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How to help prepare for future shocks to bond liquidity

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In recent weeks, the status quo of bond liquidity has been turned on its head. Amid high levels of volatility, high-quality bonds have sometimes looked more stressed than their so-called riskier counterparts. While these assets and best-quality credit should still outperform past the current market crisis, there are two main lessons for bond investors from the recent market dislocation.

After the initial sell-off in risk assets prompted by the coronavirus pandemic, many investors sought the perceived safety of US Treasury securities, pushing yields across all maturities below 1% for the first time. This drop proved to be the start of a period of fluctuations that was mirrored across global bond markets, providing an uncharted landscape for investors to navigate.

The volatility of the aggregate 10-year yield across the G3 (the euro area, US and Japan) quadrupled (see exhibit 1), while the surge in spread volatility was just as fast and furious in emerging-market assets and developed-market corporate credit. The hierarchy of bond risk and liquidity was upended: on some key measures those bonds that are seen as less volatile – because of the security and liquidity they provide – looked the most stressed (see exhibit 2).

Breaking down bond liquidity

Historically, these levels of volatility in yields and spreads have coincided with low liquidity. In simplified terms, market liquidity is the ability to sell or buy an asset as close to the required quantity and price as possible, without causing outsized price moves.

Key takeaways

- Global bond markets have seen increased volatility in the wake of the coronavirus crisis that has upended the bond liquidity status quo
- Investors who were unable or unwilling to sell riskier assets rushed to sell what they considered their most liquid holdings, but this put more pressure on higher-rated issuers
- While benefiting from central bank intervention, bond markets are likely to remain volatile in the medium term
- Adding liquid interest rate futures and credit index derivatives to a portfolio, along with a good cash buffer, could help contain portfolio volatility
- Investors should focus on high-quality issuers with the cashflow and capital structure to help survive the economic shutdown

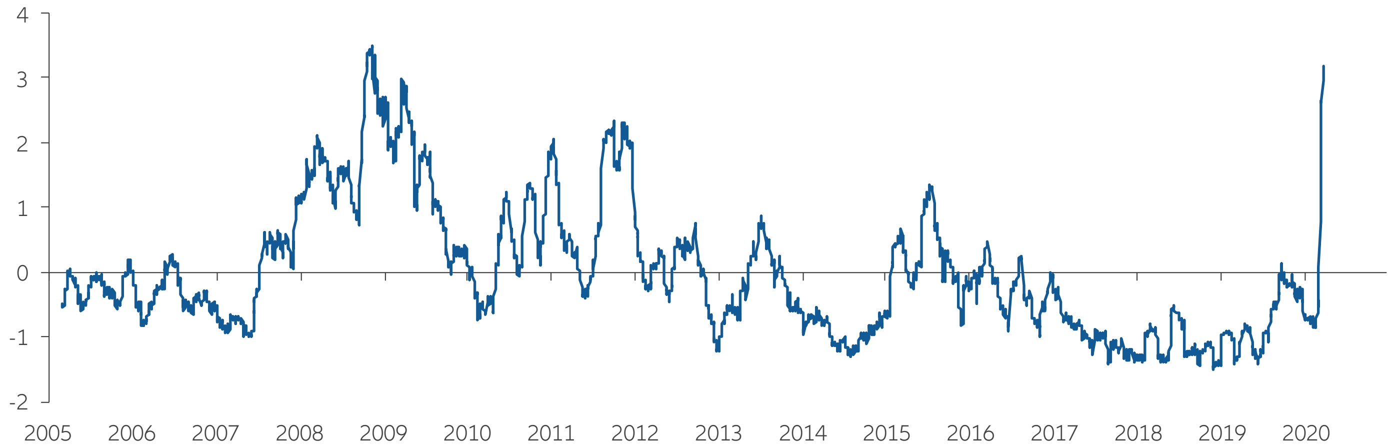
Allianz Global Investors

Exhibit 1: Widening spreads in credit assets

Indicative market index	Credit spread* (basis points)	Percentage change (%) in credit spread					Z scores** (3 years of weekly data)			
		1 month	3 month	6 month	12 month	YTD	1 month	3 month	6 month	12 month
Bloomberg Barclays global high yield	1013	79%	140%	114%	139%	140%	7.0	7.2	4.1	3.6
JP Morgan emerging markets bond	648	74%	123%	90%	90%	123%	8.0	7.7	4.0	2.8
JP Morgan corporate emerging markets bond	606	69%	95%	73%	85%	95%	8.8	7.0	3.8	3.1
Bloomberg Barclays global investment grade corporate-industrials	273	115%	173%	128%	118%	173%	9.7	8.4	4.4	2.9
Bloomberg Barclays global investment grade corporate-financials	272	132%	189%	137%	125%	189%	10.6	8.8	4.5	2.9
Bloomberg Barclays global aggregate corporate	270	120%	176%	129%	120%	176%	10.1	8.6	4.4	2.9
Bloomberg Barclays US floating rate notes	246	486%	392%	413%	278%	392%	21.9	10.2	7.6	3.6
Bloomberg Barclays euro floating rate notes	197	218%	206%	227%	149%	206%	15.1	8.3	6.4	3.0

For illustration purposes only.
* The credit spread is an indication of the difference between yields on bonds subject to default risk and government bonds considered free of such risk.
** The Z score indicates the number of standard deviations, an indication of how far the current credit spread is from the mean or average credit spread.
Source: Bloomberg, Allianz Global Investors, 1 April 2020.

