BondTalk

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Beating the liquidity freeze in bond markets

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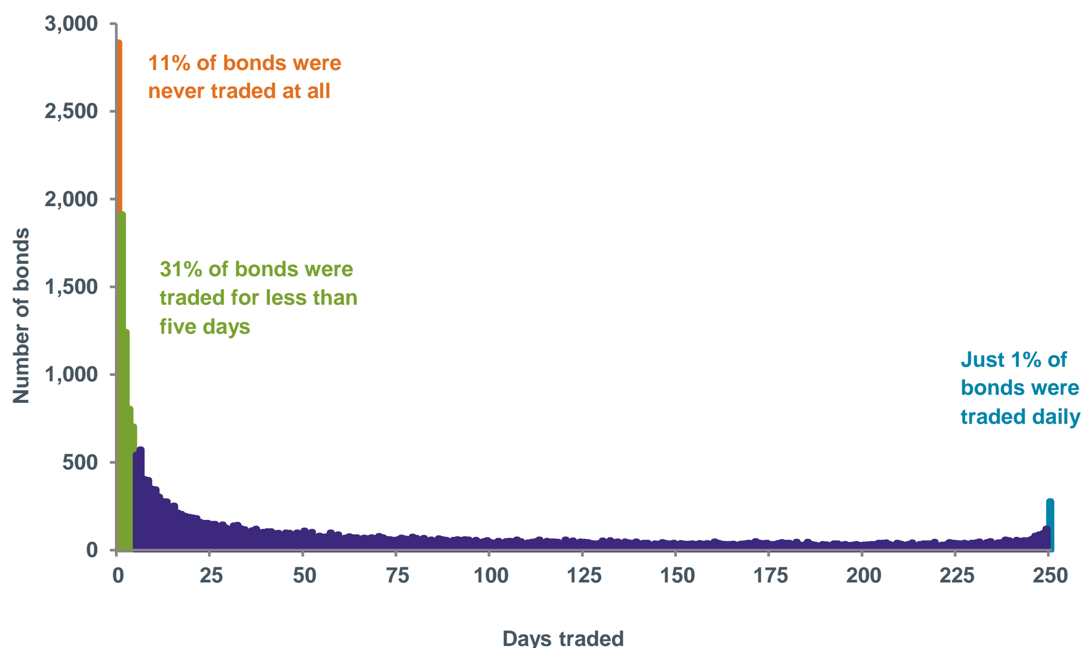
Compared to a decade ago there is significantly less liquidity in global bond markets. In this article Rory Sandilands explains the extent of the problem and considers the implications for institutional investors such as pension schemes and insurers.

I have spent 20 years working in bond markets, the vast majority with investment banks, before joining Kames Capital in 2016 to manage active fixed income portfolios, including buy-and-maintain and absolute return bond strategies. I have seen the environment of constrained liquidity from both the 'sell side' and 'buy side' and believe this has implications for investor expectations, pricing, capacity management, and the prospects for active investment fixed income strategies.

The corporate bond market is less liquid than you might think

Even the most liquid corporate bond market in the world, the US dollar market, isn't actually that liquid. Chart 1 shows, the number of trading days in a 12-month period for 26,000 publicly listed US dollar corporate bonds. As you can see, 11% of the outstanding bonds didn't trade at all, 31% were traded for less than five days and just 1% were traded daily.

Chart 1: Trading days in a 12-month period for 26,000 publicly-listed US$ corporate bonds



Source: Citi Research, MarketAxess, Bloomberg, TRACE. 2014 financial year. This is the number of publicly-registered bonds which did not trade. The total number – including private placements and the like – is likely to be far higher.

One reason for this is that real volumes in the secondary bond market are dominated by recently issued 'on the run' bonds. Many new bonds remain active for perhaps a month or two following issue, then volume really drops off.

