Bond Market Liquidity is Back—But is it Here to Stay?

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SEI Fixed Income Portfolio Management (SFIPM) manages fixed-income strategies for SEI's Managed Account Solutions (MAS).

- During the peak of the selloff on March 23, bond markets saw a collapse in liquidity as investors were simply unable to find buyers.
- Government intervention restored order, enabling bond markets to function normally.
- While financial markets remain at an elevated risk of falling back into turmoil, we still believe that high-quality portfolios are a logical way to potentially generate a stable stream of income.

From an investment perspective, the term liquidity is used to describe the ease with which an investment can easily be sold—and converted into cash. High-quality bonds are typically so easy to sell that investors usually don't even think about their liquidity. That abruptly changed as the COVID-19 pandemic tightened its grip on financial markets.

Helter-skelter markets

A bond-market liquidity crisis hit shortly after COVID-19 reached the U.S., with the peak of the disruption coinciding with the peak of the bond-market selloff on March 23. Over the one-week period leading up to that point, municipal bond yields surged by an average of 114 basis points (as measured by the Bloomberg Barclays Municipal Bond Index) while investment-grade corporate bond spreads widened by 131 basis points (as measured by the Bloomberg Barclays US Corporate Bond Index) (one basis point equals 0.01%). Under normal market conditions, yield movements are commonly in the low single-digits.

During the peak of the selloff on March 23, bond investors saw a collapse in liquidity. There was a brief period when many were simply unable to find buyers. While that phenomenon was relatively short-lived, investors continued to face a historic dislocation in bid-ask spreads. Bid-ask spreads, which represent the difference between the best buying price and the best selling price for any given security, were averaging four to five times higher than they did just a few weeks prior under normal market conditions. There were some instances in which bid-ask spreads were even greater. This phenomenon was predominantly driven by historic amounts of selling across exchange-traded funds (ETFs) and mutual funds as redemptions weighed heavily on the broker-dealer community and its ability to warehouse the bond inventory that investors were trying to sell.

Here comes the Fed

As financial markets began going into freefall, the federal government came under immense pressure to stop the bleeding. The Federal Reserve (Fed) took action on March 23. It started by reopening various credit facilities used during the 2008 global financial crisis and announced two new investment-grade corporate credit facilities:

- Primary Market Corporate Credit Facility (PMCCF): The PMCCF provides bridge financing for up to four years to companies that have investment-grade credit ratings.

- Secondary Market Corporate Credit Facility (SMCCF). The SMCCF is a purchase program for secondary-market investment-grade corporate bonds.

In addition to initiating two new investment-grade corporate programs, the Fed expanded the Money Market Mutual Fund Liquidity Facility (MMLF) to include municipal variable-rate demand notes, which are long-term bonds offered via money markets.

The market's reaction to the Fed's announcement was swift. By the time President Donald Trump signed the $2.2 trillion emergency Coronavirus Aid, Relief, and Economic Security (CARES) Act on March 27, both municipal bond yields and corporate bond spreads had rallied sharply. In the four days following the March 23 Fed announcement, municipal bond yields declined by an average of 149 basis points. Investment-grade corporate bond spreads narrowed by 78 basis points.

The unprecedented amount of fiscal and monetary stimulus gave a much-needed boost to investor sentiment—and liquidity subsequently began to improve.

Nevertheless, investors seeking to sell bonds were still at the mercy of a handful of willing buyers as bid-ask spreads remained disproportionately elevated.

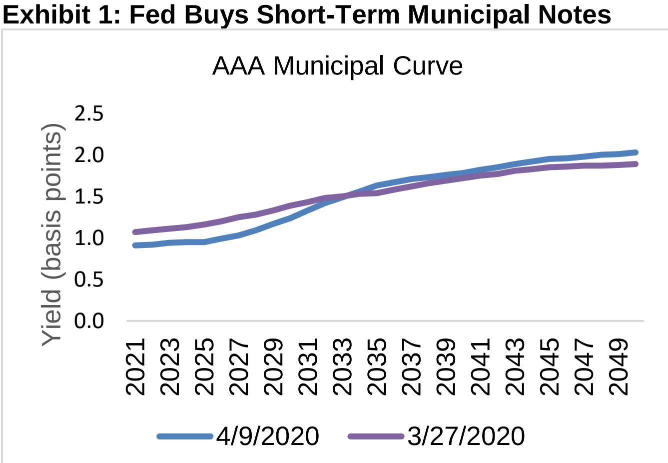
Buy with a little help from the Fed

The Fed was still not done. After the March 27 signing of the CARES Act, yields in municipal bonds with maturities up to and including the 13-year point of the yield curve declined by an average of 15 basis points through April 9; meanwhile, over the same period, yields in longer maturities climbed by an average of 9 basis points. Investment-grade corporate bond spreads declined 63 basis points.

Incredibly, at this point, the U.S. central bank announced a second monetary stimulus package that would provide up to $2.3 trillion in loans. As part of the April 9 announcement, the size of the PMCCF and SMCCF were both increased, and the scope of the SMCCF was expanded to include high-yield ETFs. It also introduced the Municipal Liquidity Facility (MLF), which is designed to help municipal issuers manage the impact of income-tax deferrals. This facility provides direct funding to eligible states, cities or counties by purchasing eligible notes directly from the issuer.

Once again, the market's reaction to the Fed's news was swift. The yield curve continued to steepen as market participants reacted favorably to municipal maturities at the front end of the curve.

Exhibit 1: Fed Buys Short-Term Municipal Notes



Source: Bloomberg, SEI

Our view: A foggy day's night ahead

Bond markets have come a long way in the month following the worst of the March doldrums. Even the most vivid of imaginations could not have foreseen bond markets collapsing as abruptly as they did and then bouncing back as sharply as they have in such a brief period time.

In response to the unprecedented amount of monetary and fiscal government stimulus that followed the liquidity meltdown, municipal bond yields and investment-grade corporate bond spreads moved well above the March 2020 lows. However, they have yet to return to the levels reached prior to the March meltdown.

Similarly, liquidity across municipal and corporate bonds is far better now than it was in March but has not fully returned to the levels that market participants had grown accustomed to prior to the market collapse that month.

Bond markets have reached a crossroad, and the path ahead is foggy. While encouraged by their continued improvement off of March lows, we expect financial markets will remain at an elevated risk of falling back into turmoil until data emerges that shows COVID-19 is under control.

In times of market stress, the cost of liquidity can go up significantly for even the highest-quality investments. Emotional reactions to sell in response to events like those we experienced in March—just a short time ago—are often proven unwarranted and costly. Therefore, we believe now more than ever in the importance of reminding investors that our portfolios are designed using high-quality investment-grade securities with the objective of delivering a stable stream of income throughout the economic cycle.

Glossary*:*

Yield curve: The yield curve represents differences in yields across a range of maturities of bonds of the same issuer or credit rating (likelihood of default). A steeper yield curve represents a greater difference between the yields. A flatter curve indicates the yields are closer together.

Index definitions:

The Bloomberg Barclays US Corporate Bond Index is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays US Municipal Bond Index covers the US dollar-denominated long-term tax-exempt bond market. The Index has four main sectors: state and local general-obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

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