Börsen-Zeitung

Year-end Edition 2024 Interview with Terrence Duffy, CME Group

It's going to be more difficult to find investors for Treasury bonds

The mounting pile of US federal debt is alarming to CME Group CEO Terrence Duffy. He predicts that Bitcoin will challenge the status of US bonds as safe haven assets and warns about potential turbulences in Treasury clearing.

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CME Group

BZ: Mr. Duffy, with the US elections behind us, the upcoming administration's plans for tax cuts and higher tariffs are at the center of attention. How will these proposals affect the US bond market and, through that, CME Group's markets?

Donald Trump is currently President-elect, which is an important distinction because his administration and conversations about policy are just beginning to take shape. I support most of his comments – for example, I think that lowering corporate taxes for domestic producers to 15% is an interesting concept. However, we'll have to wait and see which of these proposals actually come into fruition. In any case, the determining factor for interest rate and bond market volatility will not be individual tax cuts or tariffs, but the mounting pile of debt the US is sitting on.

BZ: The federal debt has ballooned to over 36 trillion dollars; deficit spending has risen to roughly 2 trillion dollars a year. Do market participants underestimate the potential fallout of these fiscal issues?

If anyone had predicted that federal debt levels would reach 36 trillion dollars ten years ago, people would have declared that person crazy. The US still need additional funding in order to run this country efficiently, but it's going to be incrementally more difficult to find investors willing to buy up those Treasury bonds. That's because we are going to see increasing competition between issuers in sovereign debt markets, as countries from other regions look for financing to break out of economic slumps. Investors will be watching the spreads between US Treasuries and European debt or other markets as a result.

BZ: How will the Federal Reserve's rate cuts factor into the debt debate?

Loosening monetary policy further is going to be very difficult for the Fed. Inflation seems to be very stubborn in the United States, especially concerning food and consumer staples. Once prices are up, they're really hard to push down; but when they're down, they can rise again very easily. A lot hinges on the first two or three quarters of 2025 – if the Trump administrations tariffs come into fruition as expected, they'll create more inflationary costs for US market participants in the near term. It's hard to see how the Fed would lower rates in that environment.

BZ: That means you're preparing for sustained high activity in CME Group's rates products?

We can't predict volumes, but investors will definitely have to manage that risk. Markets are predicting that the Fed's overnight lending rate will drop to 3.5 percent. However, the FOMC would have to be very aggressive to reach that target. Market participants also have to be conscious about other factors. Even small moves along the yield curve can have a big effect on US companies' balance sheets. With a large amount of corporate ten-year notes coming due in 2025, refinancing is going to be a challenge at rates that are still elevated. That's why I believe the market for rates products could be very active.

BZ: Are these risks as front of mind for investors as they should be? After all, many traders today have never experienced a market meltdown or large-scale liquidity constraints.

That is a fair assessment. People who were in their 20s in 2008 are now controlling large sums of money. A prevalent mentality seems to be that you should buy every dip and, if the market dips again, you just buy more because it's always going to go up. That's a difficult proposition, but it has worked for 16 years now. When the greatest market that anyone has ever seen ends or transforms into a two-sided one, market participants run the risk of being caught off guard. The Warren Buffett theory of buy and hold is a good one, but it shouldn't make up the entire portfolio. It's important to hedge, especially against interest rate risk.

BZ: The regional banking crisis of 2023 showed the potential consequences of improper risk management among institutions…

Correct, and the way that Silicon Valley Bank or First Republic Bank collapsed illustrates that these consequences can manifest overnight. When the Fed first raised rates, these institutions took on a lot of long duration risk. After monetary policy became even more restrictive in a short time-span, they incurred big paper losses they hadn't planned for. Had these banks hedged even 20 to 30% of their exposure to Treasuries through the futures market, they would still be in business today. However, people's perception and risk sentiment has changed a lot since I started out.

BZ: You got your start as a runner at CME in 1980 and you learned about the value of money the hard way. You tended bar in order to be able to attend university, and you continued to work nights after incurring a big loss due to a misheard order early in your career as a broker. Has this generation of traders grown up too wealthy?

Every generation deems itself superior to the ones that come before or after them. I would never want to kill young traders' ideas or stymie their growth, but it's important to remind them why risk controls exist and why shortcuts lead to bad outcomes. I visit a lot of universities and have earnest conversations with students about being future stewards of the market and keeping their moral compass in turbulent times. When I incurred that loss of 150.000 dollars due to a misheard order in my early 20s, I was scared. But I worked through it and and that taught me a great lesson on how to maintain discipline. That experience also taught me that it is crucial to look at how to exit a trade before you enter it.

