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FIRST ANALYSIS

Institute Alert

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Understanding bond market liquidity

Key takeaways

- As the Federal Reserve (Fed) continues to tighten monetary policy, fixed-income market liquidity may decline. The risk of a bond market liquidity event also increases as we move through an economic slowdown and a potential recession.
- The Fed has noticed a decline of market liquidity since late 2021. According to the Fed's latest Financial Stability Report, two measures of fixed-income liquidity — the bid-ask spread and dealer inventories — are signaling that liquidity appears to be less resilient than is typical, particularly in the U.S. Treasuries market.

What it may mean for investors

- Fixed income can play a vital role in many investors' portfolios. It is important for investors to understand the potential liquidity risks embedded in their fixed-income holdings. To help mitigate liquidity risks, investors can diversify portfolios, avoid overexposure to specific fixed-income classes, raise credit quality, and review individual liquidity needs with an investment professional.

As the Fed continues to withdraw monetary support and financial conditions tighten across the economy, the possibility of a more challenging liquidity environment in bond markets could begin to emerge. We believe this is an appropriate time to assess the current landscape and discuss strategies for investors to manage liquidity needs in their portfolios.

Fixed-income liquidity can be defined as the ability to monetize bond holdings (securities or funds) in a reasonable period of time within an expected price range. When a fixed-income security is not liquid, it means that the investor who is selling into the market could need to significantly sacrifice price, time, or both. Liquidity challenges tend to arise with a catalyst that is usually an underappreciated risk within a specific fixed-income asset class, sector, or security.

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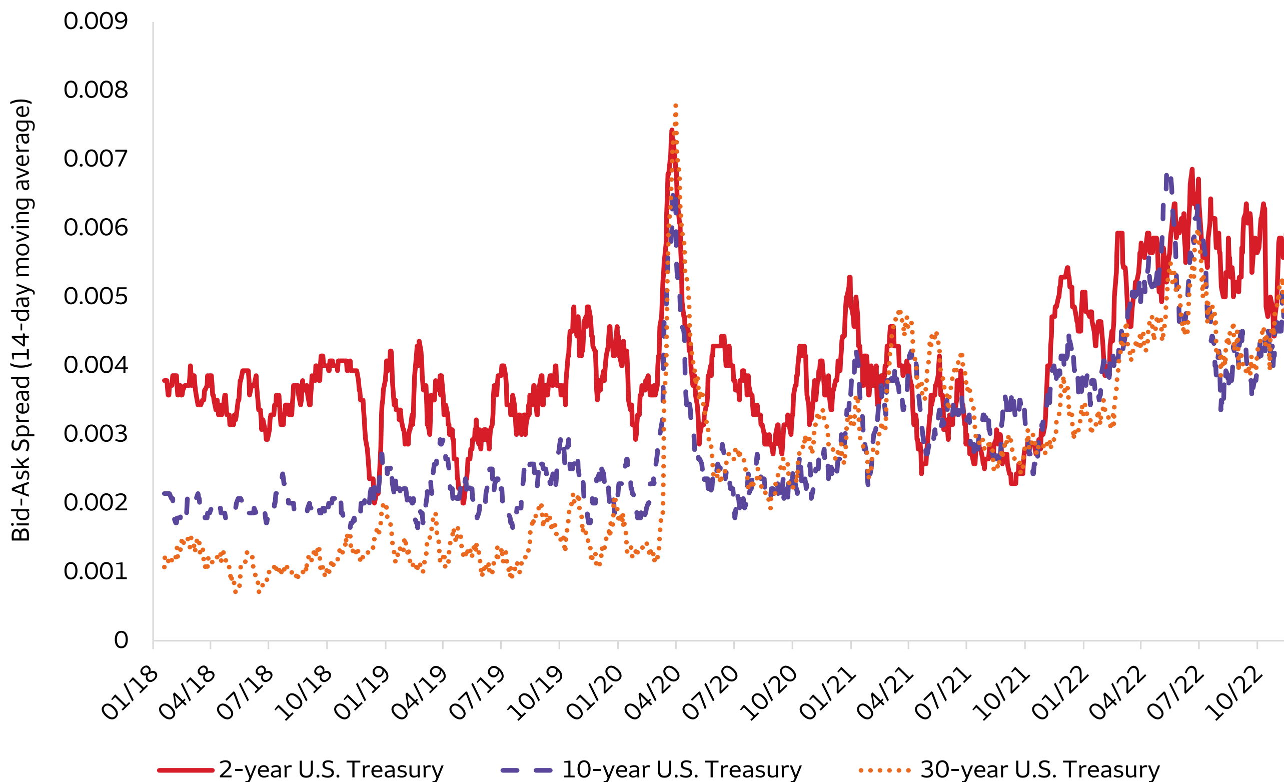
As a potential risk begins to intensify, selling pressure typically starts to build. Price declines generally follow as sell orders of the fixed-income asset outweigh buy orders — driving down prices. Underperformance (negative returns, in many cases) often follows as price declines occur, fueling anxiety for other investors who missed the initial concerns raised from the catalyst. The cycle then repeats itself, leading to more selling and larger price declines, which can be exacerbated by investment flows from market participants who were chasing yield or past performance without a thorough understanding of the investment and its risks.

