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Liquidity pitfalls threaten parched markets

Robin Wigglesworth in New York



Concerns exacerbated by widening mismatch at the heart of the market

Welcome to the desert. The financial industry's great debate du jour is "[liquidity](#)", specifically how parched it looks at the moment.

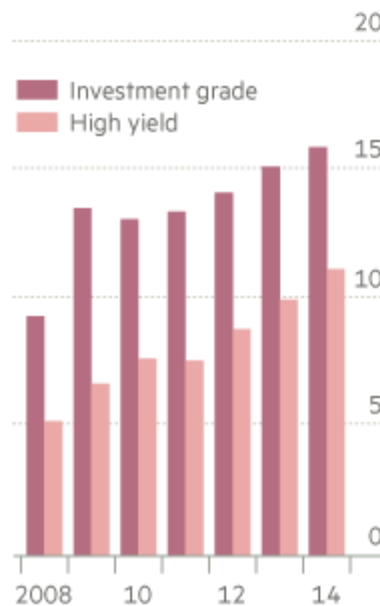
Liquidity is tricky to define, but essentially means the ease of trading a financial security quickly, efficiently and without moving the price too much. Traders and money managers differ on the extent, but almost everyone agrees that liquidity has deteriorated across nearly every market, a downturn some fear could exacerbate or perhaps even spark another [financial crisis](#). While that may be [far too shrill](#), there is clearly cause for some concern.

■ First of all, is it really that awful?

Well, it depends. As the charts from Citi (below) show, at first blush things don't look too bad. In absolute terms, trading volumes in corporate bonds and government debt are for the most part climbing (UK Gilts are a notable exception), and equity trading — although sharply down from the pre-crisis peaks — has been picking up.

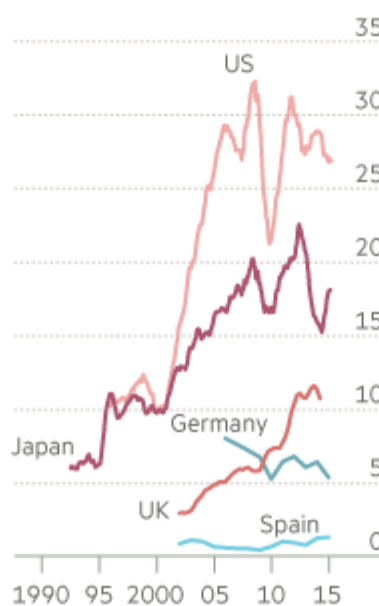
Corporate bond volumes at record highs

US cash credit annual volume (\$tn)



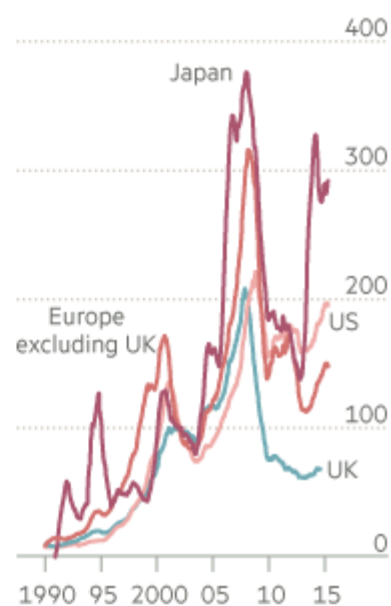
Government bond volumes steady

\$tn, fixed Apr 2015 FX, annual



Equity volumes: off peak, but rising

Index (1990=100)



Sources: TRACE Factbook; Citi Research

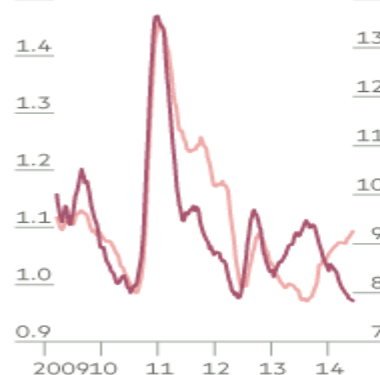
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Moreover, the bid-offer spreads, or the difference between the price investors are willing to buy or sell a bond — a popular gauge of liquidity — aren't too shabby. These charts from Deutsche Bank, JPMorgan and Citi show the bid-offer spreads for investment grade, high yield and Treasury bonds plus equities respectively.

