Surviving Whiplash:
Fixed Income ETFs Provide Liquidity in Volatile Markets

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Recent experience, during the two-day, 1,841 point Dow meltdown suggests that ETFs will continue to provide liquidity even during the most violent short-term market swings — and may provide better, more accurate price discovery during such periods than the underlying securities. That's not surprising. During normal trading environments, Fixed Income ETFs typically provide greater liquidity than their underlying markets, especially in lower liquidity sectors like high yield bonds. Yet while some market observers have argued that this liquidity is illusory and in periods of extreme market volatility might break down, last month's experience proves otherwise.

The stock market sell-off began on fears that an uptick in wages in the last employment report might be an early sign of renewed inflation. Interest rates, which had already been on the increase, rose sharply after the January report, with the 10-year Treasury note briefly hitting 2.85%, the highest level in four years. Against this backdrop, a steady outflow from high yield bond ETFs accelerated on February 5th. The market remained stable. High yield ETFs including HYG and JNK ended the day trading at a small discount to fair market value in the underlying portfolio — a gap of about 30 basis points. However, much of that discount can be attributed to a lag in the dealer market, where a mismatch between what sellers bid and buyers offered caused a temporary seize up in trading activity.

ETFs Provide a Truer Picture of Fair Market Value

iShares Trust iShares iBoxx $ High Yield Corporate Bond ETF traded 28 million shares on February 5 (and 34 million on February 6). At prices between $85.58 and $86.50, this represents just under $2.5 billion in liquidity, traded on a minute-by-minute basis with pricing updated in real time.

In the dealer market, by contrast, bonds are typically priced sporadically throughout the day, through the laborious process of contacting multiple dealers for quotes. Bonds can be marked to fair value according to bids, offers or a mid-point between the two. Yet during periods of volatility, there is often a mismatch between bids and offers, with the result that few trades are done. Institutional Investors and Market Makers then, may determine fair value based on a price no one wants to trade. As a result, it's no surprise that when prices are changing rapidly, the ETFs exchange traded prices may be a truer indication of market value — they incorporate more recent, and vastly greater amounts of data.

The ETF Market Performed Well Under Pressure

The ETF market absorbed heavy volume this week without disruptions in liquidity for a number of reasons.

First, though it is a small slice of the overall market — as of February 8, 2017, bond ETFs represented $625 billion[1], about half a trillion out of a total an approximately $8 trillion corporate bond market[2] — it is large enough to accommodate trading even on very volatile, heavy-volume days. Even in the high yield market, there is currently about ~$15 billion in HYG and another ~$10 billion in JNK and smaller amounts in other high yield ETFs – a total of about $50 billion[3]. This is enough to provide a great deal of liquidity, even under extraordinary circumstances. Fixed Income ETFs also provide liquidity by trading on holidays when bond markets are closed but equity markets remain open.

Second, the ETF market has a built-in mechanism for reaching equilibrium when there are more sellers than buyers (or conversely, more buyers than sellers). About 85% of trades are matched, that is a buyer is paired with a seller on the secondary market to execute the transaction. The remaining 15% are done in the primary market. If sellers predominate, the market maker will break ETFs into their component holdings, then sell them on the open market – a process known as redemption. If buyers are more common, the market maker will buy underlying securities on the market and "create" new ETF shares. This process provides no protection against price volatility; if prices are falling, the equilibrium will be set at the current lower level. However, it does provide investors with the ability to trade their positions through difficult markets, and even in periods where mismatches between bids and asks temporarily freeze up trading activity in the underlying securities.

Recent performance is proof that the ETF market works, delivering price transparency and liquidity even in the most challenging conditions. After ETF prices closed at a discount of over 60 basis points below NAV on Monday, the underlying bond prices continued to fall again on Tuesday, bringing NAV's back into alignment with ETF prices. That suggests that ETFs weren't mispriced but merely ahead of the bond market in reaching equilibrium. ETF liquidity has been tested again — and proved resilient even in a record-setting sell-off.

[1] *Source:* https://www.bloomberg.com/professional/blog/fixed-income-etf-flows-across-assets-maturities/ur
[2] *Source:* SIFMA https://www.sifma.org/resources/research/bond-chart/
[3] *Source:* ETFdb.com "High Yield ETFs" http://etfdb.com/etfdb-category/high-yield-bonds/

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