Liquidity has become a Fluid Concept

Q4 2016

Executive Summary

Liquidity is emerging as a hotly contested issue among those with an interest in the functioning of financial markets. While academics and regulators believe liquidity remains robust, many participants in the corporate bond markets believe that declining liquidity is impeding their ability to meet their clients' objectives effectively and efficiently. We believe that liquidity has declined dramatically in recent years.

The evidence that corporate bond market liquidity remains good is that price quotes for bonds are readily available. While this is the case, they no longer indicate that the broker is willing to trade at that price, but merely represent the level at which they believe a bond should trade.

In our opinion, liquidity in corporate bond markets has declined because of the changes in the regulatory treatment of brokers' trading book. This effect has been exacerbated by central banks' pursuit of quantitative easing strategies, and the consequent shrinking of the investment universe.

Our clients are adapting to these new circumstances by changing their investment approaches. These include reducing the need to trade by adopting buy-and-hold strategies, closer matching of near term cashflow needs and broadening the investment universe to reduce exposure to any one asset class.

Given the challenges that illiquidity introduces, an experienced bond manager can help their clients avoid having market conditions blow them off course by maintaining a diversified portfolio, and working with them to ensure that the strategy is appropriate for their objectives.

"We believe that liquidity has declined dramatically in recent years."

Price quotations do not indicate a willingness to trade

While academics and regulators believe that liquidity remains robust, many participants in the corporate bond markets believe that declining liquidity is an impeding their ability to meet their clients' objectives effectively and efficiently. As fixed-income specialists and participants in these markets on behalf of our clients, we believe liquidity has deteriorated materially in recent years.

In the liquidity debate, the evidence that corporate bond market liquidity remains good is based on price measures, such as low bid-offer spreads; the price impact of a trade; and the plentiful availability of bid- and offer-side quotes for most bonds in the secondary market.

Our concerns with these price-based arguments are:

- in over-the-counter markets such as those for corporate bonds, accurately measuring such metrics is extremely difficult and generally rests on a number of assumptions; and

- as investment banks have reduced the size of their trading books, it is our belief that an increasing proportion of trades are those where the dealer is buying to reduce a short position or selling to reduce a long position, rather than to place their capital at risk.

We agree that price quotes are often readily available for most bonds in the secondary market, but, in our experience, they merely represent the level at which a broker believes a bond should trade, and are not an indication that they are willing to trade at those prices. The price at which the trade takes place may be different from the prices quoted.

The decline in US corporate bond turnover in the past decade is clear from the trends in trading volumes as a percentage of amount outstanding (Chart 1), and the turnover of a bond in the 90-day period after new issue (Chart 2).

Chart 1: Trading Volumes as % of Amount Outstanding
Source: Federal Reserve Bank of New York, Barclays[1]

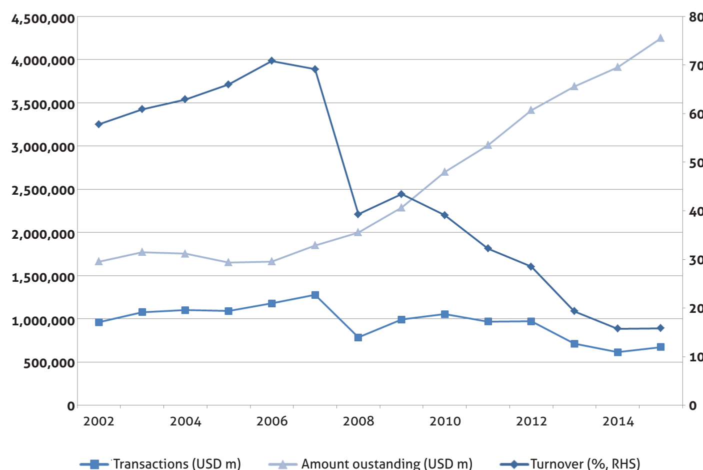
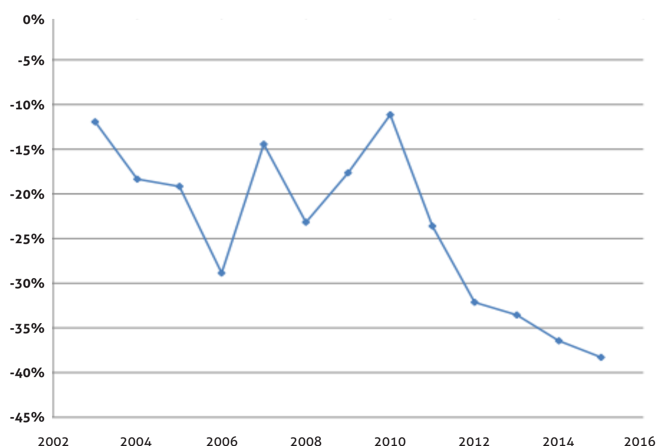


Chart 2: Reduction in Bond Turnover in the 90-Day Period After Issue
Source: Financial Industry Regulatory Authority (FINRA)



[1]Charts 1, 3 and 4 show data for USD Investment Grade bonds and exclude MBS and Agency bonds

Regulation and the actions of central banks have driven reduced liquidity

A cursory look at dealer inventories of corporate bonds since 2001 (Chart 3) shows a sharp increase in the run up to the financial crisis. Some of this increase is a distortion caused by dealers reclassifying certain banking book assets as trading book assets to benefit from the more favourable capital treatment of the latter at the time.