Secondary market bid-offer spreads

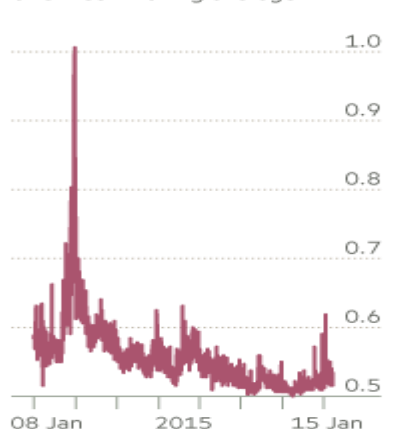
HY, 12-week average (lhs)

IG, bps (rhs)



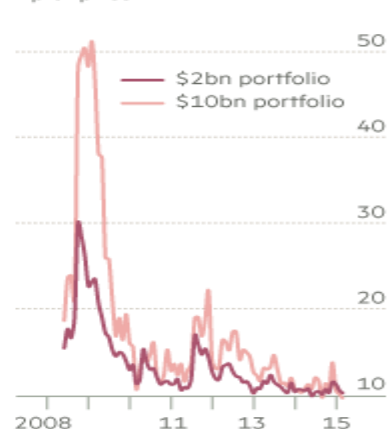
Bid-offer spreads in 10-year Treasuries

One-week moving average



Bid-offer estimates in equities by portfolio size*

Bp of price



* Estimated impact cost of \$2bn and \$10bn trades split across a global index (MSCI ACWI)

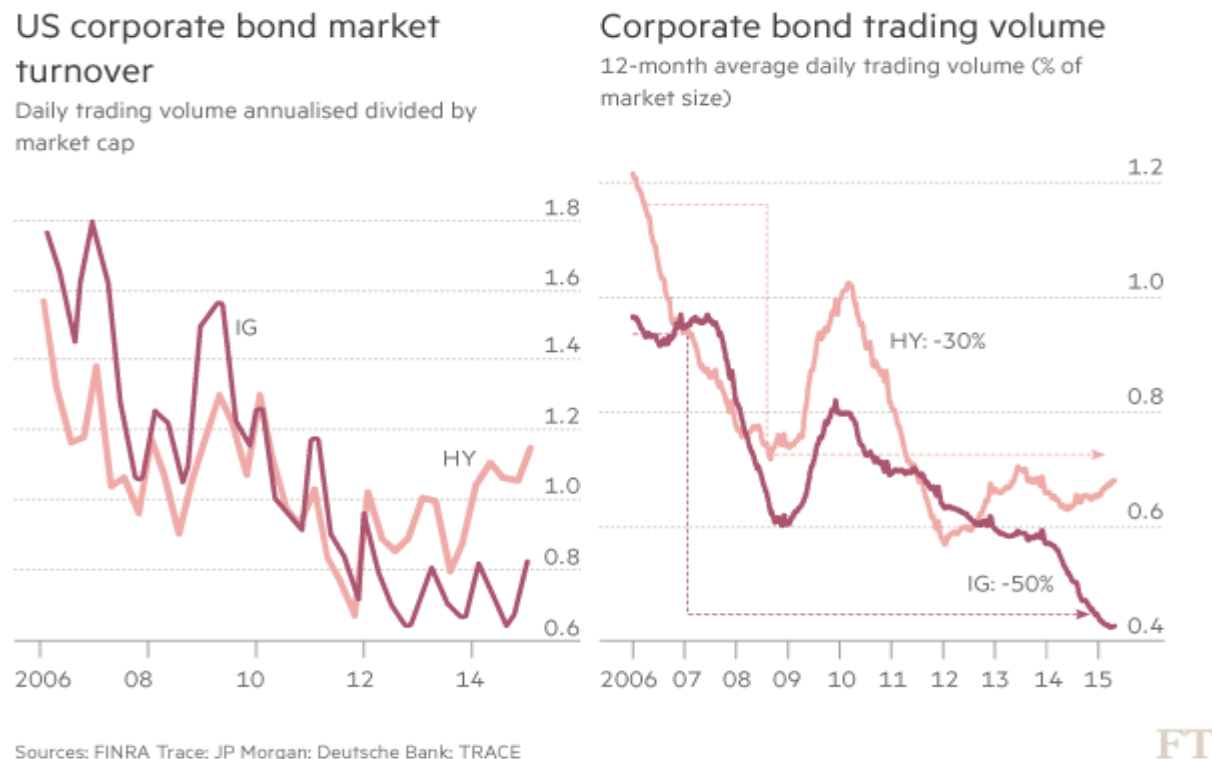
Sources: Deutsche Bank; Thomson Reuters; BrokerTec; Citi Research