BZ: Since then, you have led CME through several big events like the IPO in 2002. In the current market environment, speculation about a full resurgence for equity listings persist. In today's liquidity environment, would you attempt to take CME or any other exchange public again?

Every company is different, and I can only speak for my own. I've seen a lot of people make a lot of money being wrong and plenty of people lose a lot of money by being right in the market. If you're convinced that you have to do an IPO just to get a quick boost in your multiple, then you should not try to time the market. You'll never hit the bottom or top perfectly. If you have enough confidence in your company, you can create your own timing. That's why you go on roadshows and price your offering according to investor interest. Right now, however, everybody is trying to pick the best time for an IPO.

BZ: Equity listings are a very lucrative business for the New York Stock Exchange or the Nasdaq. At the same time, some of your competitors like CBOE Global Markets have been trying to move in on the space. Would you consider entering the IPO market as an exchange operator at all?

No, I don't see added value in that. There are two listings exchanges, the Nyse and Nasdaq, and they are both competent and capable enough to facilitate all the IPOs they want. Companies would gain very little by trying to go public through any other operator. The brand recognition added by a listing at established exchanges like Nyse, Nasdaq or Deutsche Börse is what's important to international companies. In order to break into that business, a new marketplace for listings would have to offer unique services, and it's very time-consuming and expensive to develop those.

BZ: Another formative event of your tenure at CME so far was the merger with the Chicago Board of Trade that you completed in 2007. Would a deal of this size even be fathomable in today's environment, with antitrust regulators in the US taking a very combative stance towards the M&A market?

As we move into a new year and administration, raising efficiencies will be high on the economic agenda. The big tech set will probably have problems moving forward with any merger because the market is already extremely concentrated, with seven companies taking up almost one third of the market capitalization in the S&P 500. However, businesses in other industries will be looking to consolidate to create added efficiencies. I do expect the new administration to be more receptive towards deals, but companies will have to show that mergers benefit customers as much as they benefit shareholders.

BZ: To which extent are you looking to raise efficiencies at CME Group through new acquisitions?

We are focused on the vertical model that we have established. If we're talking about acquiring another exchange, I wouldn't even know where to look right now. It might be interesting in theory to add value through acquisitions in Europe, but cross border transactions are always very difficult. I'm not opposed to new deals, nothing is off the table. However, I don't think we need to be active in M&A as much as we need innovation. I want to take a dollar, make it look like five dollars and take the risk down to 75 cents.

BZ: How do you plan on bringing more innovation to CME?

Our relationship and partnership with Google adds a lot of value to our business model. We allow our customers to utilize and test Google's artificial intelligence solutions in new strategies, for example by implementing new risk protocols that no one else is capable of enacting. We have been working with Google for three years and they have been at the forefront of this new technology, especially when it comes to solutions for financial markets. While we are committed to them, we do not have an exclusive relationship and keeping our eyes open for new developments in technology as well.

BZ: Another technological innovation that CME Group has been very involved in is crypto. How important will your Bitcoin and Ether products be for the exchange overall going forward?

The growth trajectory in crypto is amazing. Bitcoin is riding all-time highs at levels above 100,000 dollars and while there is a lot of focus on the price development, people are not talking about that for the right reasons. This fairly young asset is very limited in supply and highly sought after, just like gold. That poses a challenge for the US bond market, as this digital gold could very well develop into a safe haven asset and become a competitor to Treasuries. That is another reason why I expect that it will be hard to push interest rates lower than they are today.

BZ: The SEC, under outgoing chair Gary Gensler, has characterized crypto as a space ripe with fraud and manipulation. How have your own interactions with FTX founder Sam Bankman-Fried shaped your view of the market?

I was an adversary of Sam Bankman-Fried and I was the first person to call him out. It was readily apparent that he wasn't legit and his business practices weren't above board. That being said, any new technology – be it the internet, the cell phone, artificial intelligence or crypto – is always at risk of being misused for fraud and manipulation. Unfortunately, when you take a step forward in finance and something bad happens, you take three steps back. That's different from sectors like medicine, where problems with new treatments and medications won't lead to these developments being rolled back or scrapped completely. However, I do believe that crypto has the potential to make the financial world more efficient and democratic for everyone.

