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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **June 29, 2022**

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Last week's S&P 500 Index: +6.5%

Liquidity

Key takeaways

- Recent Federal Reserve (Fed) data points out that market liquidity has declined for U.S. Treasury securities and equity index futures.
- We believe the key is to understand your need for liquidity and focus on higher-quality stocks and bonds.

We, and other strategists on the "Street," have been talking about market liquidity for some time. As the Fed has stepped back from buying Treasury debt and mortgage-backed securities, some market participants wonder if the lack of a consistent big buyer will lead to increased volatility and less efficient pricing. Particularly when financial markets are uncertain and volatile, having more participants, not fewer, has usually led to more efficient pricing than instances where there are fewer buyers and sellers. The same can be said about the stock market. Speculators often get a bad rap when equities fall, but they do provide liquidity and often aid in helping the market operate more smoothly by providing bids and offers for securities in the open market.

Liquidity can be thought of as the ability to buy or sell a security in a reasonable period of time within an expected price range. When the stock or bond market is not liquid, it means that the investor might very well sacrifice pricing and/or time. History would show that liquidity issues arise when risks increase, especially those that seem to surprise the market in terms of timing or magnitude. Deep, liquid markets with many buyers and sellers are largely considered to be the most efficient. It is not unusual for markets to operate with reduced liquidity when selling pressure is intense.

We believe our current market climate likely has some market participants concerned that liquidity is or will become an issue. Our fixed-income analysts have pointed out that the Fed, in its latest Financial Stability Report, tells us that "Market liquidity has declined since late 2021 in the markets for recently issued U.S. Treasury securities and for equity index futures. These markets play important roles in the functioning of the economy and financial system and are usually highly liquid. Therefore, lower liquidity in these markets can amplify price volatility and result in unexpected tightening in financial conditions."[1]

This Fed report highlights some of the potential risks investors may want to consider as our central bankers step away from bond purchases in the open market and work through the process of hiking rates in an attempt to reduce demand and slow the economy with the ultimate goal being meaningfully lower inflation. Fewer buyers and sellers in any market can lead to less efficient and more erratic pricing.

Investors should be aware of and properly assess the liquidity characteristics of their portfolios. They should also understand their need for liquidity and reflect that in portfolio allocations. Some investments are more liquid than others. In the fixed-income area, we do have some liquidity concerns in the high-yield bond market and to a lesser extent the municipal-bond market. In equities, some smaller- and mid-cap stocks and lightly traded exchange-traded funds (ETFs) represent potential areas of concern when volatility increases. But even larger-capitalization stocks and heavily traded equity products can experience liquidity issues from time to time.

1. Board of Governors of the Federal Reserve System, "Financial Stability Report", May 2022.

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Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. **ETFs** are subject to substantially the same risks as individual ownership of the securities would entail. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed, or sold, may be worth more or less than their original cost. ETFs seek investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched.

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