Barclays Research Insights on

The Liquidity Gap

The decline of fixed income liquidity in 2015 can be seen as a gap between supply and demand. Banks are supplying less liquidity, yet investors are still demanding more of it. The result? Potentially severe losses in fixed income.

LIQUIDITY:
The ease of trading a financial security quickly, efficiently and at a reasonable price.
The liquidity gap creates a transfer of risk.

After the 2008 financial crisis, new global bank regulations were passed.

Regulations, such as the Supplemental Leverage Ratio (SLR), were implemented to improve stability in the financial markets. These have addressed many safety issues, but they have also changed the way banks operate.

The repo market shrinks.

Regulators are concerned that banks are too reliant on short-term funding, such as repo (repurchase agreements). The Supplemental Leverage Ratio makes repo more expensive.

The decline in repo reduces banks’ willingness to supply liquidity in fixed-income markets.

Less liquidity supplied by banks.

The decline in repo exacerbates the scarcity of safe, short-term assets, such as Treasury Bills.

Fewer safe*, short-term assets available.

Bond trading turnover has fallen since the credit crisis by more than 40%.

Source: TRACE, Bloomberg, Barclays Research

Inventory of Treasury Bills is down by more than 20%.

Source: SIFMA, Barclays Research
Investors want more safe, short-term assets. But the traditional sources are increasingly unavailable. Instead, investors turn to investments that offer daily liquidity.

Since 2009, there has been $1.2 TRILLION in inflows into fixed income mutual funds. Source: Lipper

What are the potential risks?

Open-ended mutual funds depend on the liquidity of underlying fixed income assets, which has declined due to pressure on the repo market.

1. Poor liquidity in the underlying bond market.
2. Sustained outflows lead to price decline.
3. Severe losses in fixed income.
More risk may be passed on to investors.

Investments in mutual funds involve added risk, where such funds hold underlying investments in potentially illiquid fixed income assets, such as corporate bonds.

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Source: “The decline in financial market liquidity,” prepared by Jeff Meli, Co-Head of Barclays Research Department.

* See The Liquidity Gap Glossary on barclays.com/IB for full definition.
Disclosures

Mutual funds and exchange traded products (ETPs) are sold by prospectus. Investors should consider the investment objectives, risks, charges, and expenses of the fund or ETP carefully before investing or sending money. This and other important information about the fund or ETP can be found in the fund's or ETP's prospectus. To obtain a free copy of a prospectus please call your Barclays representative or 1-888-227-2275. Please read the prospectus carefully before investing.

Investing in either ETPs or mutual funds involves risk to capital. Investors might get back less than they invest.

Bonds are subject to market, interest rate and credit risk; and are subject to availability and market conditions. Generally, the higher the interest rate, the greater the risk. Bond values will decline as interest rates rise. Government bonds are subject to federal taxes. Municipal bond interest may be subject to the alternative minimum tax; other state and local taxes may apply. High yield bonds, also known as “junk bonds,” are subject to additional risks, such as the increased risk of default.

Cash Equivalents refers to alternatives to cash (i.e., free credit balances). These alternatives historically have higher rates of return than free credit balances. Although these alternatives generally have low interest rates and are generally low risk, they carry some risk. Examples include:

- Money Market Funds: A money market fund is a mutual fund seeking to preserve the fund's share value at $1.00 per share while earning interest for its shareholders. Although generally liquid and low risk, money market funds could lose principal value (i.e., “break the buck”) and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. In addition, Securities and Exchange Commission rules may limit your ability to redeem shares during certain periods of market stress.

- Commercial Paper: Commercial paper, issued by a corporation, is short term, unsecured debt with a maturity of 270 days or less. Credit ratings from major securities rating organizations for these securities depend on the likelihood that the corporation will not repay the debt. While a higher rating means a lower default risk, there is still a risk that a corporation will not repay the debt. Like money market funds, commercial paper is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency and could lose principal value.

Government treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Repurchase agreements (repos) are widely used as a source of financing by primary dealers, other securities firms, banking firms, and institutional investors, among others. A repo involves an agreement between a seller and a buyer, typically of U.S. government securities but increasingly involving other types of securities and financial assets as well, whereby the seller “sells” the securities to the buyer, with a simultaneous agreement to repurchase the securities at an agreed upon price at a future point in time. Investing in repurchase agreements (repos) involves certain risks and may not be suitable for all investors. Repos are subject to the counter-party's credit risk, the chance that the other party in the contract will default on its responsibility. If a counter-party to a repurchase agreement defaults, the other party may suffer time delays and incur costs or possible losses in connection with the disposition of the securities underlying the repurchase agreement. In the event of default, instead of the contractual fixed rate of return, the rate of return to the other party will depend on intervening fluctuations of the market values of the underlying securities and the accrued interest on the underlying securities.

The investments discussed in this publication may not be suitable for all investors. Advice should be sought from an investment representative regarding the suitability of the investment products mentioned herein, taking into account your specific objectives, financial situation and particular needs before you make any commitment to purchase any such investment products.

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The Supplemental Leverage Ratio (SLR) is the leverage ratio established by US banking regulators to regulate certain banks’ activities. The objective of leverage ratios is to limit the size of large banks. Theoretically, they will make the banking system less concentrated and therefore less risky. A Leverage Ratio of 3% means there must be 3% of capital reserved to support a bank’s assets. It means a bank can leverage themselves 33 times to one (1/.03) – that’s one dollar in capital for every 33 dollars in assets.
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