

Dan Fuss on the Liquidity Problem in the Bond Market

By Robert Huebscher

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Each morning, the traders at Loomis Sayles' bond desk rate the degree of liquidity in the bond market, with a rating of one being the worst and 10 the best. Ratings of one or two – as corporate bonds have been receiving of late – are an ominous sign, according to Dan Fuss. “Liquidity is the God of the markets,” Fuss said, adding that he expects to deal with illiquidity for a while.



Fuss spoke last Thursday at the CFA Institute Fixed Income Conference in Boston. He is a vice chairman at Loomis Sayles and has over 50 years of experience in the bond market.

The cause of the recent illiquidity is clear, according to Fuss. Investment banks, who are the primary market-makers for corporate bonds, are reducing their leverage, at least in part because of new regulations, such as Basel III. “Day after day they are being pounded on to get their risk book down,” Fuss said.

A dearth of bonds

Fuss said that spreads have widened, not just for corporate bonds but for Treasury bonds as well. “Our ability to transact on the buying side is far more limited than I ever recall, with the exception of the fall of 2008,” he said. At the height of the financial crisis, his traders rated the liquidity a zero, indicating the market was effectively frozen.

Illiquidity has impaired bond purchases, but Fuss said it has not affected bond issuers. Both corporations and the Treasury have been able to bring new issues to the market.

It is bank deleveraging that concerns Fuss. He said that banks are unwilling to raise equity because of their depressed stock prices. At the same time, they are winding down their “risk book,” selling off assets in order to bring their capital ratios to acceptable levels, he said.

As that happens, Fuss said, it will be akin to a receding tide, exposing rocks that are perilous to navigation. “We don’t see the rocks now,” he said, “and probably a lot of people are not aware of the rocks. For that reason I’m a little bit cautious.”

Fuss said that the dangers he feared most were in the “plumbing” of the banking system, such as the payment settlement and counterparty systems that ensure smooth operation of the banking system.



Assessing the macro factors

Fuss also offered his views on longer-term macro issues. As he has in prior talks, he framed his thoughts in the context of four Ps: peace, people, politics and prosperity.

Peace or the lack thereof dominates Fuss' thinking about investing. Among the four Ps, it is now his greatest concern. He fears that forecast cuts will render our defense spending, when measured as a fraction of GDP, insufficient.

Though qualifying that he is not a "political person," Fuss said that current budget projections will not allow the US to intervene when needed around the world. The sixth fleet, stationed in the Mediterranean, will not be able to fulfill its role as peacekeeper for that region, and the seventh fleet, stationed in the Pacific, will face similar constraints.

Demographics were the second topic Fuss addressed. He reiterated established concerns about the aging of the US population. Medical costs are his overriding concern, but he said that it is "realistic" to expect that efforts to control those costs will succeed. Nonetheless, he said that budget forecasts regarding the federal government's ability to reduce costs are optimistic.

On the political side, Fuss said he was "disturbed" about the situation in Greece, and he worries that country's problems will be resolved poorly.

Under the heading of prosperity, Fuss spoke about the outlook for the federal budget and the government's debt burden. Slow economic growth, combined with overly optimistic forecasts for defense and health care spending reductions, will force the government to borrow approximately 2% more (as a percentage of GDP) than it currently anticipates.

Fuss concluded his talk by returning to the political theme. He cited recent tensions in Asia, where China has asked India to halt joint energy projects with Vietnam in the South China Sea. He said Vietnam and China had recently signed an agreement on off-shore exploration to address natural gas and oil reserves.

He said this situation had not been a concern of political leaders – until now. "Any time you have raw material in an area of uncertain ownership, you have stress." Those issues concern him "far and away over all the other issues." He said he can deal with the bankers and liquidity issues, but tensions in the political arena carry much greater uncertainty.

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