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

discussion by

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Brookings, November 17, 2015
Looking for symptoms: State of liquidity

<table>
<thead>
<tr>
<th>Liquidity indicators:</th>
<th>Treasuries</th>
<th>Corporate bonds</th>
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<tbody>
<tr>
<td>Transaction cost</td>
<td>“bid-ask spreads widened markedly during the crisis, but have been relatively narrow and stable since”¹</td>
<td>“credit bid-offer at post-crisis lows”² “much of the time the cost of trading is low”²</td>
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<td>Turnover</td>
<td>~30 times/year in 2006 ~10 times/year in 2014³ “a doubling in UST outstanding only partly explains the drop in turnover”³</td>
<td>about the same (~1) (2006 vs. 2014)³</td>
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<td>Depth</td>
<td>“depth rebounded healthily after the crisis, but declined markedly during the 2013 taper tantrum and around the October 15, 2014 flash rally”¹</td>
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<td>Transaction size</td>
<td>“after declining during the crisis and then rebounding, trade size also declined during the taper tantrum and around the October 15 event”¹</td>
<td>“it is harder to execute larger trades”³ “e-trading is mostly in odd-lots”³</td>
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<td>Price impact</td>
<td>“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</td>
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- 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

- 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

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.

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