

Why the bond sell-off might feed on itself

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Much of the time, I suspect the mainstream media, including its supposedly more serious elements, fails to give us the whole truth on significant issues. I have had a nagging doubt about this with regard to the supposed bond crisis that is engulfing the governments of many Western countries at present.

Every instinct I have tells me that the bond sales that are going on make very little sense because, although there are undoubted concerns about world events and additional government spending resulting from events like Donald Trump's war on Iran, the AI boom and disrupted supply chains for climate reasons, these narratives are insufficient to explain the continual bond selling that must inevitably involve the recognition of losses that traders must feel uncomfortable with. There must, then, be another reason why this trend is continuing.

Having recently read an FT article, linked below, that suggested all is not what it seems, I decided to investigate this issue further, using AI to assist my search. I found at least three patterns of automated or contractually based reasons for bond markets to enter what is, in effect, a doom-loop spiral of bond sales once sentiment creates an initial shift in perceived value.

Having found this, I decided, quite unusually for me, to ask ChatGPT, on which I did this research, to draft an article on this issue, and I then decided to use it here with minor edits. Before doing so, I tested the hypothesis by repeating searches, and I think the explanations offered are entirely plausible. They are referenced.

In 2022, the UK had a bond crisis after Liz Truss's government made what were undoubtedly unwise claims about its intentions. What they inadvertently triggered was a structured response from within the UK pension industry that had used government bonds, and the presumption of continuing quantitative easing, to underpin a particular form of funding. Kwasi Kwarteng's budget, combined with the announcement that the Bank of England would end QE and replace it with quantitative tightening, undermined this funding arrangement, creating a major structural funding shortfall that had to be addressed with a further round of QE.

When I began this approach, I suspected something similar might be happening now. I now suspect this is the case. I am not sure how significant this is, but the FT has noted it, and the trend in US mortgage markets does appear significant.

The consequence is very real. Yet again, it seems that we are being punished by financial markets for their own failings. Even if this is only a partial explanation for what is happening, it is another sign of the considerable stress that supposed financial engineering is creating within our society. Supposedly clever people creating structures with bond instruments for purposes they were not intended to fulfil can produce unexpected outcomes, and in this case that might be an accidentally engineered doom-loop downward spiral in bond prices, which creates the corollary of an upward spiral in supposed government borrowing costs.

I put this forward as a hypothesis worth exploring further, at the very least, given the scale of the issue that we face and the total nonsense that has been talked about it in the mainstream media.

Much of the commentary on the current government bond sell-off rests on a dangerous assumption. It is that investors are selling because they have become pessimistic, and that once their mood improves, the selling will stop. But some of this selling may have very little to do with sentiment. Instead, it may be driven by contractual obligations and automatic risk controls, which means falling prices can create the conditions for further falls.

That distinction matters. An investor who thinks a bond has become cheap might decide to buy it. An investor facing a contractual demand for cash might have to sell it, however cheap they think it has become. The second investor does not necessarily have the freedom to wait for the market to recover.

One mechanism producing this pressure is a margin call. Investors who borrow to finance their holdings, or use derivatives, can be required to provide additional cash or collateral when market prices move against them. If they do not have enough cash available, they have to raise it by selling assets. Government bonds, precisely because they are normally readily saleable, can be among the assets they sell.

The problem is that those sales can push bond prices down further. As prices fall, yields rise. Other investors then suffer losses or face additional collateral demands, and they too may have to sell. The Bank for International Settlements [*has documented*](#) *this interaction between leverage, margin calls and forced selling in government bond markets. What begins as a price movement can become a process that feeds on itself.*

A related mechanism operates through the repo market, where investors borrow cash against bonds offered as security. If lenders demand additional collateral, increase the

protection they require against losses, or decline to renew financing, the borrower may have to reduce its bond holdings. Once again, the sale need not express a view about inflation, government borrowing or the competence of a chancellor. It may simply be necessary to meet the terms on which the investor obtained its finance.

Alongside these contractual pressures are stop-loss instructions and portfolio risk limits. These can require positions to be reduced when losses or measured risks cross specified thresholds. The Bank of England [explicitly identifies](#) margin and collateral calls, withdrawals of repo funding, and breaches of stop-loss or risk limits as potential triggers for disorderly selling in the gilt market. This is a recognised vulnerability within the financial system.

