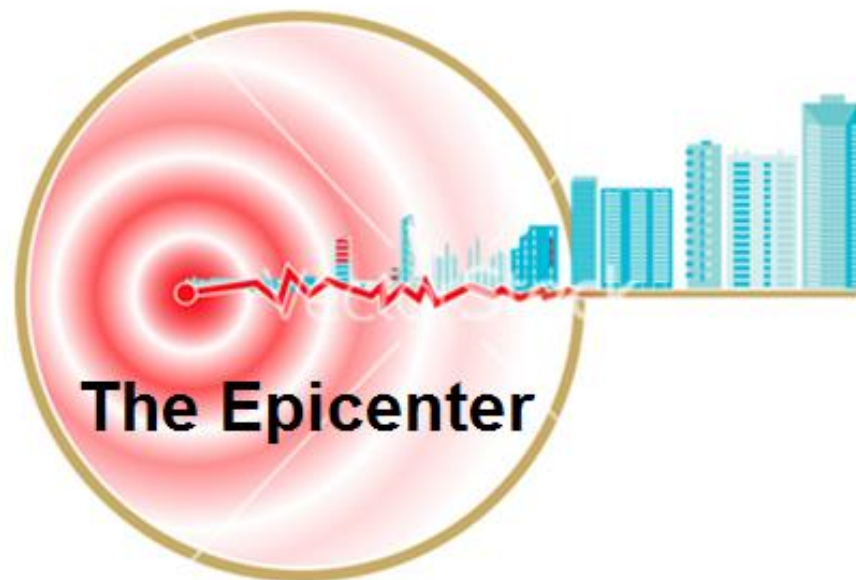


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# **DRIVER\$ – *Bond Market, the Epicenter of the Coming Storm***

ANALYTIC INSIGHTS

## **BOND MARKET**



Gordon T Long  
6/25/2015

### DRIVER\$ – The Bond Market the Epicenter of the Coming Storm *Illiquidity Fear Enters the Markets*

#### CHANGING INSTITUTIONAL FLOWS

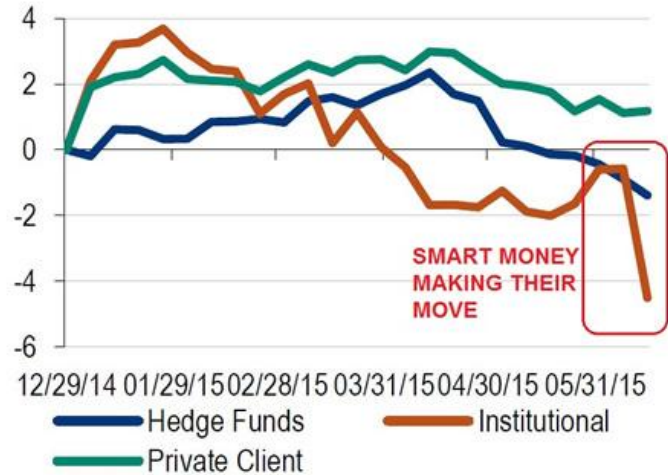
Complacency is finally and inevitably beginning to shift to nervousness!

Institutional Fund Managers are beginning to see something that actually bothers them. It certainly isn't overvaluations and many of the market internals we have been talking about for some time. It is something that the big players must always keep an eye on – it's LIQUIDITY.

Losing someone else's money is not something that bothers them. Having loses larger than someone else however can cost you your job! Nimbleness and being able to exit large positions is critical. Stop loses must be able to be filled and sophisticated trading Algos must be able to function. Everything changes when liquidity enters the equation.

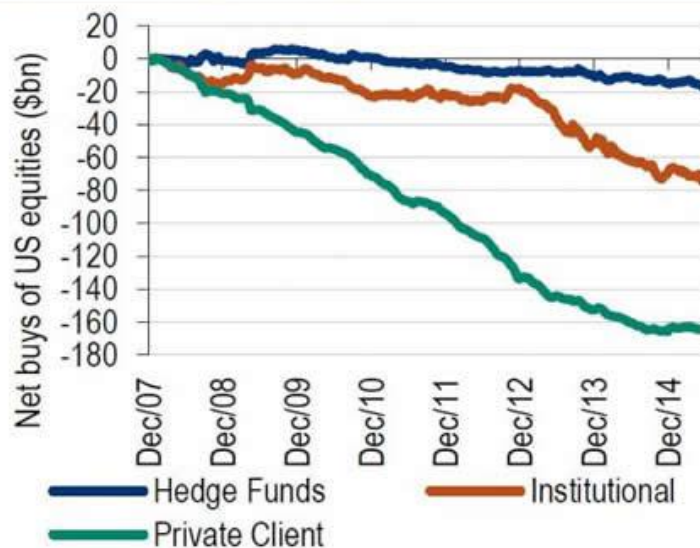
Bond and Repo Market liquidity has begun to frighten them and they are moving quietly towards the exits.