BZ: Nevertheless, there are risks associated with this very quick price rally.

Indeed, and I have a major concern. As crypto appreciates, a lot of junk will be dusted off and passed off as the next Bitcoin – coins that just don't possess the infrastructure to monitor bad behavior and offer actual value to investors. It's very important that the SEC, the CFTC and other regulators protect the public from these elements of the market through education and information. Bitcoin, Ether and maybe Ripple are the crypto currencies that are here to stay. I just hope that we stop being so fixated on the day-to-day price developments of the product and focus more on its use cases.

BZ: US watchdogs have been acting very adversarial towards crypto. While the industry has argued for new frameworks akin to the „Markets in Crypto Assets" regulation in the EU, the SEC insists that crypto should be governed under existing securities laws. Where do you stand on this issue?

Regulation breeds credibility – without it, you won't have a sustainable market. Whoever argues that the industry will move out of the US and to jurisdictions with more advanced frameworks doesn't understand the economic power of this country. These products are going nowhere unless the US eventually embraces them with a good, smart regulatory framework. The way to achieve that is for regulators to accept input from the industry to help shape rules and guidelines to protect investors from unscrupulous participants in the marketplace.

BZ: Does that mean that you think about the crypto products available at CME Group in a different vein than futures and options in other asset classes?

Yes, I do. I like to be critical of my own products and regularly check liquidity and volume tests. I don't get overly excited about the volatility in our Bitcoin or Ether products because that is a component of every market, especially a young one. But I want to know who is using these products and what for. I would like to make sure that we work with the Blackrocks and Fidelitys of this world who are offering Bitcoin as part of their portfolios and ETFs and not with unscrupulous elements in the market. That being said, a broader acceptance of crypto won't happen overnight, but gradually. I can see the product maturing over the next five to eight years as people realize more and more how much friction it eliminates and how much efficiency it adds.

BZ: Increasing efficiency has been a big topic in other asset classes. In 2024, the US moved forward with shortening the settlement cycle for most securities transactions to T+1, while European regulators are looking to take that step in 2027. Which challenges does this diverging pace of innovation pose?

It does create problems, because global financial markets are so intertwined. Having different settlement cycles creates friction, which is something we want to eliminate. That is why I probably wouldn't want to run a securities exchange today. There is no interoperability in futures trading in the US or in Europe – if you buy a contract at one of our exchanges you have to sell it there. We settle transactions twice a day. In equities, it's a different world.

BZ: However, there's talk about moving to real-time settlements for securities transactions. Central bank digital currencies might offer a path to that, according to some analysts. How do you rate the prospects for stablecoins like that actually coming to market?

Central banks shouldn't just launch stablecoins and expand them to the entire market universe. I think they should work with their systemically important financial market utilities like CME Group, other exchange operators and those banks deemed too big to fail. That way, we can make sure that payment and settlement processes based on central bank digital currencies actually work in a regulated environment before opening them up to the public.

BZ: Another big trend in US financial markets is the expansion of trading hours. At CME Group, investors can already trade derivatives practically around the clock. Now, the New York Stock Exchange has proposed an extension of equities trading to 22 hours 5 days a week, while the SEC has approved plans for a new 24-hour exchange. How do you expect this trend to affect market stability?

The world is going to move to 24/7 trading, whether we like it or not. That means that US exchanges have to adapt to that. For futures and options, we have established processes for out-of-hours trading. We set price bandwidths and use volatility control mechanisms. We can set our velocity logic tools to trigger trading halts in contracts if large price moves occur in a short period. I'm more concerned with regard to securities trading because processes there are more arcane. It's not only NYSE and Nasdaq that set quotes. Bids and offers come in from all corners of the market and even off-exchange. We have seen in our own stock how easily erroneous quotes can slip into the tape and influence prices. These problems tend to increase because liquidity tends to decrease overnight. Regulators and exchange operators need to be very careful about how they approach this. They need to unilaterally tighten their trading bands out of hours and be vigilant about stopping trades that move too quickly.

BZ: You already alluded to another central risk in financial markets: The concentration in certain industries. However, the exchange business is also very concentrated. Do you expect more regulatory scrutiny regarding the power CME Group wields?