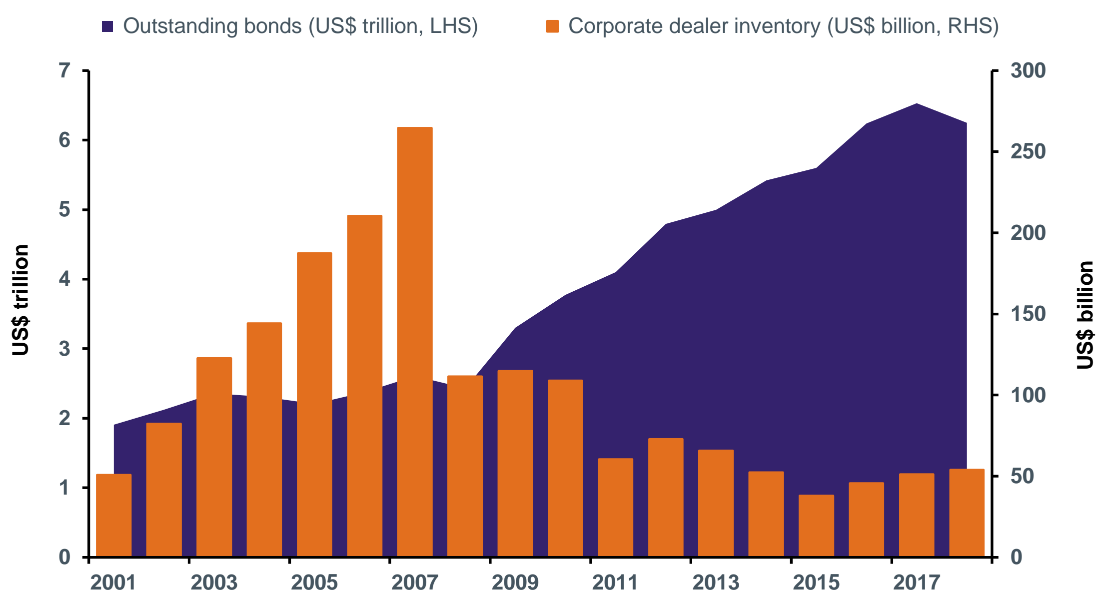
In some respects this is a structural issue – different market participants have different objectives and investment horizons. The secondary trading that takes place post issuance allows that security to find its natural home before settling down.

Why has bond market liquidity declined?

Most market participants would agree that liquidity in bond markets has declined significantly over the past 10 years. I would highlight two key drivers for this:

Firstly, changes to banking regulations, such as Basel III and the Volcker rule in the US, following the global financial crisis have increased the cost of capital for the trading books of banks. This has curtailed their appetite to hold inventory, while at the same time the corporate bond market has increased in size substantially. You can see this in chart 2, which shows the US market, where data is more readily available, although a similar chart could be constructed for a European perspective. It shows that investment banks are providing a smaller 'buffer' in the process of risk transfer between different investors operating in a much larger market.

Chart 2: As the bond market has grown, investment banks are holding less inventory



