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CREDIT MARKETS

Government-Bond Swings Burn Wall Street Investors

Shifting expectations for inflation and central-bank policy are sparking surprise moves, hurting big-name players



Short-term Treasurys were widely expected to do better than 10- and 30-year bonds, but the opposite is happening.

PHOTO: SAMUEL CORUM/BLOOMBERG NEWS

By Gregory Zuckerman and Julia-Ambra Verlaine

Nov. 7, 2021 5:30 am ET

A rapid U-turn in government-bond markets has sparked deep losses for some of Wall Street's biggest investors, a stark demonstration of how even small shifts in expectations for economic growth and central-bank policy can upend the most carefully laid bets.

Behind the losses are recent abrupt moves in government-bond prices. With central banks signaling plans to end their extraordinary stimulus measures, short-term bonds have tumbled in price, sending yields—which rise when prices fall—to touch their highest levels since March 2020.

Two-year government-bond yields



Source: Tullett Prebon



Chris Rokos's Rokos Capital has been hurt partly by its bond trades this year.

PHOTO: ROKOS CAPITAL

At the same time, yields on longer-term bonds, which tend to fall when investors expect slowing growth, have retreated from near their highs for the year. The gap between the two narrowed sharply, a phenomenon known as a flattening yield curve. That upset popular bets that a gradual return to normal levels of growth and inflation would push interest rates higher in the years to come.

Hedge funds and others who make big bond bets "were caught offsides" by the recent price moves, said Steve Kane, who helps run TCW Group Inc.'s $86 billion MetWest Total Return Bond Fund, which has also seen losses. "They're getting squeezed," he said.

A Bloomberg Treasurys index has lost about 1.5% since early August.

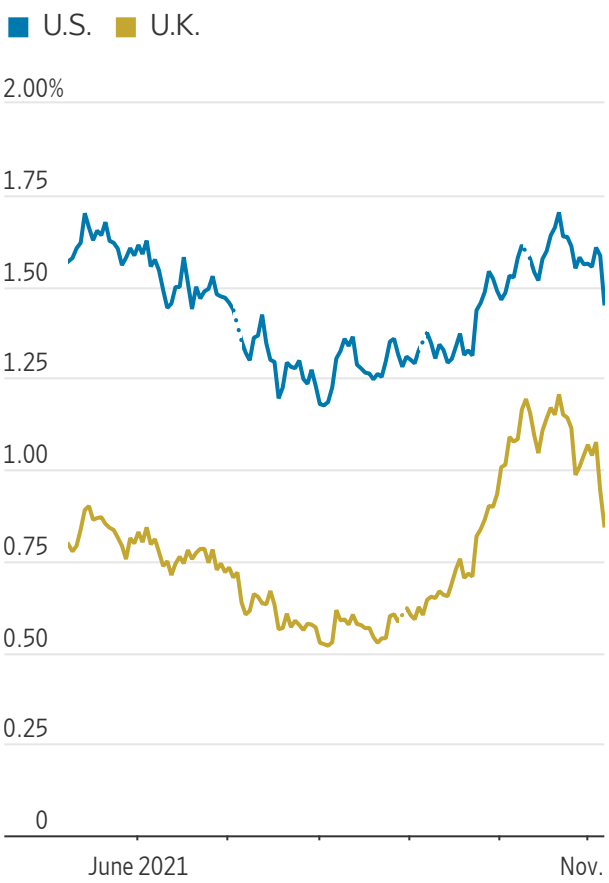
While the percentages are small relative to the recent swings in bitcoin or stocks such as Avis Budget Group Inc., many hedge funds and others borrow large amounts of money to amplify their bond bets, so mistaken trades can be painful. London-based Rokos Capital, run by the investor Chris Rokos, for example, has lost 27% in 2021 as of the end of October, according to people close to the matter, in part from bond trades. The fund is on track for its worst year ever.

Multistrategy hedge funds, including ExodusPoint Capital Management LP and Balyasny Asset Management LP, also lost money from recent government-bond moves, according to people familiar with the trades.

For months, investors had been preparing for the Federal Reserve to step down its role in the economy by reducing its bond-buying stimulus program, now scheduled to end in June. The investors also anticipated a gradual move by the Fed to raise interest rates over the next couple of years, while becoming more concerned about rising inflation. As a result, many wagered that short-term Treasurys would do better than 10- and 30-year bonds—which usually suffer most when long-term inflation rises—steepening the yield curve.

Instead, the opposite is happening, as prices for long-term bonds climb, flattening the curve. This same flattening is happening in British, Australian, Canadian and other government-bond markets. Such moves usually happen at the end of interest-rate cycles, as investors anticipate an end of interest-rate increases by monetary officials, not as investors prepare for the beginning of rate increases.

10-year government-bond yields



Source: Tullett Prebon

The recent moves underscore how challenging it has been for bond investors to anticipate inflation, central-bank policy and resulting market moves after an era of unprecedented stimulus ushered in to avoid an economic crisis. Traders say some of the recent moves are spurred by big investors acting to unwind, or exit from, existing positions, to stem their losses.

While inflation worries have racked markets for months, the recent price action suggests that the bond market is now preparing for lingering inflation over the next few years, in tension with the Fed's view that easing supply-chain bottlenecks will soon slow rising consumer prices.

Bond prices now suggest inflation will be 3% over the next five years, up from 2.5% a month ago, traders say. Investors are anticipating a series of interest-rate increases over the next couple of years, which will crimp the economy and eventually reduce inflation, explaining why long-term bonds are doing better than short-term bonds. Bond prices indicate that the Fed will raise interest rates five times by the end of 2023, resulting in a slowdown of the global economy.

Investors in stocks and riskier bonds show less concern about the outlook for the global economy. Stocks have been surging in recent weeks, with the Dow Jones Industrial Average closing above 36,000 for the first time, while junk-bond prices have also been climbing.

Longer-term yields slumped again at the end of the week after a better-than-expected U.S. jobs report and the Bank of England's surprise decision to hold rates steady. The 10-year yield settled Friday at its lowest level in six weeks.



The Bank of England's decision to hold rates steady was a surprise.

PHOTO: HENRY NICHOLLS/REUTERS

"Conviction in the path of rates has declined substantially," said Gennadiy Goldberg, U.S. rates strategist at TD Securities in New York. "Global hike expectations have been yanked forward in the most unceremonious of ways, and many people are waiting on the sidelines trying to figure out what their next move should be."

Many investors are losing money lately in the bond market, but few are more surprising than Mr. Rokos, who has also suffered from some souring Chinese stock investments, according to people close to the matter. Mr. Rokos, a co-founder of Brevan Howard, started his own firm in 2015 and has a strong record. His fund gained 44% in 2020. He is influential enough that other hedge funds sometimes copy his trades.

SHARE YOUR THOUGHTS

Have you made any adjustments to your portfolio given the U-turn in government bonds? Join the conversation below.

Mr. Rokos set up his bond trades in both U.S. and British bond markets using derivatives, according to people familiar with the moves. His recent assumption has been that central banks in both places would gradually boost interest rates, rather than moving as aggressively as the market now predicts, one of the people said.

Investors expect more swings ahead as economies recover, supply chains normalize and central banks begin raising rates.

"As we get closer to fully departing this [quantitative easing] regime, around mid-next year, we would expect to see market volatility increase," said Rick Rieder, chief investment officer of global fixed income at asset manager BlackRock. "This will likely be a healthy evolution and not a disruptive one."

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