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BlueMountain hunts for mispricings in rates markets

As QE rolls off, Colin Teichholtz sees rich pickings for relative-value fixed-income strategies. By Kris Devasabai, with editing by Joan O'Neill

Becalmed after a jagged first quarter, markets will soon be facing a clutch of forces: the uncoiling of billions of dollars in quantitative easing, a mother lode of Treasury issuance, interest rates crackling higher and the ricochet of trade disputes – all of which could reverberate in other parts of the world.

Some see thick cloud cover. Colin Teichholtz sees little but silver linings.

He is intrigued by the prospect of volatility and the off-kilter prices that follow in its wake; he is captivated by sectors parched for liquidity, "sloppy" transitions in interest rates and markets neglected by hedge funds, and mindful of lemming behaviour in retail investors.

Teichholtz looks for what he calls "mistakes in the markets" to put his relative-value fixed-income strategies to work. Instead of placing directional bets, he looks for mispricings and dislocations; small, ephemeral mismatches to exploit, at times with big leverage.

BlueMountain Capital Management, where he is head of global governments and agency mortgage-backed securities (MBS), will be seeking just such chinks in the markets.

And as markets enter a new regime, mistakes are inevitable. The upheaval of the first quarter was a good omen for Teichholtz's strategy.

"It was a propitious time for fixed-income relative-value trading," he says. "A lot of money got made."

But not at BlueMountain. Teichholtz, who previously ran fixed-income relative-value strategies at Pine River Capital Management, only arrived at the firm in late February, and had to watch from the sidelines as the markets convulsed.

BlueMountain will be ready next time. Teichholtz has quickly assembled a team of rates specialists, adding four portfolio managers in June. The new hires include Morgan Alcalay, who previously traded US Treasuries at Goldman Sachs, and Evan Boulukos, a former municipal bond trader at Citigroup. Phil Hermann and Andrew Seiz, who traded agency MBS and emerging market debt, respectively, at Pine River, have also joined Teichholtz at BlueMountain.

The firm, which manages around $22 billion in credit and equity volatility strategies, had been looking to add a relative-value fixed-income team for some time.

"Over the next year or two, we expect to allocate a significant amount of capital to the strategy," says Stephen Siderow, co-founder and co-president of BlueMountain.

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> Colin Teichholtz, BlueMountain Capital Management

Fields of mismatches

BlueMountain's mortgage strategy, managed by Hermann, is already up and running, and the firm expects to begin trading government bonds, emerging market debt and municipal bonds soon. Teichholtz has already spotted the crevices in each of these markets where money might be hiding.

The government bond strategy aims to profit from price gaps across related rates products, such as Treasuries, futures, swaps and swaptions. These "micro relative-value" opportunities tend to be small and short-lived, and reliant on a good amount of leverage.

In mortgages, the firm will seek to exploit any mispricing of prepayment risk in MBS forwards (known as TBAs), specified pools and derivatives, such as interest-only (IO) and inverse IO strips.

"The goal here will not be to use mortgages as a backdoor way to take interest rate or yield-curve risk," says Teichholtz. "We will hedge those risks out and focus on mistakes in how the market is pricing specific securities or cohorts of mortgages."

Probably the biggest of the coming dislocations will be the roll-off of quantitative easing, which defined the past decade since the 2008 crisis, suppressing volatility and leaving central banks with outsize balance sheets. The US Federal Reserve began "normalising" last October, shedding nearly $200 billion of assets in the past nine months, with more to come.

"No one can really tell you how markets will behave in terms of reabsorbing all of this risk because we have never gone through this before," says Teichholtz.

At its peak, the Fed owned $1.8 trillion of mortgages guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. "That is now reversing.

The Fed is allowing its portfolio to run off, and the reasonable expectation is that the Fed will stop buying any mortgage securities this fall," says Teichholtz. "That is a huge shift in the market."

The Fed's purchases of agency MBS filled the gap left by the government-sponsored enterprises (GSEs), Fannie and Freddie, which were put into conservatorship after the crisis.

"I've traded mortgages since 1992, and throughout my career the GSEs were the backstop for the market. They would step in and provide liquidity if the market got dislocated," says Teichholtz. "When the GSEs were put into conservatorship, the Fed took over the mantle. As of this fall, the Fed is out, and now there's nobody."

