The Illusion Of Liquidity, And Its Consequences

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Michael Lewis' *The Big Short* kicks off with the observation that "it ain't what you don't know that kills you; it's what you know for sure that just ain't so". Lewis then goes to explain that, contrary to popular belief, US real estate prices could and did roll over, unleashing a financial cataclysm that none of our readers will have forgotten.

Liquidity can prove to be the most fleeting of concepts, as investors discovered a decade ago

Yet, for financial market participants, the bigger shock of the 2007-08 crisis wasn't that real estate prices fell. The true surprise was that instruments like money market funds and triple-A rated structured products that had been considered "liquid", proved to be anything but. Numerous fixed income products went from being perfectly liquid one day to untradeable the next. And this change was not a gradual deterioration. It was a sudden regime change. All of a sudden, investors who thought they held liquid instruments found their investments gated, frozen and sometimes even unable to price.

In the corporate bond market, natural market makers play a far smaller role...

Why rehash this painful past? Because we were intrigued to hear Saba Capital's Boaz Weinstein highlight at the recent Grant's conference in New York how in 2008 the US had about US$2.8trn of outstanding corporate bonds. Against that, bond dealers kept roughly US$260bn of inventory (or a little under 10% of the outstanding). Fast forward to 2018, and a decade of zero- and negative-interest rate policies has caused the US corporate bond market to almost double in size to US$5.3trn. Yet, a whole raft of regulatory changes has resulted in bond dealers now holding a paltry US$40bn of inventory (less than 1% of the outstanding). This represents a major change.

The second important change for corporate bonds is that retail investors are now heavily involved. When Michael Milken invented the junk bond market in the 1980s, the basic idea was to peddle the liabilities of "fallen angels" to institutions like insurance companies and pension funds. Of course, the emergence of this market ultimately resulted in financing options being granted to a whole new class of companies that had hitherto been locked out of the bond market. Still, the corporate bond market remained principally confined to institutional investors.

Commeth the ETFs

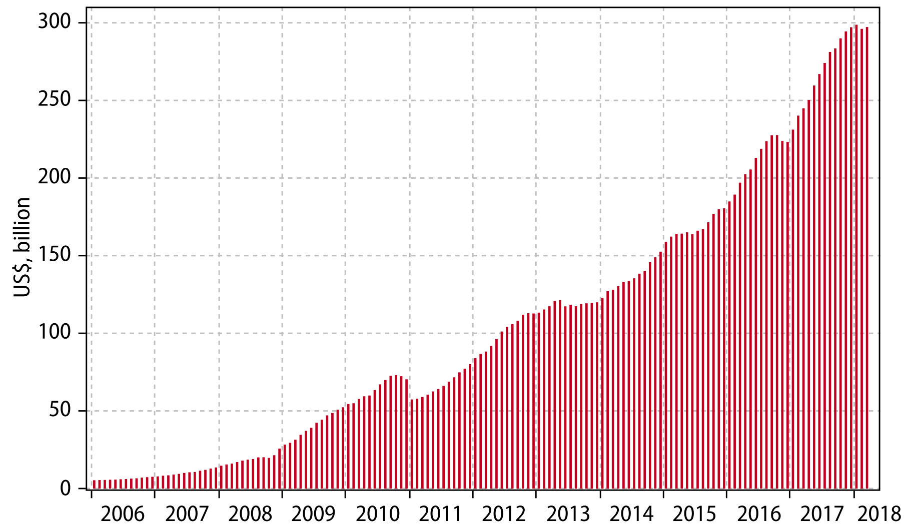
...they have been replaced by ETF investors

That has all changed. In the past ten years, retail investors have poured money into US corporate bonds through the intermediation of exchange traded funds. A decade ago, corporate bond ETFs totalled a paltry US$15-20bn; not enough to create liquidity issues for bond dealers with some US$260bn in inventories. Today, the assets under management of corporate bond ETFs stand at US$300bn, or more than seven times the inventory sitting on bond dealers' balance sheets (see chart overleaf).

Hence, we now have a corporate bond market that has roughly doubled in size while the willingness and ability of bond dealers to provide liquidity into a stressed market has fallen by more than -80%. At the same time, this market

A relentless climb upward

US corporate bond ETF total net assets



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has a brand new class of investors, who are likely to expect daily liquidity if and when market behavior turns sour. At the very least, it is clear that this is a very different corporate bond market and history-based financial models will most likely be found wanting.

Liquidity has similar properties to water as it approaches its freezing point

Returning to the quote at the start of *The Big Short*, what kills financial market participants time and again is "the assumption of liquidity", or the idea that, because a certain price is flashing on a screen an asset can be sold at somewhere near this level. Alas, financial markets have properties not dissimilar to water as it reaches the zero-bound. Down to the freezing point water flows freely, but at 0º Celsius its main physical attribute— namely, fluidity—changes dramatically.

