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Stability-Liquidity Tradeoffs in the Post-Crisis Fixed Income Market

discussion by

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Looking for symptoms: State of liquidity

Liquidity indicators:	**Treasuries**	**Corporate bonds**
Transaction cost	*"bid-ask spreads widened markedly during the crisis, but have been relatively narrow and stable since"*[1]	*"credit bid-offer at post-crisis lows"*[2] *"much of the time the cost of trading is low"*[2]
Turnover	~30 times/year in 2006 ~10 times/year in 2014[2] *"a doubling in UST outstanding only partly explains the drop in turnover"*[3]	about the same (~1) (2006 vs. 2014)[2]
Depth	*"depth rebounded healthily after the crisis, but declined markedly during the 2013 taper tantrum and around the October 15, 2014 flash rally"*[1]	
Transaction size	*"after declining during the crisis and then rebounding, trade size also declined during the taper tantrum and around the October 15 event"*[1]	*"it is harder to execute larger trades"*[3] *"e-trading is mostly in odd-lots"*[3]
Price impact	*"price impact rose sharply during the crisis, declined markedly after, and then increased some during the taper tantrum and in the week including October 15, 2014"*[1]	

- UST and corporate bond liquidity is OK by historic standards; no evidence to be concerned
- Issue: what we can measure vs. what we would like to measure
  - We are concerned that liquidity can suddenly disappear: this is not what we are assessing when we look at average levels of liquidity
  - Unique factors affect liquidity of USTs, IG corporate bonds, HY corporate bonds

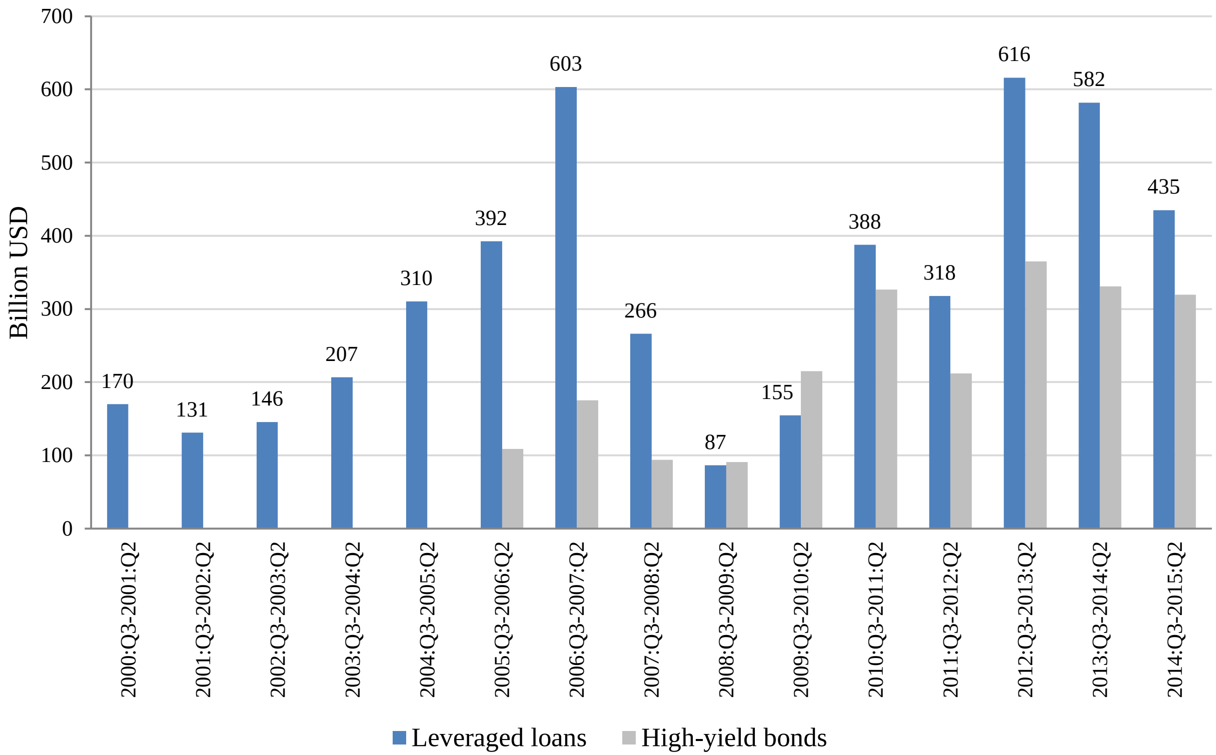
1 Adrian et al. (2015)
2 SIFMA
3 Citi Research

