Gold and silver will be increasingly bought as a hedge against the US dollar and the illiquidity in the bond markets. Part 1

HFT traders are instrumental in seeding the destruction of all markets.

“We are still the best market around”, recent quote on CNBC TV, is that with or without the monopoly money that is being thrown around endlessly? Do people ever think what the end game will be and if we can get ourselves out of this QE bacchanal without paying an enormous price? Think about it, the central banks are throwing trillions at the system and the market makers are only willing to make a market in the most liquid treasury bonds because the other debt paper is too illiquid! Hello isn’t that odd to say at the least!! Anybody home? It basically means that interest rates are too low and that they don’t realistically reflect the risk profile or it means that paper money doesn’t have any value any longer. And because interest rates are so low everybody is geared up to the tilt hence why when as a result of an event investors will have to sell we will see a self-sustaining effect on the downside because investors will have to sell because of their leveraged positions and taking into account the illiquidity already prevalent in the markets the effect will only be reinforced!

After more than six years of short-term interest rates near zero and a net $1.2 trn of investor cash placed into bond funds, the investment-grade corporate bond market has now ballooned to $4.8trn, according to a Bank of America Merrill Lynch index. Jeff Gundlach and one of his DoubleLine deputies are out calling US IG (Investment Grade) paper “one of the most unattractive risk-return propositions” ever witnessed. Between abysmally low yields, heightened rate sensitivity heading into a rate hike cycle, and balance sheet re-leveraging on the part of US corporations, it’s a bad time to be betting on corporate credit. "If liquidity is as bad as it is now, what’s going to happen when things really get adverse?” said Richard Schlanger, who co-manages about $30 billion in bonds as vice president at Pioneer Investments in Boston. Calvert Investments money manager Matthew Duch said the mystery of the flash rally (October 15, 2014) leaves him in a tough spot. He wants to buy more high-yield bonds, but said he’s worried about the possibility that a Treasury-market swing could spark broader volatility, making it tough to trade the speculative-grade debt, no bids. The reason why liquidity in what was formerly the world's deepest and most liquid bond market, that of US Treasuries, has completely collapsed is due to not only central banks "soaking up" collateral from private holders but also algorithmic HFT traders who - as it turns out - not only do not provide liquidity, but consume every last trace of it especially when it is most needed. HFT traders are

instrumental in seeding the destruction of all markets.

A measure of the debt's sensitivity to interest-rate changes, expressed in years, reached a record 7.16 this month, from 5.9 at the start of 2009. Duration is a measure of a bond price's sensitivity to a change in interest rates, measured in years. Bonds with longer durations are more sensitive to interest rate changes. If you're in a bond with a duration of 10 years and rates rise 1%, you'll see a 10% decline in the bond's price. Anyway what we are seeing is that following the QEs and the pushed down interest rates the markets are all reaching sugar highs.

Stocks surge: Nikkei tops 20,000, Europe hits 15-year high

Anticipating more easy money from top central banks pushed Japan's Nikkei past 20,000 points for the first time in 15 years and European stocks reached similar heights. If you look at IPOs, 80% of them are unprofitable when they come. The only other time we've been at 80% or higher was 1999. At the same time we saw another low for euro zone bond yields, after Greece repaid a €450m loan tranche to the International Monetary Fund and secured extra emergency funding from the ECB for its banks also helped the mood.

The dollar index was on course for its best week since 2011 bolstered by diverging bond yields in the U.S. and euro zone that should pull capital into the world's largest economy. The dollar was on track for its first weekly rise in a month as jobless claims data eased concern about the U.S. labor market and attention shifted back to the chances the Federal Reserve will raise interest rates this year whilst European central banks have introduced negative interest rates and are printing money. The euro has fallen more than 3% last week, which is an incredible move; it is crazy for the second largest currency in the world. "It's hard to avoid the conclusion that carry trades are playing a part. Note that German bond yields out to 8 years are now in negative territory, the Euro is very much a funding currency," said David de Garis, senior economist at NAB. One just has to wonder when everybody is at one side of the trade what happens when suddenly the trade gets unwound because suddenly the outlook for the US economy and rate hikes changes. And it feels like all the money in the world is hip hopping at the same time for the next yield opportunity, which makes these trades very vulnerable to sudden shocks.