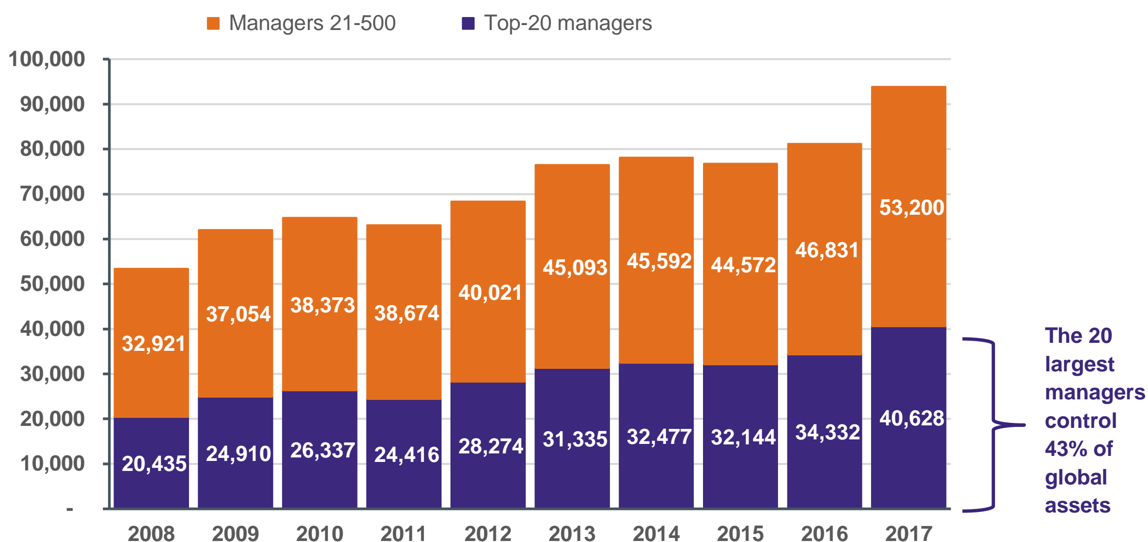
Source: Deutsche Bank

The second key driver is the substantial growth and consolidation that has taken place in the asset management industry. As chart 3 shows, in a survey of the 500 largest asset managers globally, the 20 largest managers now control 43% of global assets.

Given the smaller 'buffer' I mentioned above, it is now the asset managers who are as much the providers of market liquidity as investment banks. In normal market conditions this is not necessarily a problem. A normal market is balanced, where differing views can be expressed and the market functions properly. However, issues can arise in periods of market 'stress', when conditions become more binary as investors express the same views and the sheer scale of the risk transfer via the over-the-counter (OTC) market structure becomes problematic.

Of course other structural changes to the market, such as the growth in electronic trading platforms, dark pools, algorithmic trading desks, TRACE and MiFID II have helped to improve the transparency and efficiency of the market in 'normal' market conditions. Ultimately though we are still reliant on an OTC market structure where the agents of risk transfer (the banks) have had their wings clipped via regulation. Meanwhile their customer base has consolidated and scaled-up, so the risk of liquidity bottlenecks has increased.

Chart 3: Total assets managed by top 500 managers globally (US$ billion)



Source: Willis Towers Watson, September 2018

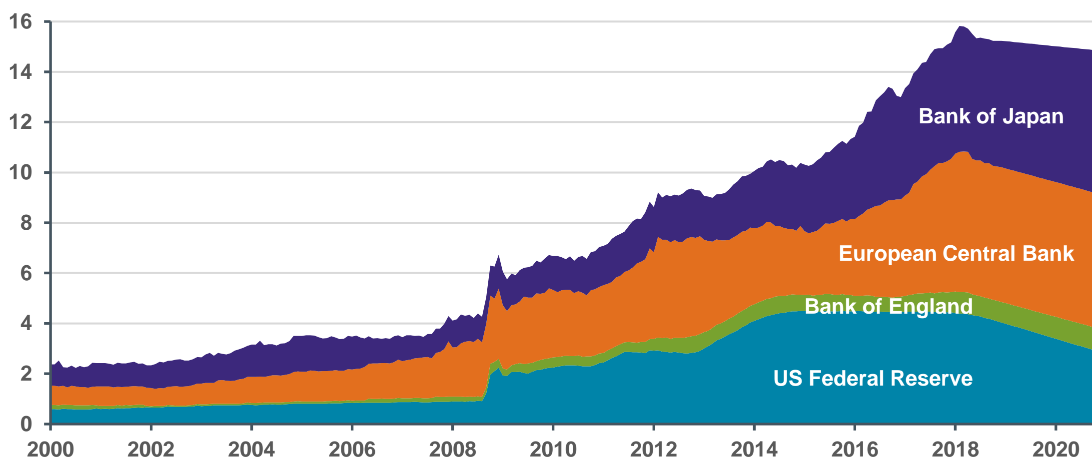
Is this likely to persist?

In recent years, the quantitative easing (QE) programmes embarked on by the main central banks have helped to temper some of the impact of the structural changes I've discussed and supported liquidity. As large, price-insensitive buyers, central banks provide a back-stop for risk and have given traders within banks the confidence to provide greater liquidity to the market. Some investment banks have actually sought to use the ECB's Corporate Sector Purchase Programme to grow their European credit-trading franchises. Although the ECB only buy so-called 'eligible securities', the very provision of that backstop has allowed traders to offset risk positions and provide greater liquidity in non-eligible securities.