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■ So we shouldn't be worried?

Unfortunately we probably should at the very least be [perturbed](#). These first charts ignore the fact that in many cases these asset classes have swollen dramatically in size, or do not reflect other changes in the market structure.

Corporate bonds have generated the most concern, both for the increasing difficulty in trading the securities and the increasing prominence of retail money in the market since 2007. Adjusting absolute trading volumes for the market sizes paints a very different picture, as the charts from JPMorgan and Deutsche Bank underscore.

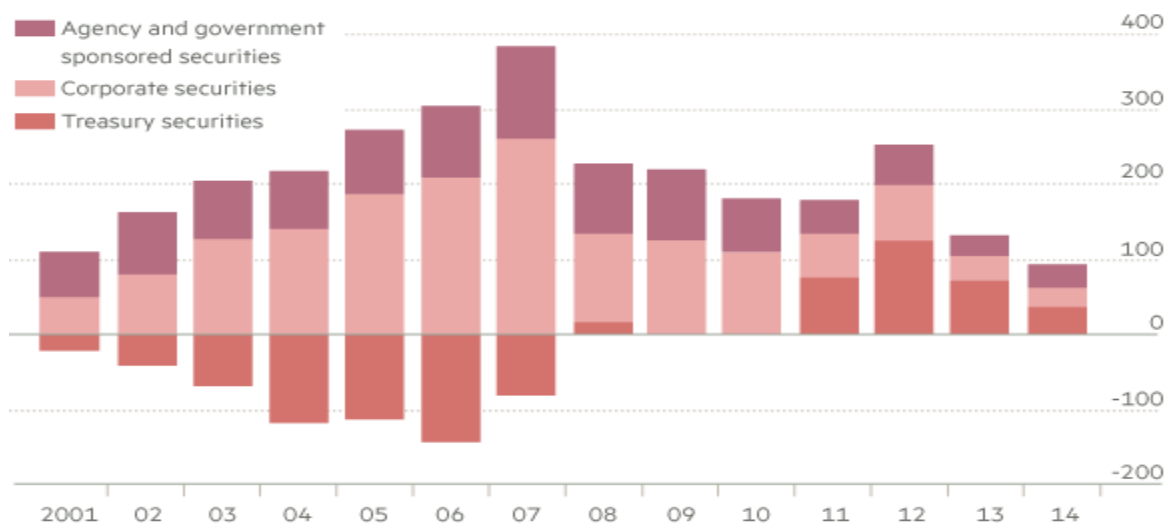


A large part of the problem is investment banks being forced to trim their corporate bond market trading operations. Hampered by regulation and under pressure to shrink balance sheets, banks have eliminated their “proprietary” trading desks and scaled back their market-making operations, with the cuts especially heavy in corporate debt.

The chart below from JPMorgan Asset Management vividly shows the shrinkage and shifting composition of the “inventories” of bonds held on banks’ balance sheets.