Exhibit 2: G3 10-year government bond yield volatility (normalised)



Source: Thomson Reuters Datastream, Bloomberg, Allianz Global Investors.
Data as at 31 March 2020.

As the coronavirus crisis took hold, the demand-supply balance was shaken both in the global economy and in financial assets. As a result, market liquidity was hit by pronounced uncertainty around asset values and fund outflows. Bond dealers reported much wider than average bid-ask spreads in the Treasury market, and exchange-traded interest rate futures were halted several times due to extreme price moves.

In credit markets, the sell-off did not seem to discriminate according to quality or duration and a record fast rate of fund outflows contributed to a demand-side shock. Many investors rushed to raise cash by selling what they considered their most liquid holdings, as they were unable or unwilling to sell riskier assets. As a result, larger and higher-rated issuers were hit harder at first. Some investment-grade bond ETFs traded at deeper discounts than high-yield ETFs. Investment-grade curves flattened, with spreads converging on bonds maturing 25 years apart. Some credit curves even inverted, with spreads on short-term highly rated debt exceeding those of longer-dated, lower-rated bonds.

The liquidity shock also had something to do with supply. Research shows that, while central bank bond purchases have historically improved underlying liquidity in times of heightened volatility, over time ballooning bond holdings at central banks and other financial institutions can make certain assets scarcer. Moreover, there are now fewer investment banks and other dealers willing to intermediate sizeable bond trades due to higher capital and risk charges on their balance sheets. In stressed markets, the remaining intermediaries and investors either pull back or naturally charge more to compensate for the increased risk they must bear.

It is worth remembering that, despite liquidity concerns, bond markets remained open amid unprecedented market swings and a once-in-a-century health crisis. Central banks have stepped in to repair liquidity and underwrite debt markets for the foreseeable future. Spreads remain highly elevated but have come down. In investment-grade credit, new bond issuance has restarted and fund flows have returned to positive. Government and higher-rated corporate bonds have clearly benefited from central bank backstops but are likely to remain volatile in the medium term.

Preparing for future shocks

What does all this mean for bond investors? There's good and bad news. The bad news is that these volatility and liquidity shocks may happen again and it's difficult for anyone to predict their timing. The good news is that we can control how we react to these shocks through active risk management and a high conviction approach. For bond investors, there are two main lessons from the recent market dislocation:

- **Stay safe and liquid.** We think core bonds continue to be attractive for now, especially as a diversifier against marked-down corporate bonds, which can benefit from price recovery and yields-to-maturity. However, safe-haven yields may continue to see outsized moves around the zero bound. Adding liquid interest rate futures and credit index derivatives where possible – and maintaining a good cash buffer – could further help to contain rate and credit volatility in portfolios.

  During the recent market turmoil, portfolios benefited from replenishing cash and reweighting positions when liquidity spreads improved, typically on the days before and after central banks announced stimulus measures. These trading sessions are worth exploiting, since liquidity spreads tend to widen again over time. In the days after central banks started injecting massive liquidity, many investors found it easier to sell cash bonds, but difficult to buy them. In two-sided markets, this is typically a sign of structurally impaired market-making and investor participation.

- **Stick to quality credit.** The kind of broad-based, distressed valuations we have seen recently will eventually give way to a recovery in liquidity, and performance will become more dispersed. High-quality issuers with strong cashflows and capital structures are best placed to weather this economic shutdown. Many emerging markets have strong sovereign balance sheets and should bounce back, although some frontier economies face external financing pressures and will need debt restructuring.

  In investment-grade credit, well-capitalised firms have already come back to primary markets with oversubscribed issues. However, others have seen their debt grow faster than cash and earnings in recent years. About half of the market is rated BBB, and around a third of these issuers would immediately drop to sub-investment grade if downgraded, presenting opportunities for high-yield investors.

  In high-yield, average duration shortened by a third over the past decade, while ratings improved with the majority of issuers now at BB. Still, averages can mask big differences in underlying credit quality. In summary, given the anticipated shake-up across the ratings spectrum, we believe that active strategies focused on best-quality, crossover and multi-sector credit opportunities are well positioned to outperform.