There is another mechanism particularly relevant to the United States. When mortgage rates rise, fewer homeowners refinance their mortgages. Investments backed by those mortgages are then expected to remain outstanding for longer, increasing their holders' exposure to interest-rate changes. Those investors may respond by selling US government bonds, or using derivatives to achieve a similar reduction in exposure.

This is called mortgage convexity hedging. The terminology is obscure, but the consequence is straightforward: rising yields can prompt transactions that push yields higher still. The Financial Times [has identified](#) this mechanism as a contributor to the current Treasury market sell-off. It is another reason why selling can continue without every seller making a fresh decision that the economic outlook has deteriorated.

None of this means that every bond sale is forced, or that concerns about inflation and government policy are irrelevant. Nor do we have enough public information to say precisely how much of the current selling each mechanism explains. But it does mean that interpreting every rise in yields as a considered verdict on a government is deeply misleading. Some of what is described as the judgement of the markets may actually be the enforcement of financing contracts and trading rules.

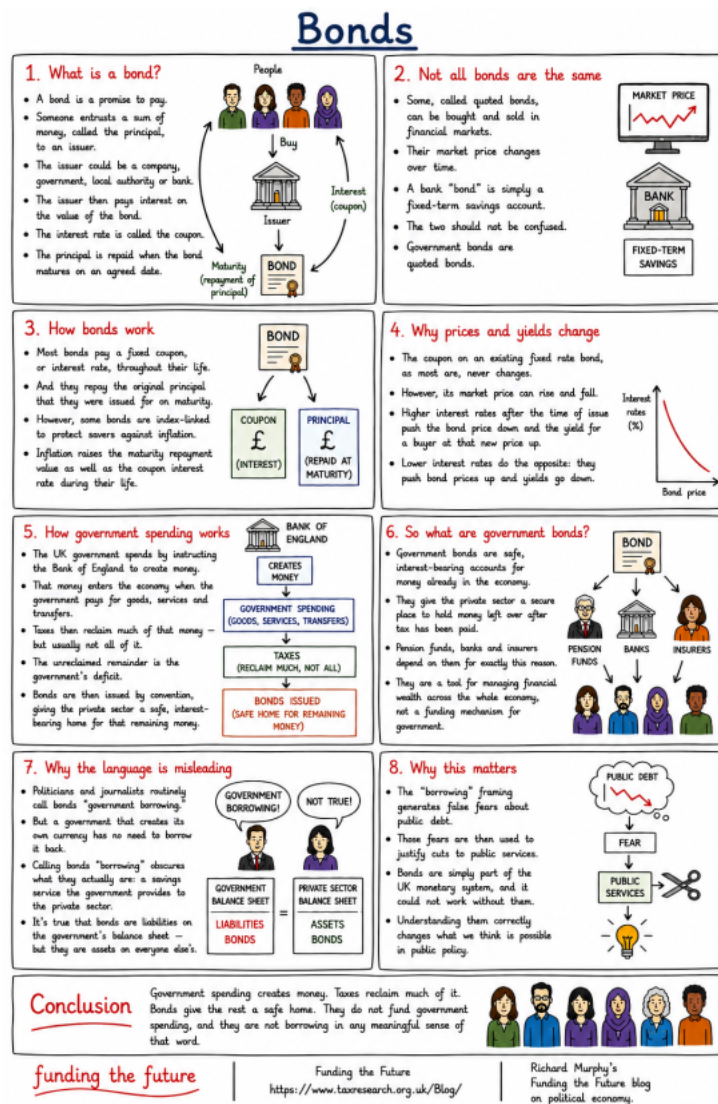
There will still be a buyer for every completed sale. The difficulty is the price at which that buyer is willing to transact. If sellers must obtain cash urgently, while buyers can wait, prices can fall sharply before a trade takes place. The existence of buyers does not prevent the downward spiral.

This is why there is no clear end in sight. That does not mean the selling must continue indefinitely. It means there is no basis for assuming that a change in mood will bring it to an end, because further price falls can themselves generate further obligations to sell.

A financial system organised in this way can amplify the pressures it is supposedly there to manage. The resulting higher yields then become the justification for more expensive mortgages, pressure on public spending and demands for austerity. Ordinary people are asked to bear the consequences of mechanisms over which they have no

control. Before treating those consequences as unavoidable economic discipline, we should recognise how much of that discipline may be imposed by the financial system's own contracts.

I think this is a moment to share my infographic on bonds. They are not meant to be toxic. It appears that in the hands of the wrong people, when used for an inappropriate purpose, they might be:



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AI use

I wrote this infographic. I used AI to create the final image.