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Bond markets suffering from decline in liquidity

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The bond purchase programme of the European Central Bank has caused a drought on the bond markets. As a result, investors now have to take into account the liquidity risk on top of the interest rate risk and the default risk.

Market participants had been anxiously looking forward for weeks to further details on the corporate bond purchase programme of the European Central Bank (ECB). All that was known was the fact that the ECB had plans to further loosen the monetary policy by starting to include corporate bonds from Eurozone issuers from June onwards, but no additional details had been divulged. The total volume of the bond purchase programme had already been raised in April from EUR 60bn to EUR 80bn per month.

At the ECB meeting of 21 April 2016, ECB President Mario Draghi has finally given additional details on the programme: the purchase programme will also include corporate bonds from non-banks with a remaining time to maturity of 0.5 to 30 years, as well as issues from insurance companies.

On the one hand rumours are that the ECB would continue flooding the market with more liquidity. But on the other hand, many capital market participants (such as investment companies and asset managers) have pointed out an ongoing decline in liquidity on the market. How is that to be interpreted?

The term "liquidity" comes with different connotations

The term "liquidity" is used across various areas in finance. However, it is crucial to differentiate between these uses, especially between the liquidity on the bond market and the liquidity (liquid funds) of banks.

The size of the liquidity premium is also a question of the rating

Liquidity on the bond market denotes the market depth of bonds, i.e. what volumes can be traded without having to grant any significant concessions as far as the price is concerned. Austrian government bonds are a good example of bonds with sufficient levels of liquidity. For corporate bonds with lower ratings, liquidity is lower as well, which is why in terms of yield these bonds have to offer a higher liquidity premium in addition to a higher default premium.

Bank liquidity for lending to the real economy
Liquidity in the context of banks refers to the funds banks have available as credit for the real economy and how easily they can refinance at the respective central bank. By buying securities from commercial banks, the central bank is providing them with liquid funds. The commercial banks pass on these funds as credit into the real economy with the goal of stimulating economic growth.

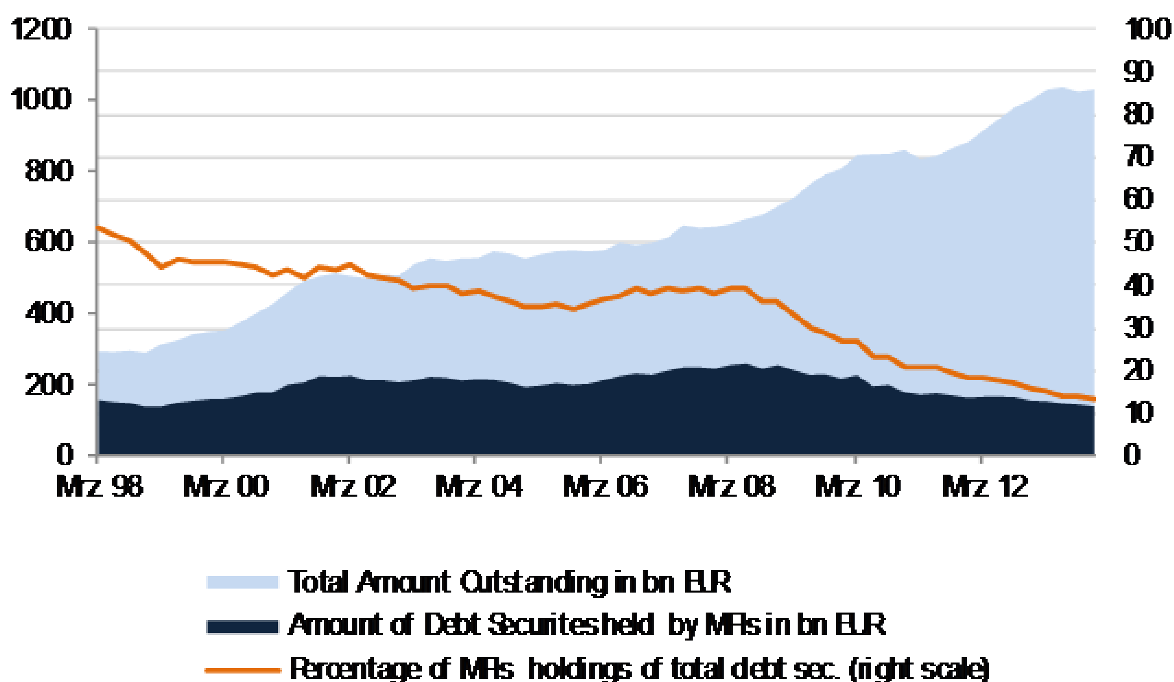
Liquidity has declined massively on the bond market
Since 2008 liquidity on the bond markets (market depth) has deteriorated massively although the ECB has repeatedly funnelled fresh money into the market. How does that add up? After the outbreak of the financial crisis, banks were incurring significant losses, which also eliminated parts of their equity. This forced them into either sourcing new equity (which was very difficult around that time) or reducing the volume of their business model. Many bond brokers – among them also big American US investment banks – have therefore significantly downsized their fixed income sales and trading business or now focus only on niches.

The number of market participants as well as the structure of the market liquidity of bonds has therefore massively changed, or indeed, deteriorated. Other providers have seized this window of opportunity by offering new technologies. The user-friendliness of various trading platforms is increasing. But while it used to be enough for a big bond investor to approach five trading partners in order to enter into a specific transaction, the same investor today has to contact a multitude of possible counterparties. And even if a trading partner can been located, the nominal value that they would be prepared to trade is substantially smaller than previously.

Nowadays the question “Where can I get this bond?” is therefore the focus of new market participants and new trading platforms.

Since 2008 the volumes traded by investment banks (brokers) have decreased significantly. At the same time trading among investors has increased noticeably. Chart 1 illustrates the fact that since 2008 the volume of bonds on the order books of investment banks has decreased substantially in terms of market volume.

Chart: Market volume of corporate bonds in EUR bn – Volume of corporate bonds at monetary financial institutions (MFIs) in EUR bn – Volume of corporate bonds at MFIs in percent of market volume (1998-2016)



Sources: Bloomberg, LBBW Research

The current liquidity problems on the bonds market have provided some market participants with a new challenge. Transaction costs rise drastically for active trading strategies in comparison with passive ones.

What effect does the problematic liquidity situation have on actively managed bond portfolios or investment funds?

- The liquidity risk has to be taken into account in the composition of the portfolio in addition to the interest rate risk and the default risk.

- The active management of a bond portfolio has to be increasingly based on derivatives or other liquid instruments that correlate strongly with the underlying investment (e.g. Finnish government bonds with German bund future contracts)
- The primary market is becoming more important still. This means that investors are increasingly subscribing to bonds at issue as opposed to buying them later on the secondary market (as used to be the case).

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Martina Groll

Martina Groll has worked at Erste Asset Management since 2010. As a senior portfolio manager in the portfolio management team she was responsible for the management of several income portfolios. Since 2014, she has been senior fund manager in the corporates team. She focuses on corporate bonds in developed markets. Additionally, she is sector specialist in the sectors Retail and Consumer.

Martina Groll has been working in the area of finance since 2002. Before Erste Asset Management, she was employed by Österreichische Volksbanken AG, Investkredit Bank AG and Raiffeisen Leasing GmbH. She studied Finance, Accounting and Taxation with specialisation in capital markets at FH Wien.

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