks were encouraged to reduce trading risk, and in recent days, it has become much harder for investors to transact.

"Did things trade? Yes. In chaos? Yes," says Susan Estes, who runs OpenDoor Securities LLC, a firm that provides anonymous electronic Treasury trading.

In the market for short-term corporate debt known as commercial paper, turmoil sent the cost of borrowing for 30 to 270 days above the cost of selling 30-year bonds in some cases. Commercial paper gives large businesses access to money for very short periods to finance day-to-day operations. While the market stabilized by Friday, easing some investor fears, some remain worried that the market could act up again once corporations start missing payments as the economic impact of the virus begins to deepen.

Investors said they were seeing firms seek these short-term IOUs that hadn't been involved in commercial paper for years—but that the potential reward isn't yet attractive enough to get them to get them interested.

Emerging-market debt also is under duress, with some dealers no longer even providing prices for investors. Salespeople on trading floors said liquidations in emerging market debt and foreign exchange derivatives continued well into Friday.

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In the municipal-bond market, where debt often goes for months without a trade, conditions are more difficult than investors can recall. Investors pulled $12.2 billion from municipal bond funds during the week ending Wednesday, prompting them to seek bids on long lists of bonds.

On Monday, Chris Johns, who manages $900 million in municipal bonds for Aquila Group of Funds, solicited bids for about $2 million in AA-rated 11-year school district general obligation bonds, a type of security that would find interest in a matter of moments in normal times. Mr. Johns received only "a handful" of offers, he says. He ended up instead selling other bonds to raise cash.

Even gold-plated bonds are trading at deep discounts. Debt backed by New York state traded at 116 cents on the dollar Wednesday, down from 125 cents at the beginning of the month.

On Wednesday, rates shot up to 5.2% from 1.3% last week on variable rate municipal bonds that reset their rates every week according to what bondholders are willing to pay, according to the Sifma Municipal Swap Index.

"Trading is very thin," said Dan Genter, CEO of Los Angeles-based RNC Genter. "There's no new issue market at all."

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What problems do you think the pressure on bond markets might presage? Join the conversation below.

The state of Wisconsin will pay about $64,700 in interest for the week that began Wednesday, compared with about $15,500 the previous week, on its roughly $58 million in variable-rate bonds, says David Erdman, the state's capital finance director. Mr. Erdman has been holding off on a $281 million bond sale he had hoped to do last week.

Troubles are deeper for high-yield municipal bond funds, which have swelled their holdings over the past few years. Investors pulled $5.3 billion from high-yield mutual funds and ETFs in the week ended Wednesday, according to Refinitiv.

If you're trying to sell a bond below investment grade, "you're probably going to get no bids," Mr. Genter said.

Economists including Barclays PLC's Joseph Abate predict Fed moves such as its backstop for commercial paper will ease pressures on the funds, though many traders say the going is slow.

"Improved, yes. Recovered, no," says Lou Brien, strategist at DRW Trading Group in Chicago.

—Ben Eisen contributed to this article.

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