IR+M INCOME RESEARCH + MANAGEMENT

IR+M'S TRADING POST

A Talk with our Traders

March 23, 2020

Last week, as the impact from the coronavirus and falling oil prices reverberated throughout the markets, the US investment grade bond universe felt a liquidity crunch reminiscent of the global financial crisis. Traders looking to sell were often challenged to find bids, and transaction costs increased significantly.

Liquidity in the bond market was impacted due to a number of different factors. Increased indexing and algorithmic trading since the 2008 crisis have changed bond market trading mechanics. Additionally, as a result of some of the post-crisis regulations, dealers are often unable and unwilling to take risk on their balance sheets. And trading desks are adapting to new work-from-home environments, which we believe has slowed down the trading process.

These issues pushed traders to focus on larger, round lot trades. Nevertheless, IR+M's traders saw pockets of strength and were able to transact throughout the week.

After trading ended on Friday, we caught up with our traders to get their thoughts on liquidity in their sectors. And today we got a glimmer of hope, thanks to the Fed.

Lucas Murray SVP, Senior Trader Corporate Bonds	**Preston Raymond, CFA** Senior Trader Corporate Bonds	**Andy Tenczar** Senior Trader Securitized (MBS)	**Mark Paulson** Senior Trader Securitized (ABS/CMBS)	**Jeremy Holtz, CFA** Trader Municipal Bonds	**Joe Alfano, CFA** Portfolio Risk Analyst Treasuries/TIPS

IR+M: How would you describe the liquidity in your sectors last week (March 16-20)?

Joe (Treasuries/TIPS): Liquidity was well below normal in the Treasury market all week. In some cases, especially later in the afternoons, it was really difficult to transact. Bid/ask spreads*, typically measured in ticks (32nds of a point) expanded significantly across the curve. This was most pronounced in off-the-runs and especially in long maturities, where bid/ask was measured in several points before the Fed intervened. The TIPS market was especially challenged and, at times, it appeared the market was broken as bids were very hard to come by. On the electronic trading platforms, the number of bids decreased significantly and the time it took to execute a list of trades changed dramatically. The algorithms were turned off, so each trade needed manual input from a sell-side trader. Pre-virus, a list of 25 trades would take about a minute. Last week, that same trade was taking thirty minutes and was worked bond by bond.

Preston (Corporates): Liquidity got worse in Corporates as the week went on and dealers were very reluctant to take risk. Spreads widened significantly throughout the week due to record setting outflows from ETFs. In addition, wide concessions on new issues caused secondary bonds to reprice wider, as the existing levels didn't make sense anymore. In general, we were seeing bid/ask spreads of at least 25-50bps and in some cases much more.

Mark (Securitized – ABS/CMBS): The volume we saw in ABS was pretty amazing. The market is used to handling $500-$700 million in bid wanted lists in a given week, but we saw three times that each day. Spreads for two-year AAA Credit Card ABS went from mid-teens pre-virus, to +130bps a week ago, and ended this past week as wide as +350bps. Bid/offer spreads in ABS started the week at 20bps and by the end of the week there were few to no buyers in the market.

Andy (Securitized - MBS): Generally, we saw Agency RMBS experience decent liquidity. There were a large amount of Agency RMBS specified pools trading over the week, and everyone wanted short settle (T+1) to cover outflows. This put pressure on bids and increased transaction costs. Unlike Agency RMBS, trading in the Non-Agency RMBS space was limited.

Jeremy (Municipals): There was a large amount of selling in tax-exempt Municipals – there was a record outflow of $12 billion from Muni mutual funds, about three times more than the previous record set during the 2008 crisis. Based on historical trends in this retail-driven sector, we expect the outflows to continue given the uncertainty in the market. The Muni short term rate, SIFMA, which usually averages between 1-1.5%, spiked to 5.2% and, without direct Fed intervention in the variable-rate market, we expect SIFMA to move higher.

