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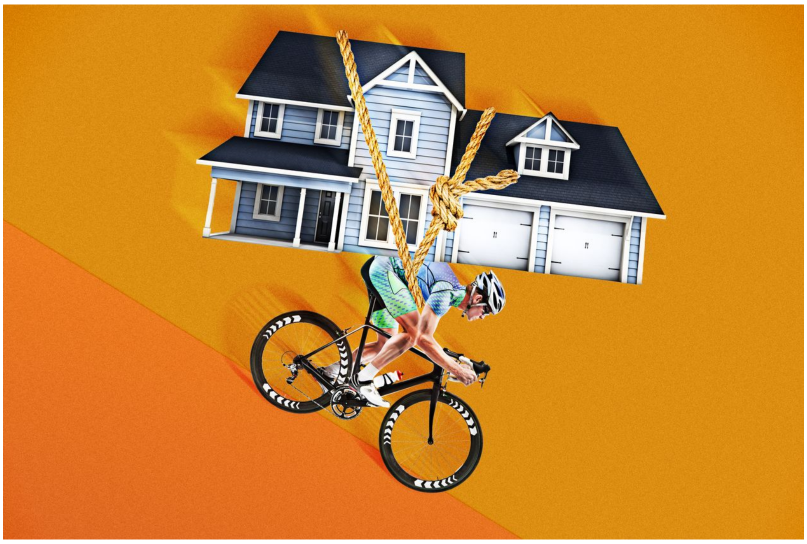
TREASURYS

Fear Isn’t the Only Driver of the Treasury Rally: Banks Need to Hedge Their Mortgages

Banks need to buy around $1.2 trillion of 10-year Treasurys to offset risks on mortgages and bank deposits



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Yields on U.S. government bonds fell to new lows and stocks dropped Friday after a better-than-expected jobs report failed to assuage growing investor fear over the global coronavirus crisis.

The yield on the benchmark 10-year Treasury note, a key reference rate for borrowing costs throughout the economy, fell for a 12th consecutive session to close at a new all-time low of 0.709%. The yield regained some ground as stocks pared losses in an end-of-trading recovery.

That move upward wasn’t enough to push the Dow Jones Industrial Average into positive territory for the day. But the index did post a slight gain for the week, a period marked by violent swings as investors gauged the progression of the coronavirus and a surprise rate cut of a half-percentage point by the Federal Reserve.

The Dow ended Friday down 1%, at 25864.78, paring what at one point earlier in the day had been a drop of more than 800 points. The blue-chip index has still fallen around 9% since the start of the year. A sharp drop in the price of oil hit energy stocks, while investors also punished bank shares.

Analysts and investors said a muted response to Friday's monthly jobs report, which showed employers adding more positions in February than expected, occurred because companies reported their headcounts before cases of coronavirus began mounting in the U.S. Many investors already expect the Fed to cut its short-term benchmark rate again by its March 17-18 meeting at the latest.

While stocks garnered much of the investing attention during the week's tumult, equally dramatic moves occurred in bond markets.

Treasury yields, which fall when bond prices rise, plunged in overnight trading before the jobs report. Investors intensified the rush to safer assets and anticipated lower short-term rates for the foreseeable future as the economic fallout from the virus spreads with each canceled flight and shuttered factory.

Adding fuel to the yield decline: the insatiable demand of major U.S. banks, whose hedging needs have risen with each fresh decline in rates.

Banks need to buy around $1.2 trillion of 10-year Treasury notes to offset risks on mortgages and bank deposits, according to JPMorgan research estimates. Commercial banks own around $3 trillion of U.S. Treasury and government-agency securities, Fed data show.

The 10-year yield, which helps set borrowing costs on everything from mortgages to business loans, has been pushed lower by worries about the coronavirus's potential impact on the economy, which resulted this past week in the Fed's first emergency rate cut since the financial crisis.

The yield has declined precipitously from 1.90% at the beginning of the year. The plunge both reflects and intensifies commercial banks' efforts to manage balance-sheet risks including sensitivity to interest-rate swings. This practice, known in industry parlance as convexity hedging, has been a significant factor in the bond market for years but has become even more momentous as a result of tighter rules adopted after the 2008 crisis.

"Convexity tends to exacerbate market moves—if rates are going lower, convexity will make the move sharper," said Gennadiy Goldberg, U.S. rates strategist at TD Securities.

Here is how it works. When interest rates fall, many homeowners who took out fixed-rate mortgages refinance to lock in lower monthly payments. The owners of the relevant mortgages and mortgage-backed securities—including the banks—lose out on higher payment streams. As a result, the prices of mortgage bonds tend to rise less in any given bond rally than Treasury securities or some other bonds, making them "negatively convex."

Banks hedge their holdings of mortgages and other assets to limit these sorts of losses, but doing so often entails buying new assets including Treasurys. Banks also use interest-rate derivatives to offset potential losses from changes in rates—usually swaps, in which the bank typically exchanges the right to a fixed payment for a floating payment under specified terms.

The sharp decline in rates is making banks even bigger buyers of Treasurys, as the probability of mortgage refinancing increases and they seek to bridge expected income shortfalls generated when higher-paying fixed-income securities "prepay," as traders say when refinancings enable a bond to be paid off early. The same dynamic plays out to some extent with deposits, which are liabilities that the banks seek to match with assets, a match that often comes under pressure when the rate environment changes significantly.

The three largest U.S. banks by assets, JPMorgan Chase JPM **-5.17%** ▼ & Co., Bank of America Corp. BAC **-4.00%** ▼ and Wells Fargo WFC **-4.65%** ▼ & Co., have steadily grown since the financial crisis, expanding their mortgage books and raking in more consumer deposits through money-market, checking and savings accounts. That means bigger hedges to manage risks.

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Are you interested in buying Treasury bonds? Why or why not? Join the conversation below.

JPMorgan held an average of $215 billion of residential mortgages on the books at the end of 2019, compared with $143 billion a decade earlier. Wells Fargo deposits climbed to $890 billion last year from $787 billion in 2016. Interest-bearing deposits at Bank of America jumped nearly 20% over two years to $900 billion in 2019.

Partly as a result of larger mortgage and deposit balances, both of which can require hedging, banks have grown more sensitive to rate changes. JPMorgan research analysts estimate the expected increase in net interest income for banks for a 1-percentage-point increase in rates is $8 billion, up from $6 billion last year. Those figures generally work in reverse when rates fall.

This sensitivity can be painful when banks misjudge the economic outlook or market sentiment. In 2018, many large banks were wrong-footed by the year-end market meltdown that ended in the Fed's decision to begin cutting rates following several years of increases.

The scale of these moves and the ripples from banks' efforts to hedge them underscore the tightrope the Fed is trying to walk as it seeks to keep the economy on track in the face of rising coronavirus fears.

“If the Fed overreacts and cuts too much, it creates other dynamics that hurt insurance companies, pension funds and the banking system,” said Rick Rieder, chief investment officer of global fixed income at BlackRock.

Compounding the problem, banks are hamstrung by postcrisis capital rules that have made assets including corporate bonds expensive to hold, making it difficult for them to buy assets with long duration that they can carry on the balance sheet.

Accordingly, they are now buying products long preferred by insurance companies, including collateralized mortgage obligations—financially engineered mortgage bonds sold in grades that can make higher-rated ones less vulnerable to prepayment risk—in the hunt for longer-lived assets that they can hold.

“This rally has exacerbated an already significant issue,” said JPMorgan’s head of U.S. interest-rate-derivatives research, Josh Younger.

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