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How Traders Trade When Treasury Markets Get Volatile

November 20, 2018

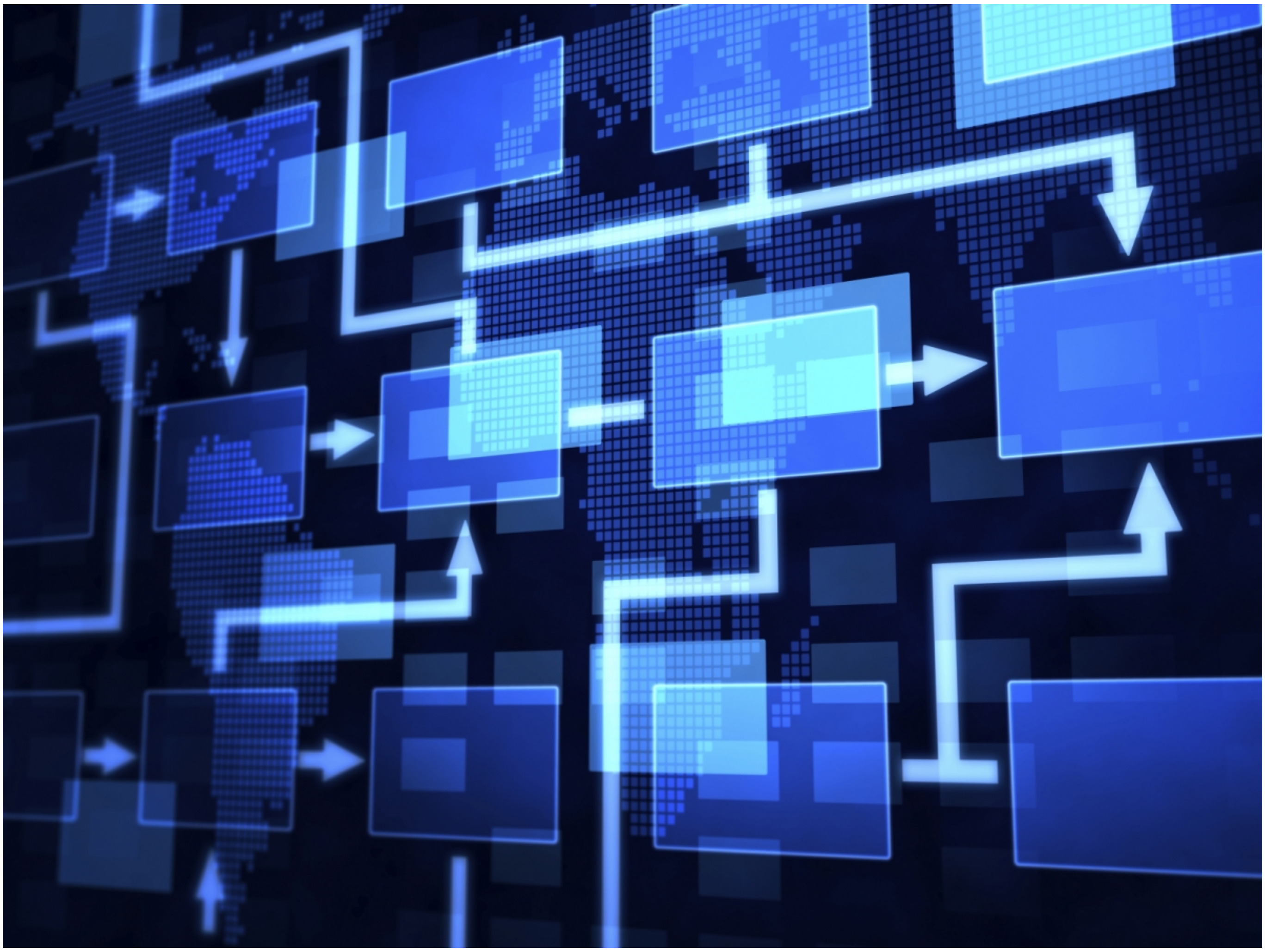
U.S. Treasury volumes in October hit their highest level since May 2018, with an average daily volume of $554 billion. The equity market's precipitous decline drove a drop in Treasury yields that brought with it the market volatility traders have long been waiting for. And while the future of the bull market remains top of mind for most, we find the impact of market volatility on e-trading much more fascinating to explore.

Volatility and E-Trading

There are two schools of thought regarding the impact of market volatility on e-trading:

The first: investors and dealers back away from electronic platforms. Investors are reluctant to execute on the screen, as the value of the market color they get from their dealers grows amidst the uncertainty. And dealers in turn widen spreads quoted via electronic channels to be sure they're not caught flat footed by a fast market move that the pricing algo can't adjust for quickly enough. We saw some of this during the flash rally of 2014.

The second: use of electronic platforms grows. The phone is too slow for investors in a hurry to reposition, and dealers are so busy with incoming inquiries they don't have the time talk. As such, the only way for the buy side to get done is via liquidity on the screen, which increasingly means trading not only with dealers but also with other investors (anonymously) and non-bank liquidity providers.



What Does the Data Say?

We examined the data from October 2018 and, at least for this moment in time, can finally answer the question of what volatility does - or in this case did - to electronic trading.

In short, electronic trading won, largely driven by volume in the central limit order books. Central limit order book volume (CLOB) was up nearly 35% in October compared with September, which was a relatively "normal" month. RFQ trading also ticked up 5% from the month before showing that clients remained confident of electronic execution. Conversely, trading volume via voice and instant messenger declined nearly 13% in the same period.

This tells us a few things. First, the evolving market structure for trading U.S. Treasuries electronically works, and works better than it did during the flash rally four years ago. It is true that the volatility this October wasn't close to what we saw in October of 2014, however, one could surmise that the lack of extreme price gaps was *because* the market structure has improved.

Second, the impact of principal trading firms on market volume continues to be substantial. The exact ratio of principle trading firm (PTF) volume to that of traditional dealers on the CLOB platforms isn't clear. However, it can be assumed that PTFs, who thrive in volatile environments, contributed the majority of the $60 billion in additional trading on CLOB platforms in October.

In December we will publish our latest research examining U.S. Treasury market structure. The report will examine the aforementiond trends, the data underlying them, platform market share and expectations for the coming year. In the meantime, it is increasingly clear that macro-market conditions, M&A and technology innovation will ensure that 2019 will be one of notable change for the U.S. Treasury market.

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