Fed members with their contradictory statements not really in touch with the economy

First it was Jim Bullard in October, after US equity markets had fallen almost 10%, talking the markets up with "QE4" and suggesting that asset purchases will make a comeback if the market drop continues. And now Minneapolis Fed president Narayana Kocherlakota was quoted "There is even a theoretical argument to be made for making asset purchases now if the economy faltered".

On the other hand according to the just released minutes FOMC officials did set a low bar for liftoff, saying they didn't need to see an increase in core price inflation or wage inflation before hiking rates. The Federal Reserve may be willing to make its first interest rate hike since the financial crisis as early as June, according to minutes from the March meeting released on Wednesday April 8. Further improvement in the labor markets, stabilization of energy prices or a leveling out of the value of the dollar might be enough to move, the Fed officials said. We should wonder how much the Fed members are really in touch with what is going on in the economy. They are flip flopping non-stop because they really don't know!

On top of that it should be mentioned that now the Philly Fed admits that it can no longer report its state coincident and leading indexes because **"the recent benchmark data revisions from the Bureau of Labor Statistics produced greater changes to the Philadelphia Fed's estimating methodology than are typical. While estimates for most states do appear to be reasonable, those for some states are not."** In other words, the BLS has "adjusted" its "data" so much (to fit within its political propaganda goal seek parameters) not even the Federal Reserve can make any sense of it, and can no longer use it for its own data analysis purposes. This explains a lot! I have mentioned many times before how much the figures of the Government don't match, what I and many others with me perceive, the real situation in the US economy is.

When QE4 will be announced because the economy is too weak the US dollar will tank

As said with me several other people have argued that the economy is by far not as strong as the authorities want us to believe hence why I believe the move into the US dollar since July 2014 has been a move by default, because of lack of alternatives. And as such making the US dollar much more vulnerable than is being portrayed by many Wall Street analysts. A lot of industry experts believe

the US dollar will strengthen further and thus become more crowded but therefore as a result will also become more vulnerable.

In my opinion at one moment the stretch in the creditworthiness of US dollar will give way following the endless QEs that have not been able to restart the US economy in a sustainable way. The definition of insanity is doing the same thing over and over and expecting different results. The bearish outlook for the US dollar, following more negative economic news, will trigger foreign investors to sell their US paper which in itself could, if not again rescued by the Fed, you have to wonder at what price, force interest rates in the US much higher and implode the whole debt structure and thus the economy and its social fabric.

When do investors wake up to the fact that QE is rendering their money worthless, debasing the currencies, when there is no sustainable recovery but only increasing discrepancy between poor and rich.

Yellen: "Holding rates too low for too long could encourage inappropriate risk-taking by investors, potentially undermining the stability of financial markets." Showing in the illiquidity in the bond markets.

Much of the debt raised has gone to fund the more than $2.2trn of shares that Citigroup says companies globally have bought back since 2011. And Moody's Investors Service said in a report last month that investment-grade companies are spending more of their cash on shareholder rewards than at any time since 2007 (see in Part 2 Druckenmiller's remarks). Yellen on March 27 said "holding rates too low for too long could encourage inappropriate risk-taking by investors, potentially undermining the stability of financial markets." It is

laughable that is water under the bridge!! As I mentioned in one of my latest articles it is showing in the bond markets where the illiquidity is creeping in and going mainstream.

Now not only hedge fund managers but also the mainstream media (which is important for awareness amongst investors) is now sounding the alarm over this most critical of topics to the US market, as described in WSJ's Michael Casey's article of April 5 "Broken bond market complicates Fed's plan to raise rates". The conclusion is very simple the Fed can't really raise interest rates!

