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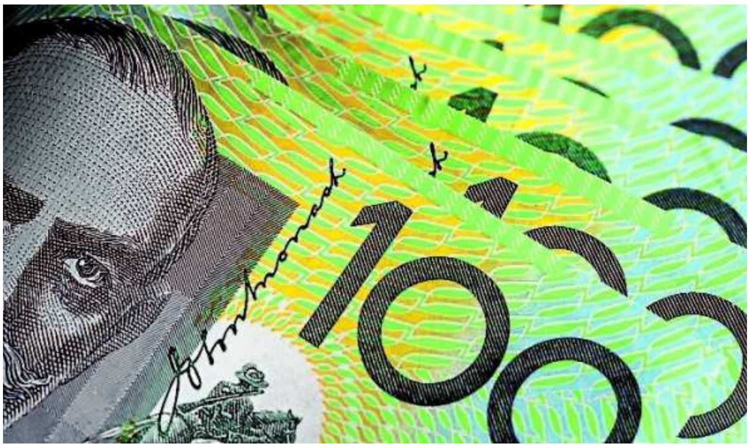
Is there a liquidity problem?


The bond market is getting twitchy and nervous about higher interest rates in the US but is there a liquidity problem?


by Philip Baker

During the week I took a call from a concerned 30 year veteran of the bond market.

"There's just something not quite right about all of this," he said, referring to the sudden spike in bond yields that some say could lead to a bond crash.

"It's all very odd, hard to get things done. Looks like the market is there, then it's not. I can't work it out but I've never seen anything like this and I'm really worried."

Here's someone who has seen first hand how 10-year government bond yields in Australia have fallen from 14.5 per cent in the mid 1980s to around 3 per cent on Friday, witnessed the rise and fall, and rise again, of mortgage backed and auto backed securities, not to mention semi-government and corporate bonds, private placements and a range of derivatives on fancy debt and credit products in the lead up to the financial crisis.

In other words he's seen the lot. And he's not the first expert to worry about the savage sell-off and the deteriorating conditions in the US Treasury bond market, the largest market of them all.

If the US bond market isn't working properly, all investors should be worried.

The spike in US 10-year treasuries has no doubt been swift, up from a yield of 1.9 per cent two months ago to around 2.5 per cent this week, a significant move for the safe haven asset.

An unusual feature of the sell off has been the lack of sellers.

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VERY EASY TO PUSH AROUND

Prices have been very easy to push around but in a market the size of the US government bond market, around $US35 trillion ($45 trillion), that seems more than odd.

Some point to the 70 per cent drop in daily trading volumes from 2006 but others say that is too simplistic. According to JPMorgan, the depth of the US bond market, as measured by the top bid and top offer rates for bonds, has dropped substantially. Since 2007 it has averaged about $US171 million, but this year has fallen to $US116 million.

Jamie Dimon, the chief executive of JPMorgan, has also waded into the issue of liquidity.

A lot of what Dimon had to say was about the so-called "flash crash" in US bonds when the yield on the 10-year note fell 34 basis points in a matter of minutes in October 2014.

Dimon said that statistically it was a 7 to 8 standard deviation event , which means it would only happen once every 3 billion years or so.

IS THERE A LIQUIDITY PROBLEM?

The bond market is twitchy about the likelihood of higher interest rates in the United States but is there a liquidity problem?

Campbell Dawson oversees Elstree Investment Management's $180 million hybrid fund, and as a former treasurer of AMP Bank and head of fixed-income at GIO Asset Management where he ran a $8 billion fund, he too has been around the traps for 30-odd years.

But he has a different take.

"We understand what they are saying but we think they confuse liquidity with something else or more cynically, it's the garbage dump that analysts use for every market move they can't explain. Most of the commentary works on the principle that if markets move a long way and it's not easy to rationalise market behaviour, it's got to be due to liquidity breakdowns" he said.

As for the unusual standard deviation event?

"If you were late to work or went out for a coffee in the morning you would have missed around seven of the eight standard deviations. Hardly a worry to anybody except those who want to sell their entire portfolio in a morning."

The way Dawson looks at liquidity is the simple ability to buy and sell assets, and how much volume you might want to transact.

SUBJECTIVE CONCEPT

There are three parts to liquidity, he says.

First, you need enough players with enough volume ready to trade. Second, you also need enough players who have the opposite view of what's value at whatever the current price is, and finally, you need to see low transaction costs. That implies a tight bid-offer spread and it also means liquidity will always be a "subjective concept".

If you are big name fund manager and need to move $200 billion of bonds in five minutes, you might have a liquidity problem. If you're tweaking your portfolio at the edges it's fine.

Dawson also points out that rather than blame liquidity, often the market itself is distorted.

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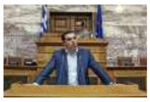

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For example, the yield on the 10-year German bund fell to almost zero, thanks to the buying program of the European Central Bank. But what happens when the bank stops buying? Investors thought about that and all of a sudden yields started to back up.

Liquidity is in the eye of the beholder, says Dawson, and running a hybrid fund he treats it as a cost.

He also shrugs off the view that because investment banks are not holding any inventory there's a lack of liquidity.

Absolute tripe, he says.

"Investment banks are like the department stores of fixed income markets, except they buy as well as sell. They only hold inventory because they can buy at one price and sell at a higher price. Like a department store, if a large seller emerged they would push prices lower to liquidate their inventory at a lower sale price."

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