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Bond ETFs Face Toughest Liquidity Test Yet in Virus Turmoil.

- **Fixed-income funds are trading at discount to net asset values**
- **Arbitrage isn't compelling amid bond market upheaval: Perlman**

Bond ETFs are highlighting signs of liquidity stress in broader markets, with cash prices trading at persistent and deep discounts to the value of the underlying assets.

The $31 billion iShares iBoxx $ Investment Grade Corporate Bond ETF closed at a discount of 3.3% to its net asset value on March 11, the largest such divergence since 2008, according to data compiled by Bloomberg. Meanwhile, the $23 billion iShares 20+ Year Treasury Bond fund's price has dropped 5% below its net-asset value, the most ever. And even the U.S. municipal market is feeling the squeeze: The VanEck Vectors High Yield Municipal Index ETF traded at a record 8.3% discount on Wednesday.

The historical volatility roiling American bond markets has created unprecedented dislocations in the ETFs that track them. But the market makers who normally step in to repair price inconsistencies, pocketing a virtually risk-free profit, are cautious. That's because their standard process has become significantly more complicated with many of their usual price gauges are out of whack.

It's not uncommon for an ETF to drop below its net-asset value — but it is unusual to see a continuation of that. In normal market environments, such a decline presents an arbitrage opportunity for certain middlemen known as authorized participants. Typically market markers will buy shares of the ETF as its price drops and redeem these shares with the issuer in return for the underlying bonds. The authorized participant will then sell those securities to capture a relatively risk-free profit. By reducing the supply of ETF shares, the fund's price typically returns to tracking the fund's net asset value.

But as the coronavirus outbreak unleashes historical turbulence in financial markets and liquidity dries up, ETFs spanning the bond spectrum are trading at steep discounts. That dynamic will likely persist until volatility subsides and market makers have a better sense of where they can sell the underlying debt, according to UBS Global Wealth Management's David Perlman.

"The market price is going to drop down to where the authorized participant believes that they'll be able to trade the bonds. They're not doing this out of the goodness of their hearts," said Perlman, an ETF strategist at the firm. "They don't jump in until they think they can execute the redemption and make a profit from doing so."

The inherent rub is that fixed-income ETFs, which trade on exchanges and behave like stocks, are much more liquid than the securities they hold. That's fueled fears that in the event of a sell-off, investors scrambling to redeem their holdings would overwhelm the managers, or the traders that channel bonds into and out of the funds. The likes of Mohamed El-Erian of Allianz SE and Scott Minerd at Guggenheim Partners have suggested they could act as a potential destabilizing force in illiquid credit markets where they have an outsized trading share.

Now, as credit spreads blow out and investors rush for the exit, fixed-income ETFs are being put to the test. That has Peter Tchir at Academy Securities concerned that authorized participants — in the process of selling the underlying bonds to lock in the arbitrage — will exacerbate the sell-off.

“That means, to me, that we are about to enter a cycle driven by arbitrage, where there is more pressure on short-dated corporate than the market can handle, causing a vicious cycle,” Tchir, head of macro strategy, wrote in a note Thursday.

So far, there’s little evidence to support the theory. But there have been a few early success stories: High-yield bond ETFs. The iShares iBoxx High Yield Corporate Bond ETF, ticker HYG, ended Monday with a modest discount of half a percentage point to its net-asset value even as its price dropped by the most since 2009. The ETF actually added $409 million of inflows that day, suggesting that despite the steep sell-off, there were buyers to be found.

And while shifting cash on a short-term basis may be more challenging this week, buy-and-hold investors likely haven’t been impacted by the turmoil — beyond the price of their investments falling.

“If you’re a long-term investor who’s looking to add an ETF position to a portfolio of bonds, for example, the trading liquidity becomes less important,” said Patrick Luby, senior municipal strategist at CreditSights.

Still, it’s crucial to be cognizant of each market’s idiosyncrasies, according to UBS Wealth’s Perlman. While this episode likely isn’t the ETF liquidity reckoning that naysayers have called for, the ease of trading an ETF is ultimately dictated by its underlying market.

“We remind our clients that you do want to take into account the liquidity of the underlying market because ultimately that liquidity is going to be reflected in the price of the ETF during these challenging periods,” Perlman said. “The ETF wrapper makes it easier to trade, but it doesn’t make liquidity costs disappear.”

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By Katherine Greifeld

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