The buying of the top quality government bonds by central banks is forcing yields on higher risk paper, such as corporate paper, upwards

As he writes: "Whether it is banks' reluctance to commit to buying and selling bonds, shortages in the securities used as collateral in short-term money markets, or the disproportionate role of heavyweight issuers in the supply of U.S. corporate bonds, dysfunction is everywhere." A Barclays note signaled that QE in Europe is driving investors into corporate credit as yields on Euro government bonds tumble under the weight of the ECB's perpetual bid. The combination of shrinking dealer inventories and heavy investor demand for corporate paper, average yields on U.S. corporate bonds have fallen to 2.94%, below the 10-year average of 4.68%, following the crowding out by the central banks of the government bonds, has the very real potential to spell trouble should everyone who has been moving into corporate credit for higher yields suddenly wants to get out. Put simply: the secondary market isn't very liquid these days. "There isn't a lot of value" in investment-grade corporates, Rieder, who oversees more than $700 billion as BlackRock's chief investment officer for fixed-income, said Thursday April 9 in an interview. "We have a higher level of interest-rate risk than we've ever had before and people have to be sensitive to it."

"Central banks have pushed investors out the risk spectrum, to the benefit of companies (or corporate debt)" said Scott Carmack, a money manager at Portland, Oregon-based Leader Capital Corp., which oversees $1.5 billion in fixed-income assets. "Investors take what is given to them, it's shoved down their throat and they smile and take it because there is nowhere else to get yield."

And the dysfunction only seems to increase leading to ……….! Well you fill it in!

BIS: “market-making is concentrating in the most liquid securities and deteriorating in the less liquid ones.”

Bond investors are complaining about the illiquidity – the idea that there aren’t enough standing bids or offers in the marketplace for investors to move quickly in or out of large positions. Which makes it difficult for investors to re-position in anticipation of the decision the Fed takes and only increases uncertainty.

Last month, the Bank for International Settlements noted “signs of increased fragility and divergence of liquidity conditions across different fixed income markets.” The problem, **the BIS said, is that “market-making is concentrating in the most liquid securities and deteriorating in the less liquid ones.” In other words, the broker-dealers that commit to buy sell and hold portfolios of bonds so that institutional money managers can readily trade them in the secondary market aren’t doing so for anything less frequently traded than Treasury securities or large corporate bonds.** What is that telling you? It means that you can issue corporate debt but that it will probably straight away trade at a discount because nobody wants to make a market in it. It shows how little confidence there is in the debt markets. Why because the economy is not recovering and because the outlook is not rosy at all or that people are afraid of much higher interest rates! That must be the conclusion because otherwise it wouldn’t be so difficult to make a market in “less risk-free” paper. The risks are clearly rising as earlier stated by several fund managers that wanted to get out of their positions and mentioned how difficult it was!! Wakey wakey!!! Even Jamie Dimon is mentioning the dangers of illiquidity in his annual letter to shareholders.

Dimon: Recent activity in the Treasury markets and the currency markets is a warning shot across the bow

Treasury markets were quite turbulent in the spring and summer of 2013, when the Fed hinted that it soon would slow its asset purchases. Then on one day, October 15, 2014, Treasury securities moved 40 basis points, statistically 7 to 8 standard deviations – an unprecedented move – an event that is supposed to happen only once in every 3 billion years or so (the Treasury market has only been around for 200 years or so – of course, this should make you question statistics to begin with). Some currencies recently have had similar large moves. Importantly, treasuries and major country currencies are considered the most standardized and liquid financial instruments in the world.

The items mentioned above (low inventory, reluctance to extend credit, etc.) make it more likely that a crisis will cause more volatile market movements with a rapid decline in valuations even in what are very liquid markets. It will be harder for banks either as lenders or market makers to "stand against the tide."

There already is far less liquidity in the general marketplace: why this is important to issuers and investors. Liquidity in the marketplace is of value to both issuers of securities and investors in securities. For issuers, it reduces their cost of issuance, and for investors, it reduces their cost when they buy or sell. Liquidity can be even more important in a stressed time because investors need to sell quickly, and without liquidity, prices can gap, fear can grow and illiquidity can quickly spread – even in supposedly the most liquid markets.