UST liquidity might be little indication of corporate liquidity

- Treasuries are:
  - much more standardized than bonds
    - Corporate: S&P 500 firms have nearly 12,000 bonds outstanding
  - much more liquid than bonds
  - less dependent on warehousing
  - money-like securities

- Useful observation on the other side of the spectrum: leveraged (HY) loans
  - much less standardized than bonds
  - much less liquid than bonds (T+10 days settlement)
  - much richer space to reach for yield
  - variable rate

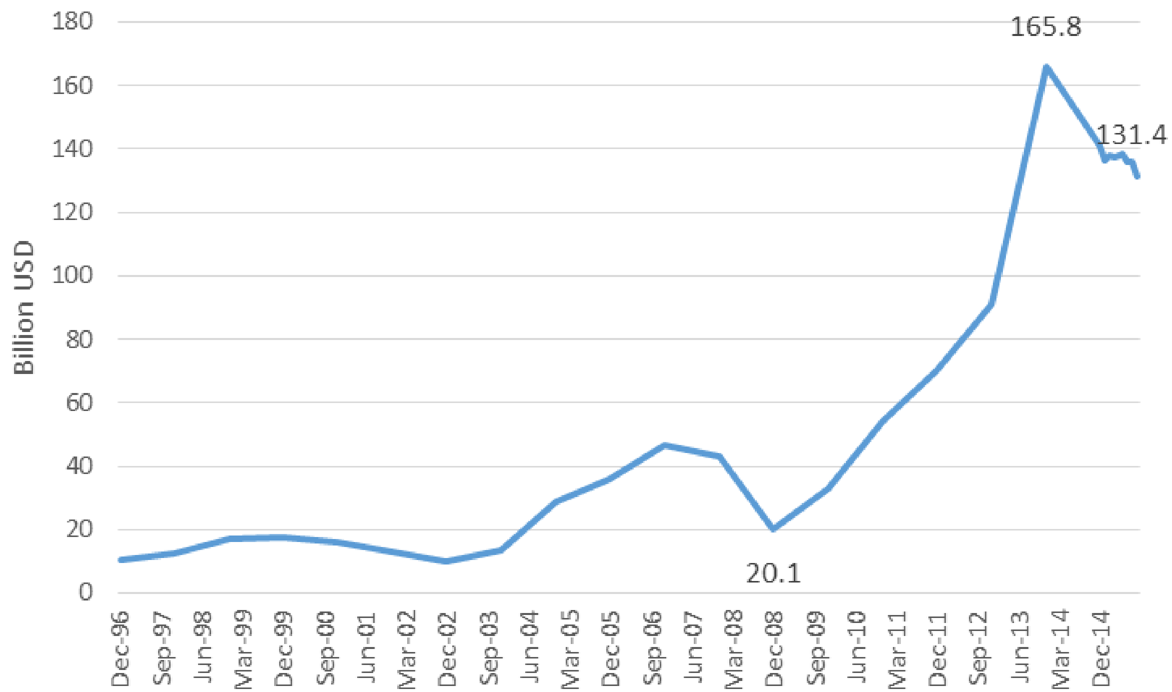
U.S. High-Yield Credit Volume (New Issues)