The Fed's exit comes as private capital has fled the mortgage markets. The proprietary trading desks at the big banks are gone, and a number of high-profile hedge funds decamped after years of sleepy returns. Structured Portfolio Management, which once managed $12 billion in mortgage strategies, shut its doors in June.[1] Premium Point Investments, another multi-billion-dollar firm, closed earlier this year after its founder was charged with fraud.[2]

"There is less capital, or even no capital, available at some of the key funds in the mortgage sector just as the opportunity set is likely to get a lot better," says Teichholtz. "That strikes me as a very good time to lean in and get involved in the sector."

The government bond markets are also poised for more volatility, with Treasury issuance set to accelerate even as the Fed trims its holdings. The market got a preview of that earlier this year when the government issued $300 billion of short-term Treasury bills just after Congress raised the debt ceiling. While T-bill rates rose a little in response, Libor and commercial paper (CP) rates blew out unexpectedly.[3]

"What we learned was the people that were buying CP didn't want CP, they wanted T-bills at a reasonable rate. And as soon as they could get them, they were done with CP, and those rates went up a lot," says Teichholtz. "As the combination of the balance-sheet reduction at the Fed coupled with the aggressive debt-fuelled expansion in the US takes hold, why shouldn't we expect to see more of that?"

The Fed's immediate challenge is controlling the Fed funds effective (FFE) rate, which has been creeping towards the upper bound of its target range. As the Fed trims its balance sheet, the rate could become more volatile. Teichholtz argues this should not dissuade the Fed from continuing to shed assets.

"[Mnuchin and Phillips] understand quite well that aspects of Dodd-Frank had probably gone too far, and that some of the constraints on banks were onerous, but not necessarily risk-reducing"
Colin Teichholtz, BlueMountain Capital Management

"The problem is that we're all used to looking at the wrong rate," he says. "FFE is driven by a tiny handful of players – essentially the GSEs exchanging risk with Yankee banks in relatively small size. The Fed is on the right path in terms of shifting the focus to SOFR [the Secured Overnight Financing Rate]."

But that could take time. The CME Group launched its SOFR futures contracts in May, while the first swaps linked to the new benchmark were traded this month.[4]

It could be at least another couple of years before the new rate begins to eclipse existing benchmarks, such as FFE and Libor. "That transition is another thing I'm excited about, because it will probably be quite sloppy at times," says Teichholtz.

The Fed has a difficult job to perform as it raises rates, shrinks its balance sheet and ushers the market towards SOFR. The 'taper tantrum' that followed Ben Bernanke's announcement in 2013 that QE would be ending is keenly remembered. Anything similar could again rattle markets and create pressure to reverse course. But if the Fed sticks to its guns, the outlook for relative-value trading appears rosy. "The less balance sheet the Fed provides to the market, the more volatility we'll likely see," says Teichholtz.

[1] *Asset-Backed Alert, June 2018,* Mortgage-bond manager shutting down, *https://bit.ly/2Mv9Y9C*
[2] *B Pierson, Reuters, May 2018,* Premium Point founder, others charged with inflating assets, *https://reut.rs/2nnTYeE*
[3] *R Mackenzie Smith & L Becker, Risk.net, April 2018,* Funding changes break cross-currency, Libor/OIS link, *www.risk.net/ 5473386*
[4] *L Becker, Risk.net, July 2018,* First SOFR swaps trade as banks test new benchmark, *www.risk.net/ 5781681*

Any volatility in the US and Europe is also likely to spill over into emerging markets, which have been remarkably stable in recent years. "That's clearly changed," says Teichholtz. As US rates and Treasury yields have climbed, and the dollar has strengthened against emerging market currencies, "you've seen the wheels come off the bus in Argentina and Turkey, you've seen spreads widen a lot in Brazil, and China is having a tough time".

Emerging markets

That will benefit BlueMountain's emerging market strategies, which exploit relative value within and across developing countries.

"A lot of the capital that gets deployed in emerging markets is very macro-focused, so if people think Mexico is doing well, they'll be long Mexico," says Teichholtz. "If we're looking at Mexico, we'll look at the whole complex – the hard dollar curve, local rates, corporate bonds, CDS, the peso – and try to figure out what's rich and what's cheap, and use the most effective instruments to set up trades within the country, as well as between Mexico and other countries."