***Bid/ask spread** *is the difference between the price at which the dealer is willing to buy the bond (the bid price) and the price at which the dealer is willing to sell the bond (the ask or offer price).*

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IR+M: We have heard some comparisons to the 2008 global financial crisis. Do you think that's valid?

Lucas (Corporates): The price action and lack of pricing transparency had a similar feel to the market immediately post-crisis. More recent banking reforms have led to structural changes within corporate bond trading where stricter regulations have put handcuffs on dealers' ability to commit principal capital in times of market stress. Dealers have shifted to more of an agency model, which is more capital friendly, but which does not address the explosive growth in buy-side assets under management. As a result, the street can provide only a limited buffer to bridge the gap between buyers and sellers in times of market volatility. This led to the wider bid/ask spreads and higher transaction costs that we saw last week.

Preston (Corporates): With the dealer community at home, it was much more challenging for them to communicate and they were pulled in multiple directions. Market participants seemed more interested in new issues than in secondary offerings, leading to less liquidity.

Joe (Treasuries): The element of sales people working remotely is definitely different, and not in a good way. This slowed the pace of activity and led to a focus on larger trades.

Lucas (Corporates): The growth of fixed income ETFs has played a major role in shifting the way that corporate bonds are traded, giving rise to the portfolio and algorithmic trading franchises at many of the Wall Street dealers. The E-trading machine has broken down recently as market volatility and poor pricing transparency have caused dealers to shut off their algorithms and significantly reduced the number of executed portfolio trades. Without this flow, the liquidity premium for trading odd lots reached levels not seen since 2008.

Jeremy (Municipals): Muni/Treasury ratios are near 300%. That's astronomical. It eclipses any GFC numbers.

Mark (Securitized): Last week, investors sold what they could, not what they wanted. Previously there was a big portion of the bond market, namely mortgage bonds, causing the problem. Today more people are worried about the overall economy but it's not directly from bond fundamentals. Maybe that means the bond market technicals will recover faster this time. We'll see.

IR+M: What's Trading Well?

Joe: On-the-run Treasury liquidity is still decent. The Fed buying definitely helped.
Preston: Anything that had been issued recently has been trading with bid/asks at ~10bps.
Lucas: We have seen pockets of strength with higher-quality long-duration corporates.
Mark: Within the ABS and CMBS sectors, trading is happening on a bond by bond basis.
Andy: Select Agency RMBS are benefiting from Fed intervention to help stabilize the sector.

A Glimmer of Hope, Thanks to the Fed

Today, the Fed announced further measures to address the liquidity issues in the US investment grade (IG) bond market. The program has expanded to include short, IG corporate bonds and ETFs. In addition, the amount of Treasury and MBS buying is now unlimited and will include Agency CMBS. The Fed is also expanding its money market facility to include variable-rate demand notes (VRDN), which is a positive for liquidity in the municipal market. The Fed's funding facility to support the ABS market (Term Asset-Backed Securities Loan Facility or TALF) will enable the issuance of asset-backed securities focused on consumer credit. In addition, the Federal Housing Finance Agency is also stepping in to provide liquidity in the secondary mortgage market.

We have seen some improvement in liquidity within certain sectors today. While we expect more volatility and uncertainty around liquidity, we do expect these programs to benefit many of our markets as they are enacted.

Last week's liquidity crunch across the entire US investment grade bond market was something that we hadn't experienced in years, but we feel that we carefully and diligently navigated the choppy waters and sold to meet our clients' needs. We were also able to participate in what we believe to be opportunistic purchases on behalf of clients as we invested client contributions and added risk selectively to existing client portfolios. Our Traders worked very closely with the Portfolio Strategy and Risk Teams to make this happen effectively in a very difficult market. The market turmoil continued today amid the uncertainty surrounding the coronavirus. At IR+M, we always look to "take what the market gives us" and will continue to stay the course as this situation unfolds.