Size and composition of banks' trading book inventories

Net outright positions of primary dealers by security type (m)



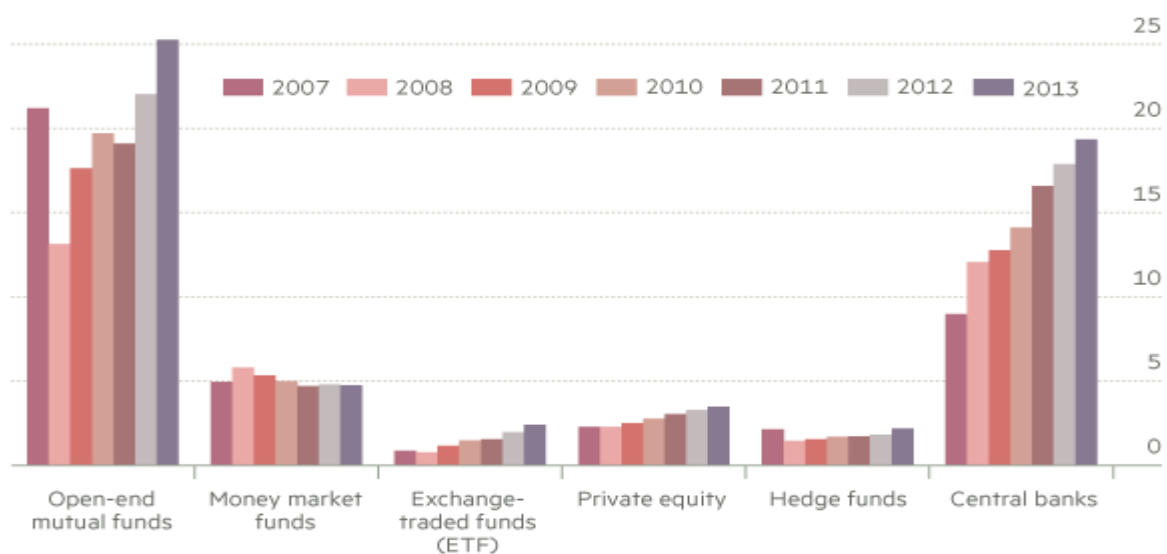
Sources: FRB; JP Morgan Asset Management

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Concerns have been exacerbated by the widening mismatch at the heart of the market. Mutual funds have become [increasingly important players](#) in corporate bonds, but their money comes from retail investors who can pull out whenever they want, even though the underlying securities their funds buy are increasingly illiquid. Citi's chart below shows the scale.

Who has the greatest potential to move markets?

Global assets under management (\$tn)



Sources: IMF; national central banks; Haver Analytics; Citi Research

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■ Is the problem exclusively in the corporate bond market?

The illiquidity might be the worst there, but corporate debt is far from the only corner of capital markets affected. As the two charts from Citi and Deutsche Bank below show, the government debt markets are also becoming less liquid. Even the [US Treasury market](#) is looking somewhat wan.



Equity market liquidity is also in the doldrums, despite many bourses exploring new record highs this year. As JPMorgan's chart illustrates, the average size of trades has plummeted in developed markets and failed to recover since. With the exception of [Chinese stocks](#), emerging market liquidity is also fading.

In the developed world it is likely at least partly a result of big trades migrating to so-called "dark pools" — as the second JPMorgan chart shows — but the trend away from the major public exchanges is nonetheless striking.

Average trade size in equity exchanges
US\$ '000



Average trade size in US off-exchange trading venues
US\$ '000



Sources: World Federation of Exchanges; JP Morgan; BATS Global Markets

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The causes of these illiquidity phenomena are manifold, and vary from market to market. But Matt King, a senior strategist at Citi, argues that the one common thread is the dominance of central banks over markets.

The paradox, he argues, is that the extra money pumped into the global economy by central banks is leading to “[herding](#)” by investors, as they run in and out of markets in a uniform fashion, prodded by shifts in monetary policy.

“Unfortunately, it leads to a rather ominous conclusion,” Mr King writes. “The bouts of illiquidity will continue until central banks stop distorting markets. If anything, they seem likely to intensify: unless fundamentals move so as to justify current valuations, when central banks move towards the exit, investors will too.”

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