In aggregate, QE has driven yields lower, compressed spreads, suppressed volatility and increased correlation across risk assets.

As you can see from chart 4, the QE programmes have been extensive, so it is hardly surprising they've been collectively described as the 'wall of money'. Indeed, at its height, the ECB's corporate bond buying programme was estimated to represent up to one-fifth of the trading volume in eligible bonds and the ECB now owns 15-20% of the eligible universe. However, as you can also see in chart 4, global QE has moved into reverse. The Fed is now reducing its balance sheet, while the others have stopped expanding.

Chart 4: Sum of 'Big 4' central bank balance sheets (US$ trillion)

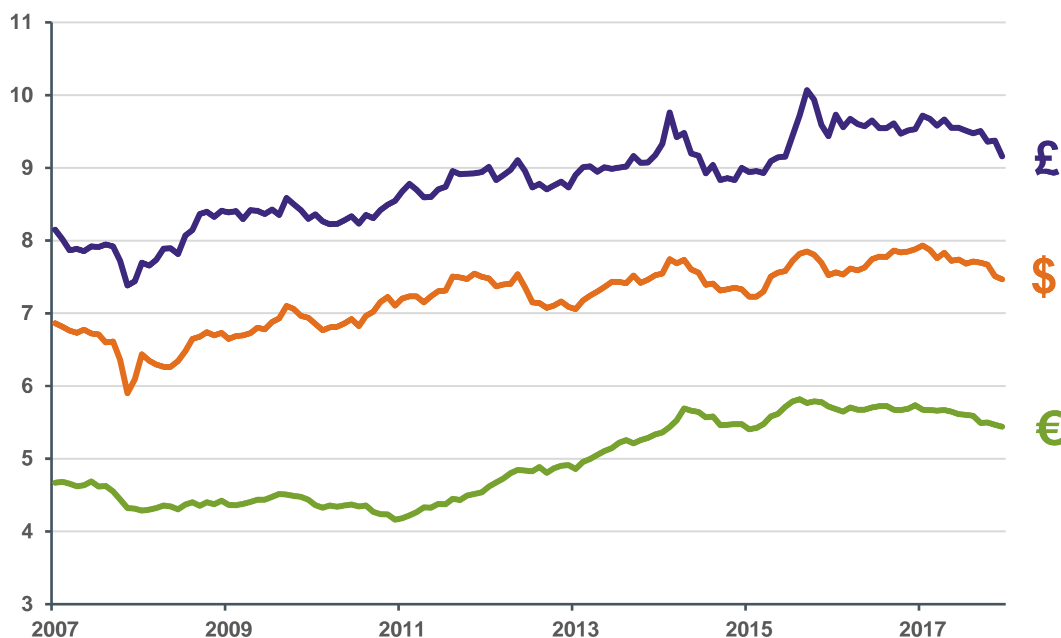


Source: Bloomberg, BofAML. Note: This chart includes financials.

The reach for yield

The crowding-out effect of the 'wall of money' has led to a 'reach for yield' by private investors, both through longer duration and lower quality. Issuers have obliged, taking advantage of lower yields to issue longer-dated bonds. As chart 5 shows, market duration has extended in sterling, euro and US dollar markets, suggesting that passive and semi-passive strategies are becoming inherently more risky.

