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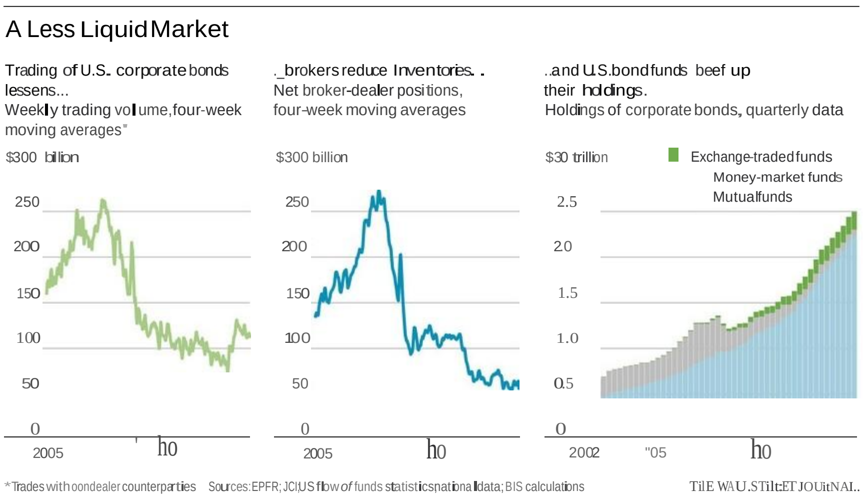
CREDIT MARKETS

Investors Raise Alarm Over Liquidity Shortage

Regulators also worried falling trading volumes could disrupt markets



By CHRISTOPHER WHITTALL And JULIET SAMUEL

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Central banks across the world have turned on the money-supply taps, but investors and regulators are increasingly worried about a shortage of liquidity that they say could lead to severe disruption in financial markets.

On Wednesday, the Bank for International Settlements became the latest major authority to sound the alarm, warning that it is becoming harder to trade in bond markets and that the problem could spill over into the real economy. Those comments echo concerns recently aired by the Bank of England, as well as the views of a slew of major bond-market investors and analysts.

Bond markets are "significantly less liquid than they used to be," said Wolfgang Kuhn, head of pan-European credit at Aberdeen Asset Management Ltd. "The risks are becoming bigger with central banks pushing everyone [in the same direction]. You don't want to be in a situation where this unwinds."

Liquidity-the degree to which assets can be bought or sold without affecting the price-has become scarcer since the 2008 financial crisis. Banks'trading desks have become more reluctant to deal in riskier securities such as corporate bonds due to a combination of tougher regulation requiring them to hold safer assets on their balance sheets and a smaller appetite for outsize bets.

Global debt issuance has exploded since the financial crisis, with borrowers taking advantage of low interest rates.Bond funds have lapped up this supply, causing them to mushroom in size.As they have grown, their moves are more likely to cause ripples,or waves,as markets grow shallower.

HEARD ON THE STREET

- Bond Markets Left High and Dry (http://Www.wsj.com/articlesJbond-markets-left-high-and-dry-heard-on-the-street-1426709908)

BIS data show that in the U.S., broker-dealers who match buyers with sellers have seen their holdings as a share of the total bond market decline from 3.63% to 1.22%,indicating liquidity has fallen.While equivalent figures for Europe weren't available, traders said a similar trend is playing out.

Central banks in Europe,Asia and the U.S.have poured trillions of dollars into the global economy to try to kick-start growth.

This wave of money has pushed investors in the same direction,with trades becoming crowded, said Guy America,global co-head of credit at J.P.Morgan Chase &Co.The so-called taper tantrum in 2013-a violent selloff across fixed-income markets after the U.S.Federal Reserve raised the possibility of scaling back its quantitative-easing program-provided an example of the risks this creates, he said.

"If a lot of investors are trying to do the same thing at the same time, then the market won't feel liquid regardless of the environment,"said Mr.America.

Regulators have also recently been alarmed by unusually sharp price swings in two of the world's most liquid markets-the "flash crash" in U.S.Treasuries in October and the one-day 30% drop in the euro against the Swiss franc in January.

"What happens in financial markets does not always stay in financial markets,"said

Hyun Shin, the BIS's head of research."We would do well to be on the lookout for any potential economic impact from financial market disruptions."

The BIS also said in its report that many market participants say trading large amounts of corporate bonds has become more difficult and that market liquidity more widely could come to "depend on the portfolio allocation decision of only a few large institutions."

Chris Salmon, executive director for markets at the Bank of England, warned in a speech last week that "future shocks could have more persistent and more widespread impacts across financial markets". He suggested policy makers raise awareness of the issue so that traders weigh these risks when setting prices.

The BIS said that the biggest concerns are in the corporate-bond market, where trading volumes haven't kept pace with the rapid growth of security issuances over the past few years.

Investors are already changing the way they trade bonds as a result.

Alain Kerneis, a managing director at BlackRock Inc., the world's largest asset manager, said BlackRock is limiting its allocations of funds to certain bonds because of the liquidity risks."You tone down your overweight [allocation] due to concerns around market liquidity," he said.

Chris Iggo, head of fiXed income for Europe and Asia at Axa Investment Managers, said some of Axa's funds try to bypass the need to source bonds in illiquid markets by trading less of its portfolio than normal.

Mark Pittman, a managing director at Allstate Corp., said he feeds his trades into the market more slowly and in smaller sizes to deal with the heightened risk.

And Mr.Kuhn at Aberdeen Asset Management says his firm has become more active in buying companies' newly issued bonds, which are easier to get hold of in large amounts than bonds trading in illiquid secondary markets.

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