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Investment Publications Highlights

Fixed Income Market Liquidity

Study group chaired by Denis Beau, Committee on the Global Financial System, Bank for International Settlements, *CGFS Papers*, no. 55, January 2016

Investors have become more aware of the importance of liquidity in fixed income markets in recent years. Despite increased awareness and new regulations to combat liquidity issues, worrisome trends still appear. The authors discuss some of these issues and argue policy changes can help improve the situation.

Liquidity can be broadly defined as the "ability to rapidly execute large financial transactions at low cost with limited price impact." Recent trends indicate a bifurcation of liquidity—that is, liquidity is decreasing for less liquid instruments and increasing for more liquid instruments. In other words, it is becoming even easier to trade the most readily available, homogenous instruments, but more difficult—and costly—to trade everything else.

There are many causes for the current trends in liquidity, such as decreased dealer inventories, increased use of momentum trading, and the shift toward electronic trading. For example, the shift toward electronic trading enables non-traditional market participants to provide liquidity without the use of a dealer or market-maker as an intermediary. This has led firms to use automated trading algorithms, which can cause larger price swings than more traditional trading platforms. Broadly, the current trends in liquidity are linked to a combination of regulatory and market conditions, which have impacted various segments of the fixed income market differently.

The authors argue the resulting liquidity issues can be improved through policy changes by central banks and other monetary authorities. Policymakers can re-examine how market liquidity is monitored and managed and reassess the tools available to address episodes of market stress. The purpose is not to decrease the risk of the underlying securities, but rather to support the market's assessment of a security's fundamental value, promote robust liquidity conditions, and provide more effective backstops during bouts of adverse market conditions.

Behavior Modification

Jeffrey Meli and Shobhit Gupta; Barclays Credit Research, June 8, 2016

To assess whether liquidity has deteriorated after the global financial crisis, the authors examine transaction costs from 2010 to 2015. They argue that although transaction costs have fallen, liquidity has not necessarily improved, as investors are trading in more newly issued securities.

The authors use TRACE (Trade Reporting and Compliance Engine) data in their methodology to estimate transaction costs paid by clients in the US investment-grade market. They focus on block trades larger than $5 million that have offsetting transactions within a five-day period. The results show that transaction costs declined by more than 10% from 2010 to 2015, with the realized bid/ask spread dropping from 3.25 basis points (bps) to 2.85 bps.

After examining the results, the authors argue that a change in trading behavior drove transaction costs lower. This change in trading behavior was mainly due to regulations imposed following the global financial crisis aimed at hindering excessive risk taking. As a result, the data indicate that trading volume in 2015 relative to 2011 is more concentrated in recently issued bonds, which are more liquid and less costly to transact than older bonds.

In addition to the concentration in newly issued securities, the authors find other evidence of risk-averse behavior. About 23% of trades had an immediate offsetting transaction in 2015, compared to only 16% in 2010, and trades without an offsetting transaction within five days declined from 47% in 2010 to 36% in 2015, indicating that dealers preferred to own risk for shorter periods of time. The authors also observe that about 28% of trades involving bonds issued more than five years ago had an offsetting trade within 15 minutes, as compared to about 18% in 2010, suggesting dealers are willing to offer lower bid/ask spreads for less liquid, older bonds to find a buyer quickly. ■

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