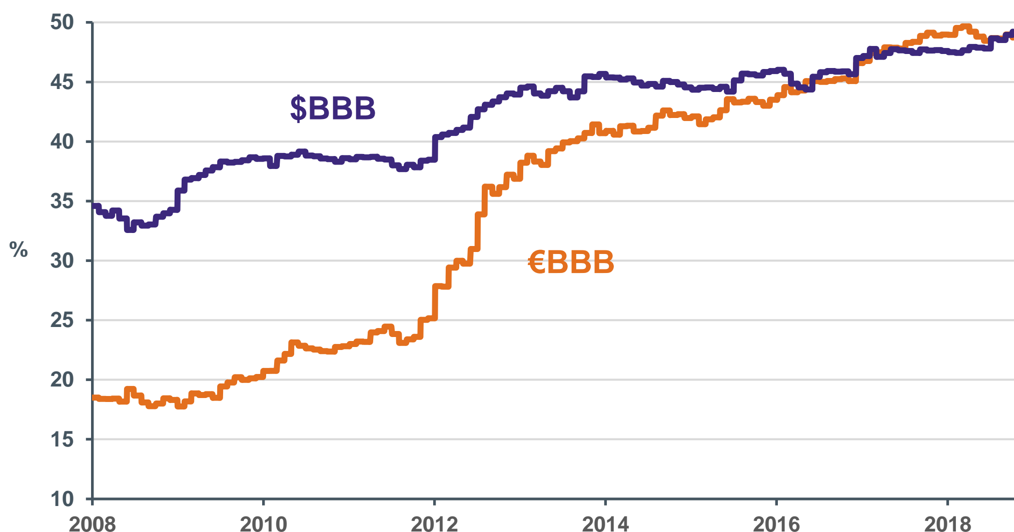
Chart 5: Corporate and non-financial bond market duration (years)



Source: BofAML.

Chart 6 illustrates the growth in the share of BBBs within investment-grade indices, as corporates take advantage of the fact that investors have demanded relatively little premium to lend to riskier balance sheets. Arguably, QE has encouraged a degree of complacency among market participants who have become somewhat reliant on the central bank bid.

Chart 6: Share of BBB bonds within investment-grade indices has doubled over the past decade

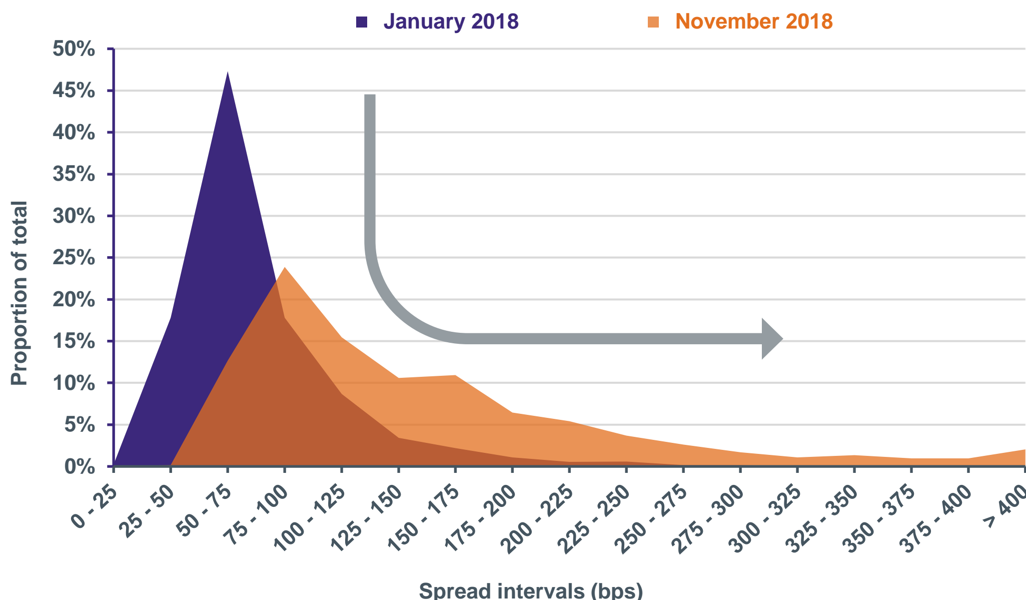


Source: Bloomberg, BofAML. Note: This chart includes financials.

Growing dispersion

As 2018 progressed and the Fed raised US interest rates, the market began to fret more and more about the withdrawal of central bank stimulus, in particular the ECB's QE programme. As a result we saw an increase in the frequency and ferocity of periods of market stress, during which liquidity became substantially more challenged. Consensual positioning was being challenged and dispersion increased, as chart 7 shows.

