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# Bond market liquidity dominates conversation

Robin Wigglesworth

## Data illustrates sharp deterioration in bond trading condition

Forget the usual medley of financial industry bugbears. Greece is so 2011-12, debt ceiling brinkmanship is now yawn-worthy, and the Federal Reserve interest rate increases (if they ever come) have been priced in. Wall Street's latest obsession is bond market liquidity.

Never before has an essentially esoteric structural issue commanded such intense attention. The latest luminary to highlight the issue was private equity titan Stephen Schwarzman, who this week argued in an opinion piece that the "liquidity drought can exacerbate, or even trigger, the next financial crisis". Nouriel Roubini dropped the qualifiers, predicting that "market illiquidity will eventually trigger a bust and collapse".

The bond industry itself is for the most part somewhat less shrill, but flocked to a conference on the topic hosted this week by Securities Industry and Financial Markets Association, a trade body. Attendance was so strong that Sifma opened an overflow room. Even the US Treasury sent a couple of staffers to hear the industry vent, underscoring how far up the food chain the fretting reaches.

The concerns are understandable. Although liquidity is a nebulous concept, all the data point to a sharp deterioration in trading conditions for bonds. Even the most liquid corners of global capital markets, such as US Treasuries, have seen a sharp decline in trading volumes relative to the size of the burgeoning bond market.

Nonetheless, some of the anguish over bond liquidity is overwrought, and arguably does the market a disservice by obscuring some important nuances. In some respects, the current problems could even prove a long-term fillip to markets.

The fear is that when the bond market faces an inevitable test — and the Federal Reserve could provide a big one as early as September — a correction could deepen into a full-blown crash.

Scarred by the financial crisis, retail investors gravitated towards the supposed safety of fixed income. But their funds have bought increasingly illiquid bonds while still offering investors the opportunity to pull out whenever they want. If losses spook investors to do that, asset managers will sell bonds in order to pay investors their money back, the type of scenario that can quickly become a fire sale. Meanwhile, banks have been forced by regulation to shrink their balance sheets and will no longer be able to act as shock-absorbers.

However, this narrative has some weaknesses. Firstly, investment banks have never been altruists when markets turned, and were often the first to dump their inventory of bonds in times of severe turmoil. Liquidity has always had a nasty tendency of being abundant when it's not needed, and to evaporate when it is.

Secondly, the bond market has been periodically tested — by the 2013 taper tantrum, Pimco's massive outflows, a high-yield quake, the energy crash and the most recent ructions — without breaking.

Illiquidity has exacerbated those routs, and Federal Reserve rate rises will be even more challenging, but if markets crash there are enough pension funds and insurers slavering for higher yields that will probably subdue the turmoil eventually. Just because some investors will lose money in the process does not make it a systemic danger.

Instead, money managers and traders will simply have to adapt to a new world, one that will be familiar to those with experience of the pre-noughties bond markets, before bank "prop" desks swelled to gargantuan proportions and liquidity was flush. Liquidity has not evaporated, there is always a price; it just may not be one that the seller likes.

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Indeed, lacklustre trading may not be a wholly bad thing. As Robert Michele, chief investment officer at JPMorgan's asset management arm, points out, it could "force people in the market to be investors again, rather than just traders". In other words, when investors buy a bond they have to do their research and should assume the exit strategy is repayment. If they have to exit before then it will cost dearly, but that may lead to more disciplined markets in the long run.

The liquidity crunch is real, and worrying, but it is not an inevitable disaster. The market will adapt — as it always tends to do.

The very fact that the industry is fretting over illiquidity lessens the chances of any debacles, and it is already exploring various solutions to the challenge. These range from tweaking regulations, improving trading infrastructure or overhauling the very concept of how corporate debt is structured and issued. Some may come to naught. But others could flourish, and that would be a positive legacy of the great liquidity fright.

robin.wigglesworth@ft.com