Data source: Standard and Poor's LCD

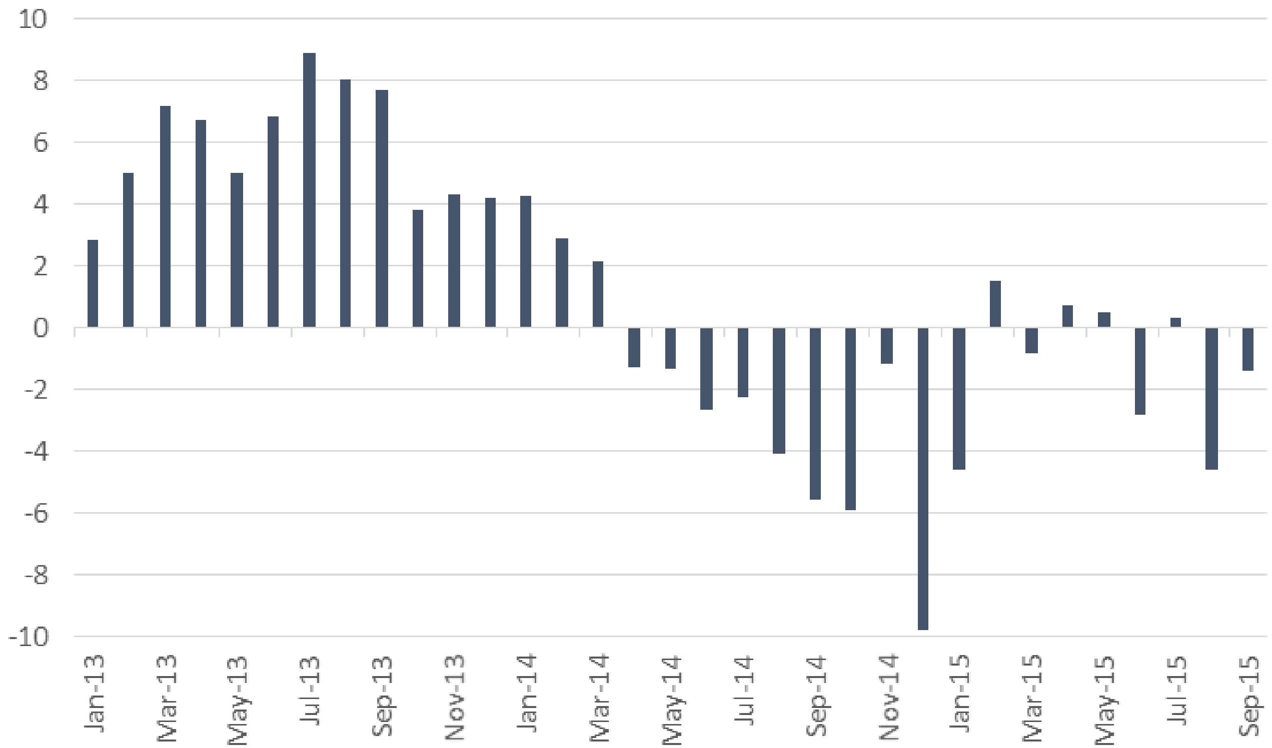
Note: Data on HY bond issuance data starts in 2005.

