Illiquidity in the Bond Market: Much Ado about ... Something

As the first Federal Reserve (Fed) interest rate hike in more than nine years looms large over the markets, investors are becoming increasingly nervous about any potential implications of this shift in monetary policy. In particular, the issue of liquidity — or more precisely the potential lack thereof — in the bond markets seems to have taken center stage. A Bloomberg Business article in June characterized the situation as follows:

Concern liquidity is drying up has intensified as the global bond rout that erupted in April [2015] erased more than a half a trillion dollars from sovereign debt and triggered swings some have likened to a once-in-a-generation event.¹

Is there, in fact, a liquidity problem brewing in the bond market?

Liquidity Defined

Liquidity is the ability to buy and sell an asset without drastically affecting the price. In a liquid market, an asset can be sold quickly without a major reduction in the price for which it is sold. Liquidity is about how big the trade-off is between the speed of the sale and the price it can be sold for. In a liquid market, the trade-off is mild: selling quickly will not reduce the price much. In a relatively illiquid market, selling it quickly will require cutting its price by some amount.² With this definition in mind, we examine some of the signs and likely culprits of the growing investor concern about liquidity.

Sizing up the Debate—Dimon vs. Bair

More? Or less? That is the question, but the issue of liquidity in the bond markets today is one measured in degrees. Much of the debate has centered on the topic of regulation. Has more regulation led to less liquidity in the bond market? Conversely, will less regulation lead to more

volatility during the next financial crisis? A recent internet debate (of sorts) between JPMorgan Chairman and Chief Executive Officer Jamie Dimon and former Federal Deposit Insurance Corporation Chair Sheila Bair demonstrated to us the difficulty in answering these questions.

In his annual shareholder letter, Mr. Dimon blamed heightened capital controls and liquidity requirements for rendering banks unable to provide the market with necessary liquidity or market participants with access to capital during the next crisis period. While he does commend regulation for putting the industry on a more stable footing than precrisis, he also disputes the notion that the $2.7 trillion held by banks in excess reserves at the Fed and the $500 billion in Treasury bonds held on bank balance sheets can be tapped as an extra source of liquidity. He claims these assets will not be accessed in a crisis due to the need to maintain higher liquidity coverage ratios. In his opinion, low dealer inventories and a reluctance to extend credit would lead to a “rapid decline in valuations” as banks simply step aside, instead of stepping in to help support the market.

On the other hand, Ms. Bair believes it is dubious to think that banks, which rely heavily on commercial paper for their day-to-day operations, will extend credit to market participants as a provider of last resort, so to speak, if their own solvency is in question. While she does agree that liquidity rules require some finessing, she believes loosening regulations on banks would only serve to ignore the lessons gleaned from 2008. Instead, she believes that more regulation is required to reinforce stability in the marketplace.

**Has the Nature of Liquidity Changed?**

In our view, the fundamental nature of liquidity has not changed. As Howard Marks, Chairman of Oaktree Capital, wrote in a recent memo to Oaktree Capital investors, “The liquidity of an asset often depends on which way you want to go…and which way everyone else wants to go. If you want to sell when everyone else wants to buy, you’re likely to find your position highly liquid…But if you want to sell when everyone else wants to sell, you may find your position is totally illiquid.” We believe this remains true today and highlight that the genesis of illiquidity is often a herd mentality among investors. When investors have similar outlooks and expect similar outcomes, the market typically becomes susceptible to violent swings—illiquidity—if and when developments invalidate the consensus view.

A classic example of this behavior occurred back in February 2000. According to an article by Gregory Zuckerman in the *Wall Street Journal*, traders across Wall Street had implemented short positions on U.S. Treasury bonds as then Fed Chairman Alan Greenspan warned of further increases to the federal funds rate. Traders expected these positions to pay off in response to Mr. Greenspan’s comments. Instead, the bond market experienced incredible volatility and the yield curve inverted, with the Treasury department

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4 [http://www.wsj.com/articles/SB951228909649046143](http://www.wsj.com/articles/SB951228909649046143)
unexpectedly cutting supplies of U.S. Treasuries. The supply shock led to panicked buying, pushing down yields at the long end of the yield curve, while short-term yields rose in response to the central bank policy. Traders were jolted out of their Fed-inspired complacency, scrambling to adjust their positions.

Fast forward to 2015, and investors have been starved for yield for quite some time. As a consequence, many investors have taken similar approaches to collect additional yield both by pushing out the yield curve and looking further down the credit spectrum. With many fixed income investors positioned similarly, we think prices in certain corners of the bond market may have overshot. As the business cycle advances, and the Fed eventually lifts from zero, we believe there may not be a sufficient number of counterparties to step in on the opposite side as this positioning unwinds.

Although the fundamental nature of liquidity is no different today, we believe rapid growth in financial innovation, increased regulation, and collective shifts in the behavior of key market participants have given rise to changes in market dynamics. These new dynamics may serve to amplify the effects of traditional market illiquidity, especially as the Fed eventually moves to normalize policy.

Recent Market Behaviors
Possible manifestations of impaired bond market liquidity are not in short supply. Although a causal link is not well-defined, we believe the following could easily have been the result of structural market changes:

- May 2013: U.S. long-term interest rates throw a “tantrum” and spike 100 basis points after the Fed signals the end of quantitative easing.
- October 2014: Treasury yields drop almost 40 basis points in 12 minutes on the heels of surprisingly weak economic data.
- April 2015: 10-year German bond yields jump from 5 basis points to almost 80 in just a few days.