The worry is that markets have become far more volatile this year

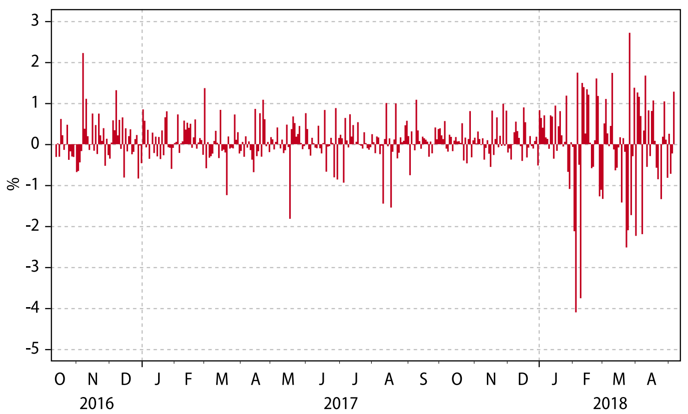
Today, in an environment of high US corporate margins, few bankruptcies and central banks in Japan and Europe maintaining NIRP, it may seem too early to worry about corporate bonds. Yet, talk to corporate bond market practitioners and they bemoan a crucial lack of liquidity. On big "event days" when the S&P 500 falls more than 1% the ability to trade such bonds—even investment grade corporate bonds—is severely curtailed. That was perhaps not an issue last year, but 2018 has proven far more volatile.

The impact of higher inflation

One reason for higher volatility has to be the move higher in US inflation, which has raised doubts as to whether fixed income instruments are still the best hedge for equity investments (see **A "Once In A Generation" Shift**). Also, the US government is borrowing more than ever, and shows no signs of changing its ways. Given that the Federal Reserve has made it clear that the US central bank no longer wishes to fund higher government borrowing, the Treasury must now turn to the private sector as a funding source. The corollary, however, is that whatever money flows into treasuries is no longer flowing into other asset classes.

A more volatile environment

S&P 500 index daily % change



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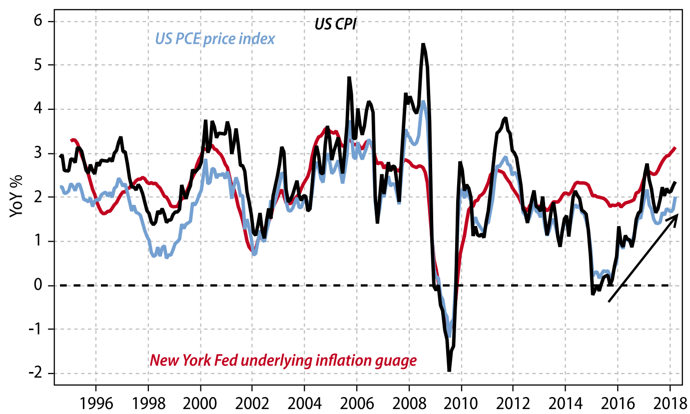
The only way is up

Various inflation measures in the US



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So imagine that at some point in the coming quarters, investors decide that owning twice as much US corporate debt as they did in 2008 is no longer the path to riches. And that these same investors decide to head for the door. Facing this uncertainty, we come up with three possible scenarios:

There are various scenarios that could produce different outcomes for the corporate bond market

- **Scenario 1: The optimistic scenario.** Regulators realize that investment banks, and even hedge funds, serve a purpose in our societal fabric. i.e., they may not be doing "God's work", but they do provide useful liquidity to financial markets in times of stress. The optimistic scenario would see US regulators be proactive and continue to ease up regulations on financial intermediaries. Thus, when the next panic-selling episode hits corporate bond markets, intermediaries would be there to pick the pockets of ETF investors (a repeat of what happened with the VIX implosion). This scenario would be bullish for listed investment banks and hedge funds.
- **Scenario 2: The most likely outcome.** Assuming that regulators stay focused on the last war rather than looking ahead to future battles, the next corporate bond market panic is likely to see intermediaries retreat to their bunkers. In this event, the job of clearing markets will again fall into the Fed's lap. In this scenario, the US dollar would likely take a big leg down as all hopes of further Fed tightening measures would be dashed.
- **Scenario 3: The nightmare scenario.** But what if scenario 2 unfolded, and neither US financial intermediaries, nor the Fed stepped in to provide liquidity to help markets clear? In this scenario, the US dollar would likely shoot up for a few days, or maybe weeks, but following a period of upheaval, start a prolonged collapse as the world tired of a reserve currency managed by technocrats who regularly unleash financial crises.

The more worrying outcomes all look to be bad for the US dollar

The bottom line is that the fundamentals of the US corporate bond market look unstable. This doesn't mean that an implosion is around the corner. But it does mean that a relatively routine event could knock the market off course; perhaps a sharp rise in inflation, a spike in oil prices or a big bankruptcy? In this case, the first victim would likely be the US dollar. Hence, I continue to see the best hedge for portfolios as a "short-dollar" positions. At the very least a shock to the US corporate bond market is likely to see investors pricing in an easier Fed. In either case the US dollar would likely take a big leg down.