Some investors take comfort in the fact that spreads (i.e., the price between bid and ask) have remained rather low and healthy. But market depth is far lower than it was, and we believe that is a precursor of liquidity. For example, the market depth of 10-year Treasuries (defined as the average size of the best three bids and offers) today is $125 million, down from $500 million at its peak in 2007. The likely explanation for the lower depth in almost all bond markets is that inventories of market makers' positions are dramatically lower than in the past. For instance, the total inventory of Treasuries readily available to market makers today is $1.7 trillion, down from $2.7 trillion at its peak in 2007. Meanwhile, the Treasury market is $12.5 trillion; it was $4.4 trillion in 2007. The trend in dealer positions of corporate bonds is similar. Dealer positions in corporate securities are down by about 75% from their 2007 peak, while the amount of corporate bonds outstanding has grown by 50% since then.

Inventories are lower – not because of one new rule but because of the multiple new rules that affect market making, including far higher capital and liquidity requirements and the pending implementation of the Volcker Rule. There are other potential rules, which also may be adding to this phenomenon. For example, post-trade transparency makes it harder to do sizable trades since the whole world will know one's position, in short order.

The illiquidity is also not missing its effect on the repo market that uses bonds as collateral

Another example that things are not working can be found in the $2.6 trillion repurchase securities, or repo market in which banks, money-market funds and other institutions lend and borrow money over short periods and which is

affected by shortages of the high-quality securities that they use as collateral. A lack of treasury securities is creating bigger swings in short-term rates, making it more expensive and unpredictable for institutions that need overnight finance or which must put excess cash to work.

The daily shortage of treasury collateral as manifested by collapsing rates in the repo market, where the repo tightened "immensely", plunging to super special rates of -224 bps, which implies the liquidity shortage for the 10Y is now the worst since June of 2014. Some people are saying that the liquidity shortage across the US curve has virtually never been worse. A breakdown of repo rates by maturity bucket shows that both the 3 and 5 year are once again trading special, with the 2 year just barely exiting negative repo territory after being there for the past 2 days.

Repo Rates								
Dates	Fed Funds	GC	2-Year	3-Year	5-Year	7-Year	10-Year	30-Year
03/31/15	0.03%	0.38%	0.22%	-0.49%	0.27%	0.33%	-0.44%	0.06%
04/01/15	0.13%	0.24%	0.12%	-0.09%	0.15%	0.28%	-0.29%	0.03%
04/02/15	0.12%	0.25%	-0.06%	-0.39%	0.12%	0.20%	-0.14%	0.03%
04/06/15	0.13%	0.22%	-0.04%	-0.64%	0.21%	0.22%	-0.79%	0.00%
04/07/15	0.13%	0.22%	0.01%	-0.36%	-0.03%	0.21%	-2.24%	0.06%

Source: ICAP. Rates as of 8:30AM

At this rate the entire US bond curve will soon have a structural shortage as more foreign central banks quietly scramble to buy up all US paper.

As reasons for the scarcity are again mentioned tougher regulations (a major influence according to industry insiders), competition from HFT firms and the crowding out by the central banks. Many Wall Street bankers blame the tougher post-crisis regulations. But the point of those rules was precisely to reduce the excess risk-taking that led to the crisis. Competition from high-speed trading firms, whose proprietary programs exploit differences between prices more readily than can traditional broker-dealers, has also discouraged the latter from providing liquidity by making it less profitable. Next to that they are inclined to withdraw it at vital moments, creating profound volatility and “flash crash” incidents. Then there’s central bank policy itself. Although the last “quantitative easing” program ended in October, the Fed still regularly buys Treasuries and government-backed mortgages to keep a steady balance sheet as existing holdings mature. This privileging of government-backed securities over private debt means that as the European Central Bank now conducts its own government bond-buying program, money-fleeing rock bottom Eurozone yields continues to disproportionately seek US treasuries and housing agency debt.

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