What is Different Today?
Impact of Financial Innovation
Some market participants may be concerned that structural changes in the fixed income market have reduced investor liquidity. Those who support this idea cite several causes, including significant growth in investor demand for bond funds followed by the creation of exchange-traded funds (ETFs) and liquid alternative instruments. Such investment vehicles feature daily, or even intraday, liquidity for their investors. To deliver this kind of liquidity, however, the liquidity must ultimately be available in the underlying securities. Ironically, by creating the perception of enhanced liquidity, we think these products may undermine the actual liquidity of the market when it is needed most.
Even with such significant growth in demand, a recent Blackrock Investment Institute analysis showed that just 2.6% of high yield debt and 1.3% of investment grade debt in Barclay’s indexes are made up of ETFs focused on global corporate bonds. This same analysis also demonstrated (Chart 1) that “the value of ETF trading on exchanges has averaged more than five times the level of fund creations and redemptions since 2007. This means for every $5 of ETF activity on the secondary market, only $1 of liquidity was needed from the primary (over-the-counter) bond market.”

While we take some comfort from this five-to-one ratio, we interpret it with care. It suggests to us that the ETF market has not yet put much strain on the liquidity of the underlying bond market, but does not rule it out. This is an example of a so-called “latent risk,” a risk which exists but is not evident in the data because it has not yet been observed. By their very nature, such risks are especially difficult to quantify.

**Where Have All the Broker Dealers Gone?**

Bonds are typically traded in the inherently less liquid over-the-counter market, where broker-dealers have historically played a key role in both market-making and trade facilitation. As shown in Chart 2, from 2001 to 2007, broker-dealers expanded their inventories of corporate bonds rapidly, a nearly six-fold increase. Liquidity concerns were not on the radar screen, and the traditional role of market-maker appeared firmly intact.

Post-2008, however, broker-dealers have slashed their corporate bond inventories, down more than 80% and back near 2001 levels. Further, the number of U.S. primary bond dealers has fallen from 46 in 1988 to 22. Many have argued that the Volcker Rule ban on proprietary trading has effectively choked off a past source of fundamental market liquidity, making it more onerous and costly for banks to hold substantial bond inventories on their balance sheets, essentially disincentivizing this activity. Previously, banks would step in during periods of heightened market stress to help balance supply and demand fundamentals.

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ultimately dampening or smoothing short-term volatility. Under the current regulatory framework, it is less clear whether banks will choose to step in, or even be prepared to do so, should the need arise. If broker-dealers are not readily assuming the market-making counterparty role they once did, who is? We think electronic trading platforms may be the stop-gap measure, but uptake, particularly in the corporate bond world, has been slow to catch on, and it is still unclear what proportion of market share will ultimately take hold. 7

Cornering the Market
A recent Bloomberg article highlighted how large asset managers own a growing share of the corporate bond market today. Between 2009 and 2012, the 20 largest asset managers added $4 trillion of corporate bonds to their portfolios, now controlling 60% of the assets under management of the top 300 managers versus a 50% share back in 2002. 8 Yet bond issuance has exploded during this same timeframe. According to the Securities Industry and Financial Markets Association, total outstanding corporate debt rose 75% between 2002 and 2012. So these largest asset managers appear to be garnering an accelerating share in a rapidly growing market. With such a dominant market presence, their priorities and incentives will ultimately become the market’s priorities and incentives, potentially leading to significant unintended consequences, in our view. We believe liquidity ranks high on the list of potential casualties.

The Bottom Line
As a result of both traditional liquidity concerns, such as investor herding, and changes in certain market dynamics, we think the stage may be set for short-term dislocations to occur in the Treasury and corporate bond markets as the Fed begins to raise rates. Never constant, liquidity disappears when everyone is looking for it simply because everyone is looking for it. Bond investors have been “herded” by recent Fed policy, and this helps increase the likelihood that something unexpected happens to rapidly correct the disequilibrium. What is even more concerning to us today is that changes in certain market dynamics create a giant unknown: How will markets function the next time investors all make a move for the door at the same time? Our view is that the exit ramp may be a bit bumpier this time around.

Investment Implications
Ultimately, we think there is enough evidence to suggest that a liquidity drought is not fully priced into the markets today, which would likely result in increased short-term volatility, if not outright yield spikes. When combined

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with the fact that the markets are also pricing in a shallower overall rate trajectory than the Fed is projecting, we believe there is a chance the first rate hike (and subsequent path) could catch investors off guard, resulting in a wave of selling. Also, the perceived enhanced liquidity of ETFs, in contrast with the actual liquidity characteristics of the underlying bonds, especially in high yield, could aggravate the problem.

In light of these concerns, we believe investors should focus on using actively managed fixed income strategies as opposed to purely passive ones (ETFs, index funds). We think actively managed strategies should be more nimble in periods of heightened market volatility and better able to take advantage of potential price-value disconnects that may arise.

No one can know exactly what the Fed will do and when. As such, we view “following the herd” by investing according to the rate hike probabilities implied by Treasury futures to be overly risky. We prefer to allow the bond markets to recalibrate to the Fed’s actual actions, increasing duration once we feel the market is not spring loaded for potentially liquidity-inspired rate volatility. As long-term investors, such risks ultimately reinforce our short-duration stance within client portfolios. Should we begin to see a more sustained rise in yields, our current positioning would enable us to opportunistically lengthen duration in order to begin capturing higher yields.