What factors impact market liquidity in the fixed income universe?

Before answering this question, it might be useful to first define the concept of ***market*** liquidity since it differs from the ***portfolio*** liquidity that has been described in our previous videos.

Market liquidity refers to how quickly and easily a security can be sold and converted to cash. A highly liquid market is one in which there is a deep pool of buyers and sellers ready and able to quickly transact at mutually agreeable prices. A liquid market often has characteristics which include small differences between buyers' and sellers' prices (also referred to as narrow spreads), high transparency, and large trading volumes. Certain markets tend to have stronger market liquidity over time. For example, the U.S. Treasury market is widely recognized as the most liquid sector in the fixed income markets and is helped by its sheer size, number of willing buyers and sellers, and the credit quality of the United States. When constructing fixed income investment portfolios, portfolio managers will factor in the relative liquidity of policy-permitted investment sectors.

Many factors can impact market liquidity. Structural elements such as size of the particular market, number of participants, and perceived credit risk tend to define a market's general liquidity over time. However, other forces can have significant impacts on market liquidity, too. For example:

- Regulatory factors: these affect dealer balance sheets, issuance trends (known as supply), and even investor behavior (known as demand).
- Technology: the advancement and the adoption of electronic trading, and more specifically, peer-to-peer trading in recent years has improved liquidity in many markets.
- Investor sentiment and overall market volatility: general risk appetite from market participants changes regularly and from a variety of factors.

How did market liquidity fare during (a volatile) 2020?

High-quality fixed income markets that typically enjoy strong market liquidity quickly deteriorated in March of 2020 as COVID-19 emerged in the U.S. The uncertainty and fear surrounding the emerging pandemic froze markets, basically sideling buyers of all types. In an environment like this, liquidity quickly evaporated without a deep pool of buyers and sellers. The Federal Reserve quickly acknowledged this systemic issue and stepped in to provide support through a series of emergency facilities. These actions quickly restored confidence and stability to financial markets, which was the intention of the Fed. And, although the actual underlying usage of these Fed facilities has been minimal, the market has taken great comfort in the fact that they were and are available if needed. This has been a major contributor to the lower volatility and improved liquidity that markets have experienced in recent months.

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