

Are Fixed Income Markets Still Thirsting for Liquidity?

Featuring: **Laszlo Hollo**, Risk Management and Liquidity Core Research

Adam: This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass and today is April 23rd 2020. This week, we spoke with Laszlo Hollo from his home in Budapest, where he works on the risk management and liquidity core research team. Laszlo, thanks for joining us, we're very glad to have you.

Laszlo: Thanks for inviting me.

Adam: We've talked a lot on this program about dealing with the unexpected and unusual market situations, but you had an unusual week yourself.

Laszlo: You know in the last week, I have three of my friends having their new born within a week timing, including my manager here at MSCI. So it was kind of funny or unusual to call them and have a drink online to congratulate them for the new born.

Adam: Let's talk liquidity. What's been happening in the market?

Laszlo: So in mid-March there was a sudden deterioration of liquidity across the board. So at the same time equity liquidity was dropping in terms of transaction costs. Fixed income liquidity was dropping, dealers started to pull back from providing quotes for bonds. The beta spread, the most well-known or widespread measure of transaction costs were increasing across the board. Basically from one week to another all asset classes were impacted and even civilian bonds, so US treasuries, UK (...).

Adam: Your team was watching investment grade ETFs at the time, right? What did you notice?

Laszlo: There were days where the discount at which the ETF frustrating compared to the (...) was as high as 5%, 6%. So you can imagine if the ETFs were trading at large discounts, these authorized participants would have, purchase the ETF Mango to the phone provider redeemed the ETF share, got the basket of underlying and sell the underlying on the secondary markets. And this is the difference between the basket price and the underlying and the ETF price, are large, they can simply pocket the difference. And the puzzle was that we saw quite large discount still lasting for a couple of days. How could it happen? How could this, all the treasure did not take advantage of the situation?

Adam: Why do you think that is?

Laszlo: The ineffectiveness of the price discovery.

Adam: Explain that please.

Laszlo: So if we were looking at the trading prices of these bonds, of the ETF basket, the prices are all over the place. So it's so hard to tell which one is the correct price. The ETF price that was pretty well

known because the ETF was trading on the exchanges of the underlying front any we was only an approximation because the bonds in the markets were trading at very different prices on the same day. Market participants were trading even treasury bonds at very different prices. And that was kind of surprising because treasuries are one of the most liquid markets globally. And what happened in mid-March is that the liquidity started to somehow disappear, or evaporate or decrease on the treasury markets. Since the treasury market is an important cornerstone of the financial market. Many fixed income securities are benchmarked against treasuries. So having these uncertainties in the treasury market is not good for the entire market, it can spill over to all fixed income classes.

Adam: So beta ask spreads, which can affect transaction costs and are an important measure of liquidity as you mentioned. What were we seeing there?

Laszlo: All across the board for investment-grade and high-yield securities numerations and develop markets, the beta spread measure was suddenly increasing at the end of the second half of March. Just to give you a compare reason, at the end of 2018, there was a high-yield bond sell-off where the beta spread of high-yield bond holdings increased by 50%, 60%, 70%. And that was considered as a high increase back in 2018 December. Now, this increase was not 60%, 70%, but rather 200%, 300%. The cost of trading increased so the beta spread of off the round treasury increased by a factor of 4 up to 80 days response that this kind of all time high beta spread for of the round treasury. And at the same time, we were looking at this price dispersion.

Adam: How did this affect active managers?

Laszlo: Record outflows from actively managed funds.

Adam: Why is that?

Laszlo: Active managers needed to raise cash to pay out their investors who were pulling back, withdrawing their investments. That was one source of the increase in the beta spread, larger style pressure from the asset management industry. And at the same time, dealers, central market makers were kind of pulling back from the market making activities. So we saw about 30% decrease in the quoting bond universe starting from mid-March compared to the February level. And we also see that the average number of dealers quoting the same bond was also dropping by 30%, 40% in mid-March. So that shows that dealers were not that much keen on providing quotes for bonds in the smaller time markets.

Adam: Okay, all this is going on, market makers are pulling back, prices are unpredictable, even US treasuries are affected. What do the central banks do?

Laszlo: Yes, so the central banks, the Fed, the ECB, Bank of England, all of those three have started a secondary bond, a secondary market bond purchasing program, either by direct secondary market purchasing, or through ETFs to provide a remedy for these liquidity concerns.

Adam: And did it work?

Laszlo: Of course it's hard to judge whether the market was coming down by itself, or the central bank action was giving some remedy for this issue, but what we can first really see that for Eurozone bond, UK bond and US bonds that are eligible for this bond purchasing programs, so basically investment grade bonds. The price uncertainty started to revert back to the normal level right after the central bank announcement. The number of dealers providing quotes started to revert back to the crisis levels and even the beta spread started to decrease and stabilize at some lower levels than before the central bank announcement.

Adam: One last question. In times like these, people find comfort in tradition. Was there some particular tradition to celebrate your friends becoming fathers, or was it just a bunch of guys having some drinks?

Laszlo: The story around that is that the amount of drink that the parents consume high correlates with the milk producing activity of the mother. So there is a huge incentive on the father to consume as much as they can. So this is the tradition.

Adam: That's all for this week. Thanks to Laszlo and to all of you for joining us. Be sure to follow us on the MSCI LinkedIn page and to bookmark www.msci.com/coronavirus for all our crisis related content. Until next week, I'm your host Adam Bass and this is MSCI Perspectives. Stay safe everyone.

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