The sharp decline immediately after the Global Financial Crisis (GFC) reflects not only dealers reducing inventory but also the fall in valuations of many assets held on trading books. In addition, in 2013 the regulator restricted which assets could be classified as trading book assets and this change resulted in the further step down in dealer inventories.

Since the GFC, regulators have not only changed the nature of the assets that can be classified as trading book assets, but also they have set tougher regulatory capital requirements for those assets. It is worth noting that regulatory capital must be held both against long positions, where a dealer owns a bond on their trading book, and against short positions, where a dealer has sold a bond that they don't own. As a result dealers are as reluctant to buy bonds that they own as they are to sell bonds they don't own, making liquidity on the offer-side as poor as it is on the bid-side.

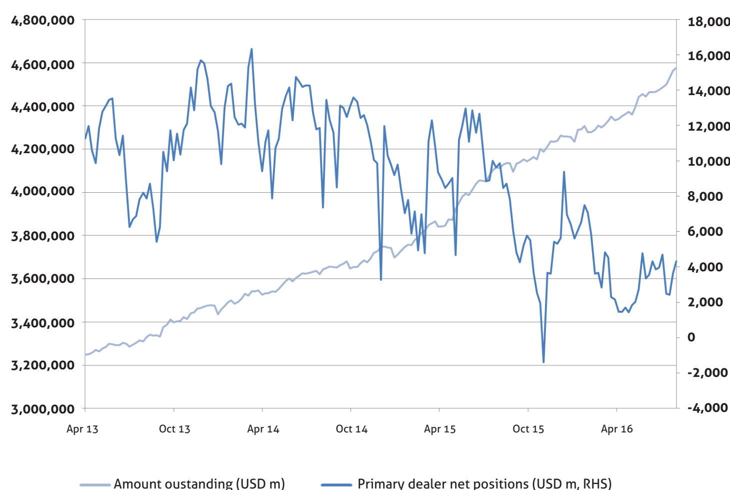
These changes in the regulatory treatment of trading book assets for dealers, particularly with regard to capital requirements, have led to a reduction in liquidity.

This is starkly evident in a comparison of US dealer inventory since 2013 to the size of the US investment grade corporate bond market (Chart 4). Although the bond market has continued to grow, dealer inventories have fallen, suggesting a likely cause of the decline in liquidity.

In other markets, where quantitative easing has extended into credit markets, the resultant shrinking of the overall investment universe will further limit liquidity.

Chart 3: Dealer Inventories
Source : Federal Reserve Bank of New York

Chart 4: US Dealer Inventory vs Amount Outstanding
Source: Federal Reserve Bank of New York, Barclays



Clients are responding to the liquidity challenge by adopting new approaches

Banking regulation is likely to become more onerous and with the European Central Bank and the Bank of England buying investment grade corporate bonds, we don't expect a return of plentiful liquidity in corporate bond markets in the foreseeable future. So how are investors responding to the challenges of diminishing liquidity and to the resultant distortions and market inefficiencies?

We see our clients taking actions that are consistent with reduced liquidity:

- adopting new investment strategies to deal with the problem, such as a buy and hold approach to illiquid assets; and
- seeking to construct portfolios to match their liability cashflows, to guard against being forced to sell assets in difficult markets.

In addition, where clients have the flexibility, they are using a broader investment universe. We believe this approach has two principal benefits. First, global markets are interrelated, and factors directly affecting one will indirectly impact others. An investment manager that is permitted a global investment opportunity set is better able to meet their clients return expectations.. Second, having a broader range of markets in which to invest makes it easier to avoid the distortions in individual markets and can give an investor the best chance of achieving their clients' investment requirements.

An experienced bond manager can be invaluable to developing approaches to deal with illiquidity. Such a manager can help their clients avoid having market conditions blow them off course by maintaining a diversified portfolio, and working with them to ensure that the strategy is appropriate for their objectives.

Contact

Keith Logan
keith.logan@cameronhume.com
T +44 (0) 131 603 6988
M +44 (0) 7860 925 131

Author

Melanie Mitchell is an Investment Manager at Edinburgh-based fixed-income specialist Cameron Hume Limited

Disclaimer

Cameron Hume Limited ("Company") is registered in Scotland (company number SC408024) and has its registered office at Exchange Place 1, 1 Semple Street, Edinburgh, EH3 8BL. The Company is authorised and regulated by the Financial Conduct Authority (FCA Register Number 579495).

This document does not in any way constitute advice or recommendations in any jurisdiction, nor does it form the basis of a contract.

The information in this document does not purport to be comprehensive and it has not been independently verified as to its accuracy. Whilst the information in this document has been prepared and compiled in good faith, no representation or warranty, express or implied, is given by the Company or its officers, employees, agents or advisers in relation to the accuracy or completeness of the information in this document or any other written or oral information which has been made available by the Company (or its officers, employees, agents or advisers) to you, your employees, agents or advisers pursuant to our on-going discussions and any such liability is expressly excluded. The Company does not give any undertaking to update the information contained in this document or correct any inaccuracies in it which may become apparent.

The Company accepts no liability for the content, accuracy or completeness of this material or for the consequences of any actions taken on the basis of the information contained in this document.

Investment markets can go down as well as up and market conditions can change rapidly. The value of an investment, and any income from it, can fall as well as rise and investors may not get back the amount invested. Past performance is not a guide to future returns.