Loan mutual funds' AUM expanded over eight times



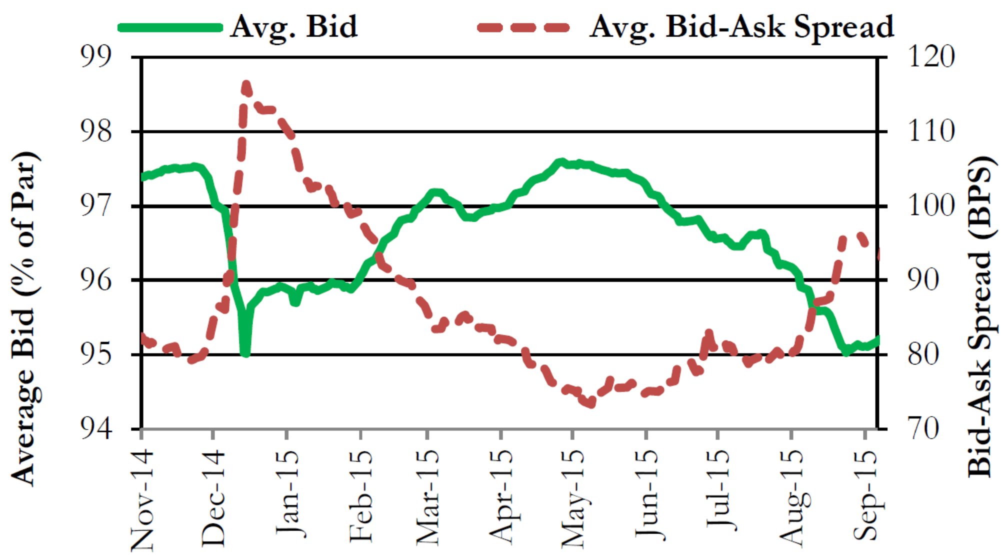
Source: S&P, LCD

Net monthly cash inflows to loan funds



Source: S&P, LCD

State of liquidity: High Yield Loans

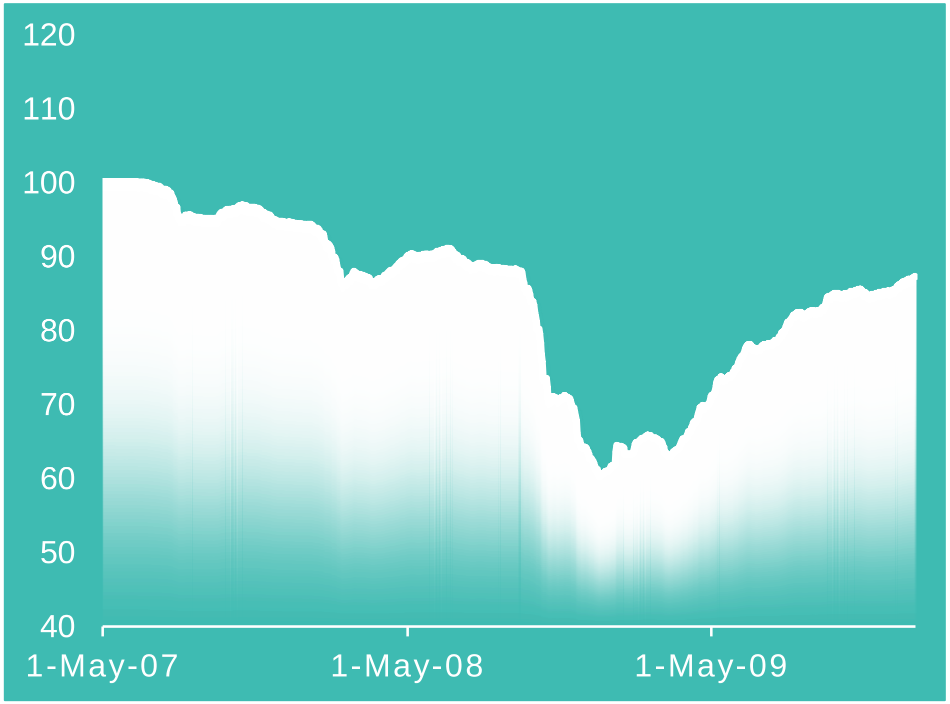


Source: LSTA

- Turnover: ~10% drop in 3Q2015, ~3% drop in 2Q2015
- But, all in all, no signs of a “run”

