Bond Market Perspectives

October 15, 2013

Liquidity: You Don't Miss It Until It's Gone

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Highlights

Liquidity may pose a challenge to the bond market in the form of: 1) more volatile interest rate movements; and 2) greater swings in lower-rated or more economically sensitive bonds.

We view near-term liquidity risks as manageable and remain focused on more credit-sensitive sectors such as bank loans and high-yield bonds.

"That's the trouble with liquidity. It's never there when you really need it," remarked John Meriwether, founder of hedge fund firm Long-Term Capital Management (LTCM) back in 1998, who was forced to liquidate and close his fund in response to the market turmoil. LTCM was unable to exit certain positions and forced to sell other holdings at much lower-than-anticipated prices due to poor liquidity. The vast majority of investors do not own the esoteric securities or complex trades owned by LTCM that rely on good liquidity in various sectors of the market, but this does highlight an extreme case of an illiquid market.

Liquidity is the oil that lubricates financial markets and is particularly important in the bond market where trading is not done on a major exchange. The over-the-counter nature of the bond market requires two parties to agree on price for a certain transaction. A lack of willing participants to make markets in a specific security or segment of the market leads to illiquid trading, which can exacerbate price weakness even if the intrinsic fundamental value of a security may not have changed. If a buyer views an investment as possibly difficult to sell, a lower price may be demanded up-front to compensate for the potential future difficulty. This is particularly evident during periods of volatile markets, when many investors may try to avoid risk of any kind and shift focus to the highest quality, most liquid securities within a particular sector or market.

A Growing but Manageable Risk

Liquidity has become a growing risk in the bond market as banks, traditional large-scale players in the bond market, have gradually reduced their market participation. Due to new financial regulations over the past few years, financial institutions have less incentive to maintain an inventory of fixed income securities and warehouse certain types of bonds. Declining liquidity is an unintended consequence of Dodd-Frank financial regulation. The inventory of corporate bonds held by bond dealers remains near the lowest levels since the end of the financial crisis [Figure 1].

Bond dealers' reluctance to participate in broader bond markets, compared to prior years, highlights two potential risks:

- **More volatile interest rate movements.** In our view, bond dealers not stepping up to support the bond market last spring was a contributor to the recent bond market sell-off. Federal Reserve (Fed) data highlighted in last week's commentary showed that bond dealers unloaded bond holdings in May and June, which played a role in bond market weakness.

li·quid·i·ty

LIQUIDITY IS THE ease with which an investment can be bought or sold. The larger and higher quality the market, the greater the liquidity and vice versa. Housing is considered an illiquid investment since it typically requires weeks or months to sell a home whereas most stocks and bonds can be bought and easily sold on a daily basis.

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1 Bond Dealer Holdings of Corporate Bonds Remain Very Low

Source: Federal Reserve, LPL Financial 10/02/13

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In the absence of bond dealer participation, bond prices may have fallen more than warranted by fundamental data alone before yields reached a point to entice other buyers. As we highlighted last week, liquidity, or lack of it, may play a key role in how the bond market reacts to the gradual withdrawal of Fed bond purchases.

- **Greater swings in lower-rated or more economically sensitive bonds.** Lower-rated bonds, such as high-yield bonds, are among the bonds most influenced by the availability of liquidity. Due to their default risk, high-yield bond prices and yields usually incorporate some consideration of liquidity as they may be difficult to sell during times of market stress. During weak and volatile markets, rising default risk can cause investors to shy away from lower-rated bonds. This past spring high-yield bond spreads initially spiked, and high-yield bond prices weakened, on Fed tapering fears before investors began to buy and take advantage of cheaper valuations [Figure 2].

2 High-Yield Bond Spreads Widened Initially During the Bond Pullback in Response to a Less Liquid Market Before Buyers Returned

Source: Barclays data, LPL Financial 10/14/13

The Dodd-Frank Wall Street Reform and Consumer Protection Act is a federal statute in the United States that was signed into law by President Barack Obama on July 21, 2010. The Act implements financial regulatory reform sponsored by the Democratically controlled 111th United States Congress and the Obama administration. Passed as a response to the late-2000s recession.

High-Yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

Liquidity, or lack of it, may play a key role in how the bond market reacts to the gradual withdrawal of Fed bond purchases.

Of course, illiquid markets can also provide opportunity. The lack of liquidity led to cheaper valuations and high-yield spreads widening to almost 6%, a seven-month high. Investors who purchased on weakness, recognizing the sector was still backed by good fundamentals and the prospect for continued low defaults, were rewarded as valuations improved and the sector outperformed Treasuries from late June through the end of September 2013. Similarly, smaller markets such as emerging market debt and municipal bonds bounced back in September as new investors stepped in to take advantage of more attractive valuations brought about by illiquid markets that exacerbated weakness.

The prospect of Fed tapering, and potential bond market impacts, along with bond dealers' reduced participation in the bond market means that liquidity may still pose a challenge for bond investors in coming months and years. In July, the Treasury Borrowing Advisory Committee, a group of bond dealers that consults with the Treasury on bond market conditions and issuance recommendations for the Treasury, highlighted declining bond market liquidity. We remain vigilant to liquidity challenges, but with bond valuations broadly much more balanced now, we view near-term liquidity risks as manageable and remain focused on more credit-sensitive sectors such as bank loans and high-yield bonds. Both sectors remain supported by good credit quality metrics, and third quarter earnings season and the resumption of economic data releases (when the government shutdown ends) are likely to be bigger drivers of performance over coming weeks rather than liquidity. ■

High-yield bond performance is represented by the Barclays US Corporate High Yield. Treasury performance is represented by the Barclays Treasury index. Emerging market performance is represented by the J.P. Morgan Emerging Markets Bond Index Global (EMBI Global). Municipal performance is represented by the Barclays Capital High Yield Municipal Bond Index.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Treasuries are marketable, fixed-interest U.S. government debt securities. Treasury bonds make interest payments semi-annually, and the income that holders receive is only taxed at the federal level.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

INDEX DESCRIPTIONS

The Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High Yield Index is part of the U.S. Universal and Global High Yield Indices.

The Barclays Treasury index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include t-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation Protected Securities (TIPS).

The Barclays Capital High Yield Municipal Bond Index is an unmanaged index made up of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year.

J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for U.S. dollar denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. Currently, the EMBI Global covers 188 instruments across 33 countries.

RES 4355 1013
Tracking #1-212150 (Exp. 10/14)