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OPINION

Volatility Is a QE Bug, Not a Feature

We shouldn't 'get used' to volatile bond markets. Large price swings signal something is going wrong.

By Marcello Minenna

European Central Bank President Mario Draghi warned last week that "we should get used to periods of higher volatility." The yield on the benchmark 10-year German bund promptly skyrocketed to nearly 1%, capping off a two-month period in which investors have grappled with bond prices moving very quickly in unexpected ways.

But Mr. Draghi left something out of his comments. He attributed this new era of increased volatility to the low-interest-rate environment, as if that environment were a natural force like the weather, beyond human control. Not only does this play down the ECB's responsibility for causing the low interest rates, it also misses the ways that the design of the ECB's recent monetary programs has directly contributed to much-greater volatility.

The basic cause of the gyrations in yields that started at the end of April is simple: Traders are trying to buy low and sell high. Bond prices have fallen (and yields have risen) as investors who benefited from the rise in bond prices since the ECB announced large-scale purchases of sovereign debt in January now try to lock in their profits. This age-old strategy is interacting with peculiarities of that bond-purchase program, or quantitative easing, which formally began in March.

The additional demand for government bonds as a result of QE has accelerated the decline of all eurozone bond yields, bringing many of them into negative territory. In April the nine-year German bund yield slipped below zero, bringing shorter-term bonds with it. For the first time ever, in the same period, an Italian six-month bill reached zero yield. By mid-April, eurozone government debt with a face value of €2.8 trillion ($3.14 trillion)—around 25% of the total—had negative yield, according to data from Bank of America-Merrill Lynch and Bloomberg.

The hitch is that under the rules the ECB has set for its QE program, the national central banks of the eurozone—which are tasked with conducting QE's bond purchases—can't buy securities on the secondary market with yields of less than -0.2%.

Approaching the -0.2% limit becomes for traders a signal that it's time to sell, since a bond's price won't rise any further once it becomes ineligible under QE and the central banks stop buying. Instead, suddenly banks and other investors start creating excess supply of bonds as they attempt to take profits on their holdings.

The recent swings in German bund prices can be explained largely by these trading patterns. It's not an accident that, as more and more bonds are bought under QE, even long-dated bonds approach the -0.2% yield floor. Similar dynamics can be observed in the markets for other eurozone sovereign bonds, although the volatility has been less pronounced since negative rates are not yet so widespread.

This oscillation in prices has been amplified by other features of both the QE program and broader regulatory policies that have reduced trading volumes, and therefore liquidity. In particular, national central banks in the eurozone are accumulating extraordinary stocks of government debt.

At the same time, private-sector banks are scaling back on their traditional market-making function as tighter regulations on their capital bases make doing so more costly. With fewer securities circulating, normal trading strategies can induce significant price movements.

As a consequence, the face value of eurozone sovereign bonds exhibiting negative yields dropped to around €1.3 trillion since the flash crashes of April and June. This is an autoimmune reaction of market participants to the likely scarcity of bonds eligible for the QE program. Since investors expect the liquidity situation to stay as bad as it is now or to deteriorate further, and having seen how rapidly prices can swing under this policy framework, some investors have been more reluctant to hold eurozone sovereign debt while others have been quick to sell at the first hint of trouble.

Over the longer term, QE will turn into a hide-and-seek game between banks and the ECB. The central banks will provide cash in exchange for sovereign bonds, pushing prices up to dizzying heights. Then banks will sell off their holdings just as quickly, reversing the fall in yields. Banks are especially well-equipped to play this game since post-2008 capital regulations have left them holding ample reserves of sovereign bonds to sell to the central banks at the right moment—and they can always use the cash provided by the central banks to buy more government bonds when the prices

La volatilità è una lacuna del QE, non una sua componente

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are right.

Despite the short-term volatility, this is a great deal for the banks. Based on a comparison of the average book-value of government bonds on bank balance sheets and the average price at which those securities have been sold to national central banks during eurozone QE, I estimate the profits already delivered by this trading strategy to be around €12 billion.

But if banks can enjoy guaranteed capital gains on a regular basis as a result of the structure of the QE program, they're unlikely to be tempted to engage in the riskier lending to households and businesses that economists thought QE would stimulate. This helps explain why, after a three-year decline, the reduction in bank lending displays only a pale deceleration but still no reversal into growth (-0.1% year-over-year in April against -0.2% year-over-year in March) despite the big changes QE has wrought in sovereign bond prices and the euro exchange rate.

The recent volatility in bond markets is a bug in the QE program, not a feature as Mr. Draghi would have markets believe. Rather than getting used to it, the ECB should be urgently working on revisions to its program if it is to have any hope of delivering on its reflationary goals.

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