The Upside to Low Liquidity Bond Markets

By the Multisector Full Discretion Team
Portfolio Managers Dan Fuss, Matthew Eagan, Elaine Stokes & Brian Kennedy; Product Managers Kenneth Johnson & Fred Sweeney

Understanding Bond Market Liquidity

In trading, liquidity is the ability to easily purchase or sell a security at a reasonable price in a reasonable amount of time. However, liquidity is notoriously illusive; normally functioning markets can suddenly become significantly less liquid due to unforeseen catalysts. An investor exodus, for example, pushes prices down because the number of sellers exceeds the number of buyers. As this occurs, buyers willing to step in provide liquidity in exchange for the higher yields that result from lower prices. However, falling prices stoke risk aversion, driving up the number of sellers and snuffing out bid-side appetite. Under these conditions, the vicious cycle of falling prices, higher volatility and evaporating liquidity accelerates.

KEY TAKEAWAYS

- Structural changes in the bond market have reduced liquidity, and cyclical trends may increase this impact.
- Using our long-term credit cycle view, we seek to exploit liquidity as selective, opportunistic buyers when sellers predominate.
- As structural and cyclical factors converge, we believe our long-term, value-oriented approach will enable us to uncover considerable opportunities.

Bond market liquidity continues to slide. Structural market changes, including new regulations, have weakened liquidity. Additionally, we believe the credit cycle is approaching a stage when liquidity is normally low. We expect these converging trends to create a lower-liquidity environment that will be punctuated by market dislocations. While unnerving to many, discerning opportunistic investors can use this environment to purchase fundamentally strong credits trading at significant discounts.
Structural Changes in Liquidity

Sharply lower dealer inventories and rising levels of outstanding corporate debt have created a significant liquidity gap in credit markets, as illustrated in the chart on the next page. Regulatory changes enacted in the wake of the global financial crisis sparked several structural changes. Specifically, banks have reduced risks associated with their proprietary trading desks. Historically, proprietary trading desks worked two ways: agency trading, when a bank matched buyers and sellers, and principal trading, when the bank itself took the other side of the trade (a source of secondary market liquidity precrisis). Due to the Volcker rule passed as part of the Dodd-Frank financial reform act and Basel III reforms from the Bank for International Settlements, principal trading is more onerous and less profitable, so banks primarily engage in agency trading. As a result, banks are less willing to bridge temporary supply and demand imbalances, giving rise to larger price and liquidity swings.

Regulatory changes, while significant, have not been the only structural changes. The bond market has grown since the crisis, and its buyer base has evolved. Corporate bond issuance has doubled since December 2007, fueled by low interest rates, central bank quantitative easing and high demand. Additionally, large institutional buyers, such as insurance companies, sovereign wealth funds and liability-driven investors, purchase new issues and hold them until maturity, functionally draining market liquidity. Since secondary supply is scarce, yield-starved investors have flocked to the primary market, often oversubscribing new issues. With bond investors tending to crowd the same sectors and issues, markets trend up strongly with decent liquidity yet are prone to rapid, sharp corrections. In our view, these structural changes magnify selloffs and prolong the return to normal market conditions.

**LIQUIDITY TRENDS**

When does liquidity really matter? Transactionally, when you want to buy or sell. With thin and more volatile markets, what you expect to be liquid might not be. Turnover, generally considered a loose proxy for liquidity, has declined since 2005.

**CORPORATE BOND MARKET TURNOVER**

![Chart showing corporate bond market turnover from 2005 to 2018]

Turnover is trading volume as a percent of outstanding corporate debt. Source: Barclays Research. Data through 12/31/2018.
Looking Beyond Liquidity

Deteriorating liquidity can push security prices well above or below fair value. However, short-term price movements may be difficult to interpret without a broader view of the credit markets. Our assessment of the credit cycle, with inputs such as corporate health, leverage, profits, economic growth, inflation and investor risk appetite, informs our three- to five-year credit view. When markets begin to trade away from our long-term view, we draw on our deep research to identify value-oriented opportunities. We believe a key ingredient of our long-term alpha generation is capturing value when prevailing market conditions cause deviations from our fundamental view.

We believe the US credit cycle is in the expansion to late-cycle phase when bonds become more fully valued, although the yield in specific sectors remains attractive. If history holds, the cycle can continue for an extended period with credit metrics stable, low default risk and ongoing profit growth. Eventually, the cycle will progress into a downturn, characterized by low liquidity, widening spreads, falling prices, rising yields and investor flight. Leading up to this transition, we believe we will see increased instances of market dislocation, as occurred in 2015 in the energy sector.

Given our expansion-to-late-cycle assessment, we are comfortable holding higher-than-average reserves, such as cash and high-quality developed market sovereign debt. This gives us room to potentially capitalize on market disruptions without having to sell existing holdings into the same weakness. Since we expect higher US rates or volatility to present buying opportunities, we intend to patiently use reserves to invest in our best ideas. This is a basic tenet of our investment approach; we take a long-term view, carefully research opportunities and step in to buy what we consider attractive securities that seem to have fallen out of favor.
A Perennially Opportunistic Stance

Bond markets will continue to adjust to the new liquidity environment, and the credit cycle will eventually progress. We believe we are well positioned to add value through this possibly prolonged late-cycle period and into the next downturn. Leveraging our proprietary insight and long-term view, we seek to exploit liquidity as selective, opportunistic buyers when sellers predominate. Our approach intends to add value over three- to five-year credit cycles through a disciplined investment process, deep fundamental research and good security selection. We believe our long-term, value-oriented approach will help enable us to uncover considerable opportunities offered by these evolving markets.

This report was originally published in July 2015. We have updated the content as necessary and otherwise believe the information is current and relevant.
Disclosure

*Barclays US Aggregate Bond Index* is an unmanaged index of investment grade bonds with one-to ten-year maturities issued by the US government, its agencies and US corporations. Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.

This paper is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P. Investment recommendations may be inconsistent with these opinions. There can be no assurance that developments will transpire as forecasted and actual results will be different. Data and analysis does not represent the actual or expected future performance of any investment product. We believe the information, including that obtained from outside sources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

The views and opinions expressed may change based on market and other conditions. There can be no assurance that developments will transpire as forecasted.

Past market experience is no guarantee of future results.

*LS Loomis | Sayles* is a trademark of Loomis, Sayles & Company, L.P. registered in the US Patent and Trademark Office.