The Fed has been noticing a decline of market liquidity since late 2021, and according to the Fed's latest Financial Stability Report[1]: "The likely predominant driver of recent low liquidity appears to be elevated uncertainty about the economic situation and the outlook for monetary policy. In general, volatility and liquidity tend to move in opposite directions because higher volatility increases the riskiness of providing liquidity, and intermediaries therefore tend to either reduce the amount they quote as a way of managing the risk or charge more compensation for the risk of providing liquidity, in the form of a wider bid-ask spread."

Two common liquidity measures

Market liquidity can be measured in a variety of ways, one of which is the spread between the price at which dealers are willing to buy and sell securities. This "bid-ask" spread may widen — indicating that dealers require greater compensation to trade — if there are fewer dealers willing to transact in the marketplace or if it becomes more expensive for dealers to conduct proprietary trading activities. As shown in Chart 1, the bid-ask spread for 2-year and 10-year U.S Treasuries has increased during the past year, indicating a moderate reduction in liquidity for these bonds.

Chart 1. Average bid-ask spread for 2-year, 10-year and 30-year U.S. Treasuries



Sources: Wells Fargo Investment Institute and Bloomberg, November 15, 2022. Daily data from January 1, 2018 to November 15, 2022. The bid-ask spread represents the difference between the highest bid price and the lowest ask price for a security. The spread directly measures the cost of executing a trade of limited size. **Past performance is no guarantee of future results.**

