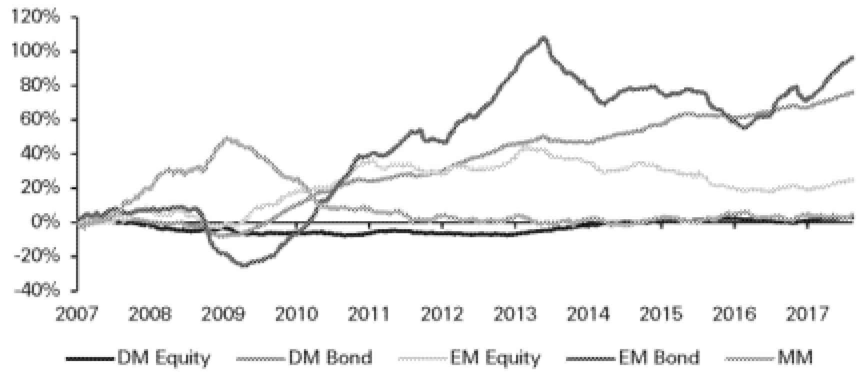
(A lack of) Financial Market Liquidity…and changing market structure

Another topic which has generated some debate in recent years is the decline in market liquidity. Traditional trading levels have dramatically reduced in most vanilla products since the GFC and the inventory levels of market makers have also fallen sharply. Fixed income seems the most vulnerable as it's the market that has seen a combination of large inflows, huge growth and reduced market making activity. If we first look at the flows into the asset class in recent years Figure 66 shows that both EM and DM bond funds have seen significant inflows in recent years. Equities and money market fund flows have been broadly flat for over a decade now.

Figure 66: Fund flows as a % of NAV (rebased to 2007)



Source: Deutsche Bank, EPFR

Whilst this is not automatically a worry it would argue that if there was a change in the yield environment and returns suffered, bond funds would arguably be vulnerable to these 'return chasing' momentum flows. If this occurred at the same time as central banks started to reverse their substantial purchases it could lead to a sharp correction in prices that could encourage or exacerbate a crisis.

As alluded to earlier, the problem with any major shift from inflows to outflows is that trading volumes and dealer inventories have both taken a major shift down in recent years. The US market has more available data detailing this. First we'll look at the trend in arguably the world's most important market namely US Treasuries.

As Figure 67 shows, daily trading has dropped to just under 4% of the market size which is more or less the lowest level that we've seen in the post-crisis era and over a third of their pre-GFC levels.