The fourth and final strategy in Teichholtz's theatre of operations is municipal bond trading – a $4 trillion market that has largely flown under the radar of hedge funds.

"When you talk to people about munis, the common reaction is 'that market never moves'," says Teichholtz. "It actually moves around all over the place. If you look at the ratio of high-quality muni yields to Treasuries, that spread has quite a bit of volatility."

That volatility reflects the behaviour of retail investors, who hold the bonds for their tax-exempt status, but are quick to sell if prices fall. So during rate shocks, munis can become severely mispriced relative to Treasuries.

"During the taper tantrum in the summer of 2013, when rates sold off abruptly, munis actually sold off more than Treasuries, which doesn't really make any sense given the tax exemption. They should trade only as a percentage of Treasuries, but they traded at meaningfully greater than 100% of Treasuries because retail investors were getting out in droves," says Teichholtz.

BlueMountain will also play a more structural role as a liquidity provider, bridging the gap between the somewhat arbitrary new-issue calendar for munis and the buying patterns of retail investors.

"We can take advantage of some of the repeating cyclicality in the market by providing liquidity during periods of heavy issuance, when retail investors may not be willing to add risk, and holding that risk until those investors want to put money to work," says Teichholtz.

A good portion of what happens in the markets may be in the hands of people whom Teichholtz knows from his former lives on Wall Street. And their vision of the right amount of risk for the markets seems to dovetail with his own.

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Finding a balance

Teichholtz has some history with Donald Trump's Treasury department. Treasury secretary Steven Mnuchin led the mortgage securities division at Goldman Sachs when Teichholtz started his career as a trader there in the 1990s. When he joined Morgan Stanley in 2003, Teichholtz reported to Craig Phillips, now counsellor to the Treasury secretary with responsibility for financial deregulation.

Any dislocations or volatility arising from Mnuchin's handling of the economy or the national debt could be manna for BlueMountain's government bond arbitrage strategies, while Phillips' push to loosen the constraints on the banking sector will make it easier to get hold of the leverage and liquidity the firm needs to execute its trades.

And Teichholtz – who, like Phillips, contributed to Hillary Clinton's presidential campaign in 2016 – likes what he has seen so far. The US economy is humming – up 4.1% in the second quarter. (The full politics: Mnuchin was Trump's campaign finance chairman; Phillips was on Clinton's national finance committee.)

"I think they're a very quietly successful part of the Trump administration," Teichholtz says of his former superiors.

He also likes the promise of deregulation. Banks have already begun expanding their balance sheets – an element that is key to his investment strategy.

"[Mnuchin and Phillips] understand quite well that aspects of Dodd-Frank had probably gone too far, and that some of the constraints on banks were onerous, but not necessarily risk-reducing," says Teichholtz.

The Treasury recommended a series of tweaks and fixes to Dodd-Frank in a white paper in June 2017,[5] which was well received within the financial sector.

"The banks' reaction to that has been an increased willingness to provide balance sheet for high-quality government bonds and agency MBS," says Teichholtz. "It's still not their favourite type of business, but they're more willing to do it now."

While volatility and looser leverage may benefit BlueMountain's relative-value game plan, Teichholtz, who sits on the advisory committee for the Treasury department's Office of Financial Research,[6] is not advocating a return to the pre-crisis status quo – unlimited bank leverage and liquidity for investors. Instead, he wants policymakers and regulators to find an equilibrium between bank solidity and more balance sheet availability.

"When you take off your hedge-fund portfolio-manager hat, you think what is the right balance for markets? If you had an infinite amount of leverage and liquidity, you would look at the market and see that everything is perfectly in line most of the time. But if something got dislocated, it could be extraordinarily disruptive to the whole global financial system. You don't really want that. You don't want to go through 2008 again," Teichholtz says.

"On the other hand, if you make it impossible for relative-value players who use leverage to be active in the markets, you could have wide, persistent dislocations," he says. "You need to find a balance." ■

[5] *US Department of the Treasury, June 2017,* A financial system that creates economic opportunities: Banks and credit unions, *https://bit.ly/2sVxOlt*

[6] *Office of financial research, Financial Research Advisory Committee, July 2018,* Committee members, *https://bit.ly/2vU88rE*