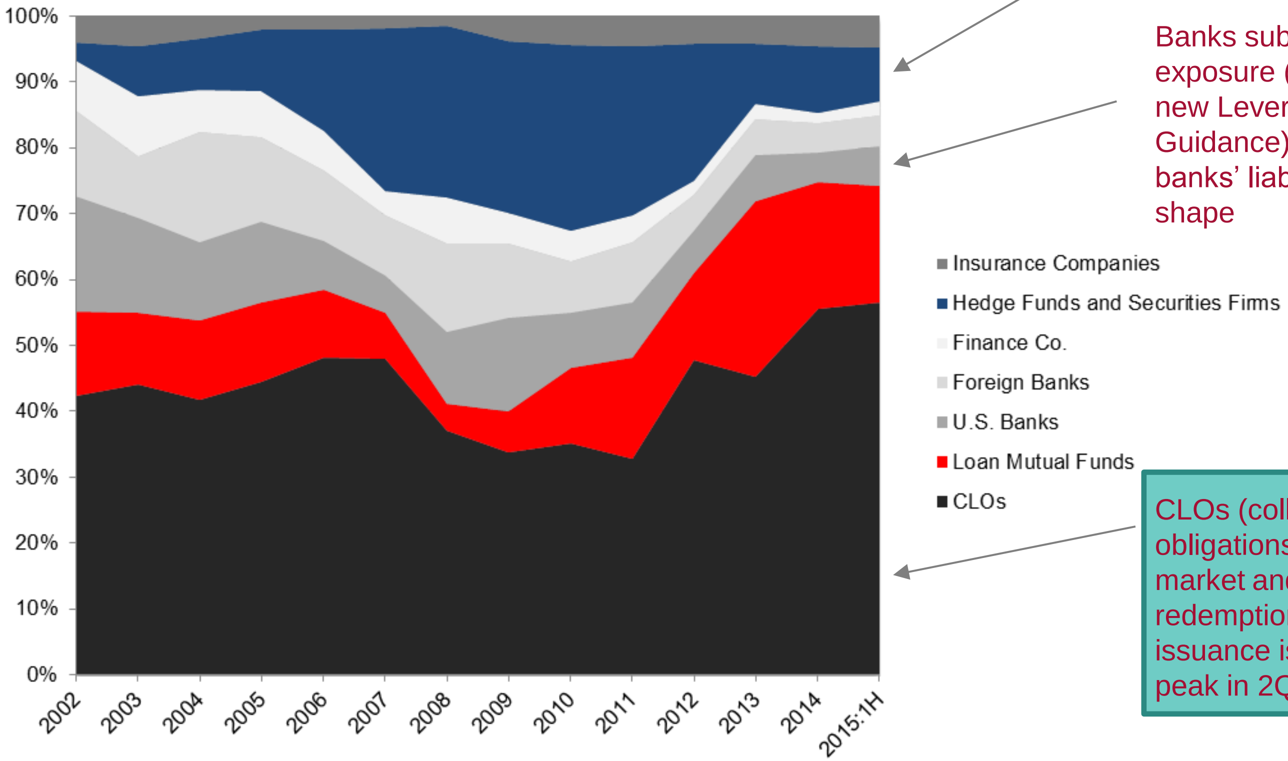
Are the accelerating forces from 2008 still in place?

Average Bid Quote for Secondary Loan Market
(leveraged loans)



Less leverage in this segment

HY Loan Investors (at origination)



Source: S&P, LCD

shadow banking

TRS structures that dominated this segment are mostly gone; now, "managed accounts," not a levered structure

Banks substantially cut their exposure (under Fed scrutiny: new Leveraged Lending Guidance), and, of course, banks' liability side is in better shape

shadow banking

CLOs (collateralized loan obligations) are not mark-to-market and are not subject to redemptions; that said, CLO issuance is contracting since its peak in 2Q2014

In sum

- Evidence to date suggests that, in the near term, short-lived market dislocations are unlikely to escalate and be a threat to the broader financial stability
  - Even in the leveraged loan market (the most illiquid segment of the fixed income market), 6 quarters of a very weak mutual fund environment was not conducive to a sell off
- But some of the forces holding things together are market forces
- Continuous monitoring of liquidity and underlying market structure is essential