No, I don't expect our size to become a concern for regulators. I spoke about weighing antirust tenets against the higher efficiency larger companies can offer to the market earlier. We have cross-margining agreements with the Depository Trust and Clearing Corporation and the Fixed Income Clearing Coporation that reduce the collateral brokers need to deposit with clearinghouses for their clients drastically. Our margin offsets against fixed income futures lead to cost reductions of more than 1 billion dollars every day. If you include the effects of offsetting swaps against the futures portfolio, that adds another 7 to 8 billion dollars, and cross-margining through the interest rate futures and options portfolio creates another 11 to 12 billion dollars of efficiencies a day. Overall, these are 20 billion dollars in capital savings to the largest market participants in the world. I think regulators see the advantages our size offers.

BZ: Still, antitrust regulation in the US has been driven by ideology rather than practicality in many instances in the past four years…

I don't believe corporations should be punished for being big, they should be rewarded for having achieved that status. We have also diversified well, for example through our relationship with S&P Global. We own 27% of the index business and have licenses to trade all the equity products, which – again – adds a lot of efficiency for investors. I'm very comfortable with where we are.

BZ: Are you looking to leverage the strength of your clearinghouse into further competitive advantages?

The fact that we have had our own clearinghouse from day one already is a big advantage. We have nurtured and built it for over 50 years, and we are always looking to work with new clients to take financial products off their balance sheet. However, leveraging our clearinghouse out into different assets would be a bit of a stretch. I like to make sure that we have a deep understanding of everything that we clear at CME Group. When the Dodd-Frank act was voted on in 2010, I made sure that it included a paragraph saying that we could reject any swap that we would not be comfortable with. Everything you put into the clearinghouse adds exposure to the rest of the participants. And I'm not going to that for esoteric swaps just to generate a few dollars more of revenue.

BZ: The SEC adopted a large-scale reform to expand central clearing of Treasuries at the end of last year, with implementation set for 2025. How does that affect your business outlook?

We just filed our application to clear US Treasury cash and repo transactions and hope for approval in 2025. This is an exciting development, and we just have to be ready for the expansion of central clearing and any changes in the market environment. However, as I explained to my friends at the DTCC and FICC, just because we have the ability to clear cash Treasuries and other products, that doesn't mean we have to do it. We have strong relationships with these clearing institutions that provide our clients with the margin offsets I described earlier. I believe that FICC will prevail.

BZ: There has been some controversy about one of CME's new competitors. Howard Lutnick's BGC Group in September launched FMX, a futures exchange that plans to provide even greater margin savings through a partnership with the London Clearing House. Do you feel threatened by FMX?

No. The reason I argue against the clearing of Treasuries and the netting off of clearing margins through LCH centers around the default authority that gets to oversee the resolution of trades in a default scenario. Again, LCH is a duly regulated clearinghouse and I'm not saying they are going to fail. But in the event that they were, there would only be one authority that will oversee the resolution of the US sovereign debt futures cleared in London, and that is the Bank of England. The United States, the Treasury or the Fed would have no say in that scenario. That would be a massive detriment to the 27 trillion dollar Treasury market and the even bigger market for Treasury futures, which is now 13% larger than cash.

BZ: What Mr. Lutnick suggests is definitely unprecendented…

Exactly, we would be the only nation on the planet that would be clearing its own sovereign debt under foreign oversight in a default scenario. When Brexit happened, European entities that had been clearing trades in London had to move these operations to Paris. That's because European nations needed their sovereign debt to be cleared under the laws of the European Union. Look what happened when a short squeeze in nickel sent the price of that metal above 100,000 dollar per tonne and a massive margin call occurred. The London Metal exchange tore up 12 billion dollars of nickel trades without going through the proper protocols for a default scenario, which resulted in damages to investors and several lawsuits. Now Howard wants to clear transactions in the much larger Treasury futures market in the same jurisdiction where this crisis occurred and investors shouldn't make a fuss about it? I think that's wrong and that's why I oppose it.

BZ: Brexit has also changed the outlook for the exchange business in Europe. In general, a lot of doom and gloom persists about the European economy and the outlook for European capital markets. How interested are you in doing business there, especially in Germany?

I have always been very interested in the European and German market. The sentiment is very negative at the moment, and I believe that the part Brexit played in this downturn is still underestimated. We are working through the fallout from that, but this economic slump should provide good opportunities to strengthen our partnerships over there. Germany has more innovative potential than people think and has a really good chance to become the dominant leader in the Union again.