1. Board of Governors of the Federal Reserve System, "Financial Stability Report", November 2022.

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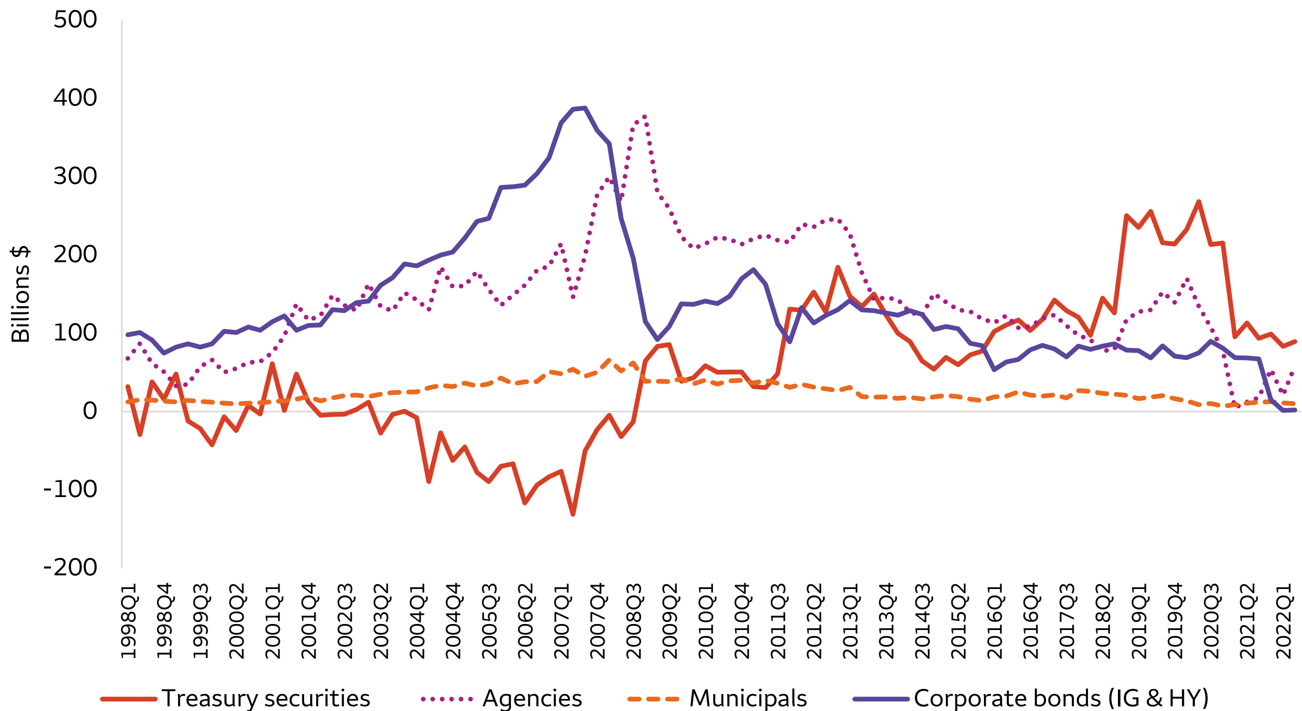
Another measure of market liquidity is the size of dealer inventories, which indicates dealers' willingness to hold proprietary positions on their balance sheets. The liquidity that dealers may provide is important to the functioning of markets. However, the risk associated with holding inventories of securities generally increases with higher volatility. Thus, markets tend to be less liquid during periods of higher volatility. In extreme cases, some liquidity providers may pull back from the market altogether, which can result in very low depth and wider-than-usual bid-ask spreads.

Chart 2. Dealer inventories have declined for several fixed-income asset classes



Sources: Wells Fargo Investment Institute and Federal Reserve Board. November 15, 2022. Quarterly data from January 1998 to June 2022. Net security brokers and dealer holdings (inventory) of specific securities as reported by the Federal Reserve in the Z.1 Financial Accounts of the United States report. IG = investment grade, HY = high-yield. Negative net asset holdings of Treasury securities in certain quarters imply that dealers had sold more Treasuries than they owned.

In extreme cases, such as the market turmoil at the onset of the pandemic in March 2020, low liquidity can impair the ability of the financial system to respond to a large shock because investors may not be able to adjust their portfolio holdings to raise cash or hedge risks. Moreover, persistent liquidity strains could result in higher liquidity premiums and, as a result, lower valuations. However, for now, market participants are not reporting major problems obtaining quotes or executing trades, and current levels of liquidity appear broadly in line with the historical relationship between liquidity and volatility.

Investor Implications

Fixed income can play a vital role in many investors' portfolios, and we believe it is important for investors to be more proactive in assessing the potential liquidity risks embedded in their fixed-income holdings. We would offer the following guidance:

- Construct portfolios thoughtfully: It is essential for investors to communicate their liquidity and risk tolerance needs to their investment professionals and to update this information as it changes. We believe a portfolio should reflect these needs — and be appropriately diversified between more liquid investments (such as government securities) and less liquid investments (such as high-yield corporate bonds). Investors

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should evaluate holding size, structure, maturity, bond class, and sector to arrange for investor-specific liquidity requirements.

- Be selective: Reduced dealer inventory across several fixed-income sectors may mean that liquidity risks could be higher now, relative to other periods. In terms of liquidity, we are mostly concerned about the high-yield corporate sector, and to a lesser extent, municipal bonds.
- There can be opportunity in times of market stress: Liquidity events can offer opportunity for nimble market participants who are willing and able to withstand the significant volatility that has typically occurred during these market shocks. Professional asset managers and distressed debt managers are some of those who often seek to capitalize on liquidity events. There may be opportunities in liquidity events for long-term investors to provide market liquidity by buying holdings during the market selloffs.

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Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. U.S. **government securities** are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

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