Chart 7: Euro investment-grade spread distribution



Source: Deutsche Bank. 26 January 2018 and 27 November 2018. Covers 95th to 5th percentile of market.

Although dispersion increased in 2018, it is still below historical averages and is likely to rise further as QE is withdrawn and we get closer to the next turn in the cycle. Chart 8 shows the sharp increase in euro BBB dispersion in 2018.

Chart 8: Euro BBB spread distribution

Source: Deutsche Bank. From 1 January 2010 to 21 November 2018.

Bond-level risks

Although rising dispersion is good for active managers, in that it provides a broader opportunity-set to express relative-value views, the lack of liquidity buffer can exacerbate spread moves and lead to ‘gap risk’, where spreads can move aggressively in a very short period.

A recent example at an individual bond level was GE. As chart 9 shows, GE exhibited significant spread volatility over the course of 2018 as the market began to question its credit quality. Then, on 31 October both Moody’s and S&P downgraded GE from A to BBB. The spread reaction was ferocious.

Chart 9: GE spread relative to benchmark in 2018

Source: Bloomberg. GE 5.875 $38 bond from 1 January 2018 to 18 December 2018.

Why was the reaction so severe? For years GE was regarded as a solid bellwether credit. With a debt stack of around US$100 billion it is a reasonably significant constituent in indices and its bonds are owned within many credit portfolios. Although there had been warning signs ahead of 31 October, the downgrade led to forced selling from holders unable to retain BBB debt. A combination of mandate criteria, the lack of market buffer, the scale of the debt stack and perhaps some complacency on the part of some holders meant there was little appetite to ‘catch a falling knife’ and so liquidity evaporated.

While idiosyncratic examples such as GE are by definition unique to their own circumstances, the likelihood is that such instances will become more common as QE is withdrawn and the end of the cycle approaches.

Conclusions

There are three main areas in which I believe market participants should prepare for a new-normal of constrained liquidity.

1. Investor expectations

We have lived through a period in which market beta has dominated returns. The withdrawal of QE and the late-cycle credit environment means that we are now entering an environment in which 'alpha' will have a greater role in returns.

The low volatility, low dispersion, low yield environment that we are emerging from has not been ideal for absolute return bond funds. Our own funds are relatively conservative, with a focus on preserving capital and delivering a steady positive return. Some other funds have more aggressive return targets, so have been forced to take on more market beta, which in some cases has resulted in bigger drawdowns in periods of weakness.

Looking ahead, I believe we are entering a more favourable environment for absolute return bond funds. While some investors have become frustrated with returns achieved, I believe it would be the very worst time to abandon these strategies.

2. Riskier indices

Passive solutions may be cheaper, but they are inherently more risky than in the past, due to elevated idiosyncratic risk, the falling quality of indices, and the duration extension as more longer-dated debt is issued.

I believe that, when assessing buy-and-maintain or semi-passive strategies, institutional investors should look for managers offering active sector and credit selection to mitigate some of these additional risks.

3. Capacity awareness

Asset consolidation is a major theme in the market, partly driven by an understandable desire from investors to lower costs. For example, the pooling of local government pension schemes is leading to bigger mandates, often with restrictions on who can tender based on minimum assets under management.

This trend exacerbates the risks of liquidity bottlenecks in the future, so might not ultimately be in the best interests of clients due to some of the challenges highlighted in this paper. I believe that mid-sized managers such as Kames Capital have both scale and agility, so are ideally placed compared to the very largest managers.

About the author

Rory Sandilands is an investment manager within Kames Capital's fixed income team. He co-manages an absolute return bond fund, buy-and-maintain credit mandates and a sterling corporate bond fund.

Before joining Kames Capital in 2016, Rory was a vice president in credit sales at Goldman Sachs. In addition, he has also worked in credit sales for Morgan Stanley and in fixed income sales for Merrill Lynch. He has extensive experience working with both cash bonds and derivative products across the full ratings spectrum.

Rory holds an honours degree in Law with Accountancy from the University of Edinburgh. He has 20 years' industry experience.

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