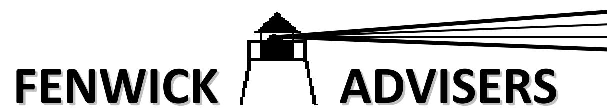
On Liquidity

The subject of the liquidity of bond portfolios has arisen in some discussions with institutional investors, so I spent some time sitting on a trading desk in New York with a long-time colleague who heads the credit trading desk for a large broker-dealer. Not too surprisingly, business has not been particularly good as margins have collapsed and new bank regulations have greatly reduced the amount of capital dealers are willing to commit to trading activities. Dealers hold little inventory of bonds and hence cannot take advantage of price abnormality as often as they once did. Moreover, surprisingly few end-buyers are willing to sell their bonds - at any price.

My colleague recalled how the sudden spike in US Treasury prices a few months ago (i.e. when the yield on the 10-year bond fell to 1.86% and then bounced back to 2.3% within a matter of a couple days) and noted how that volatility was accompanied by very limited liquidity. In other words, the spike in prices occurred because no one would sell their bonds rather than because there were so many buyers, often described as a flight to safety. In this case, it was barely a flutter, yet prices moved several points. Even today, a large ticket is around $5m in both High Yield and Investment Grade securities. US Treasuries offer not much better liquidity, despite nearly $15 trillion in bonds held by someone other than the Federal Reserve. In short, the size of the bond issue or the amount of debt outstanding is not particularly relevant; even huge issues of US Treasuries are not traded very much.

It is difficult to think of bonds as being as volatile as stocks but that may be where we are headed – not because of forced selling (as with equities) but because of the lack of selling as bondholders have become increasingly 'buy and hold' and dealers are withdrawing from the playing field. This predicament raises some unusual questions. First, all bond managers seem to face similar liquidity challenges unless they enjoy some special niche. The only advantage of the largest fund managers is preferential access to new issues because of their clout with brokers. My colleague recounted how many new issues, including the huge Alibaba deal that began trading during my visit, are taken down in large part by a handful of big names in bond land. About 20% of new issues are flipped and the remainder is tucked away and rarely sees the light of day. Second, such minimal liquidity raises the specter of large price volatility even when there is little to warrant the price action. In other words, bonds are becoming as vulnerable as equities to gaps in prices and those gaps can run across the gamut of credit. Granted, bond prices for the best creditors are likely to normalize first after a purely liquidity-driven spike but in the short run the price action does not necessarily follow the usual credit fault lines and is not necessarily a good guide in sorting out worthy creditors from vulnerable ones. Indeed, if lack of liquidity is due to a dearth of participants rather than a change in fundamentals, it is not clear that long-term investors should respond to these aberrant price signals as vigorously as many did during the sudden selloff in long-dated Treasuries in the spring of 2013.



By contrast, investors should be much more concerned about the implications of illiquid bond markets during the next financial downturn. Again, the initial price action may prove irrelevant, but as a recession gains momentum, bond pricing is likely to play out much differently across the quality spectrum. As a recession drags on, investors are likely to become yet more disinterested in selling good credits, while brokers will have even less capacity to hold inventory and will not want to risk finding buyers for bonds of issuers whose creditworthiness is vulnerable to the business cycle or may need urgent refinancing for maturing debt. In short, regulators in their campaign to bolster banks' capital adequacy and leverage ratios inadvertently may end up with chronic illiquidity in bond markets, with the unintended consequence of undermining the usefulness of the bond pricing mechanism and an attendant exaggerated bifurcation in bond pricing. As much as the regulators would like to ring-fence systemic risk, they just may be shifting it from banks to capital markets.

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