Chart 2: YTD cum. flows by client type (\$bn)



Source: Bank of America Merrill Lynch

Chart 1: Cumulative flows (\$bn) by client type, January 2008-present



Source: Bank of America Merrill Lynch

The adage that the Fed has your back may not play out because it is not a shortage of cash but rather a shortage of high quality collateral. The Fed can't fix this except for doing something unprecedented like stepping in and guaranteeing it. Precisely what we expect during the coming market scare

## "DON'T FIGHT THE FED" MANTRA – SOON TO BECOME "DON'T FIGHT THE MARKETS!"

Here is what the Smart Money Sees:

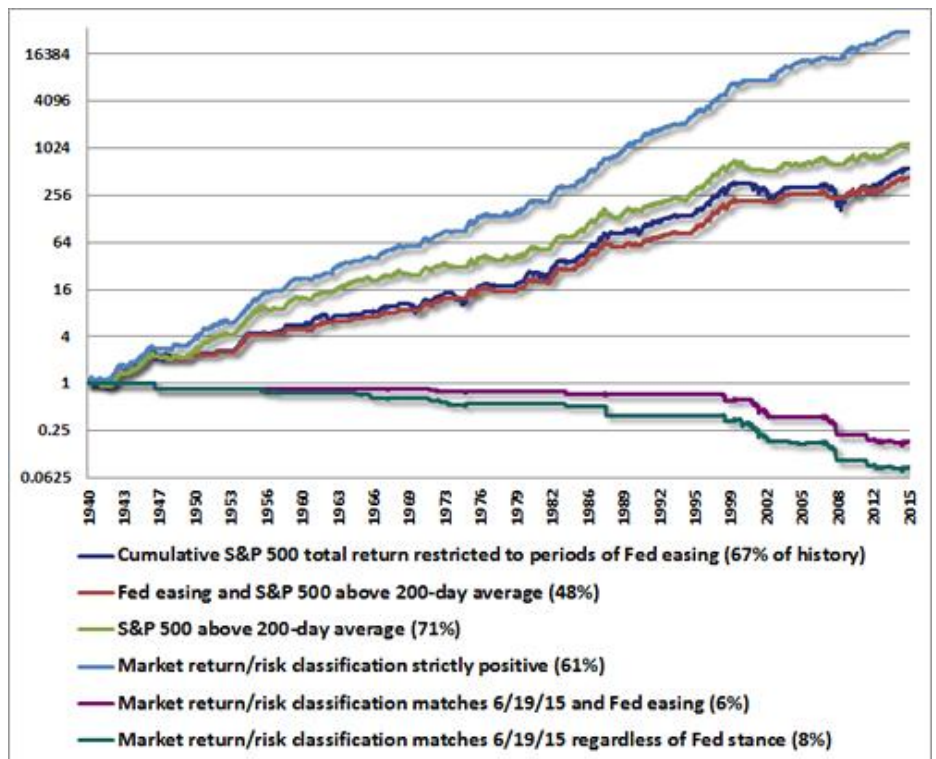
- Real growth expectations are flat to falling.
- Inflation expectations are rising.
- Capital is flowing away from the US and back to international markets and economies.
- Credit markets are starting to get worried.
  
- Europe does not appear to have changed any economic policy sufficiently to affect their long term growth arc.
- Japan is improving but only slowly.
- Most people seem to think that China has a stock market bubble that will end badly.
- Australia, Canada and most of Latin America are dependent on China.

It seems best to trust what the market is saying. So, forget the Fed. **Don't fight the market.**

## RISK ADJUSTED RETURNS DON'T PASS INSTITUTIONAL RISK MITIGATION STANDARDS

Investors whose strategy is to follow the Fed – in the belief that stocks will advance as long as the Fed does not raise interest rates – are free to place all their eggs in Janet's basket. On the other hand, for investors whose strategy is historically informed by factors that have reliably distinguished market advances from collapses over a century of history, John Hussman's suggestion is to consider a stronger defense. His greatest successes have been when his investment outlook was aligned with valuations and market internals, and his funds greatest disappointments have been when it was not. Both factors are unfavorable at present, and his and other smart money is aligning accordingly.

The following is only one of many examples:



[\\$140 Billion Bond Fund Goes To Cash As It "Braces For Bond-Market Collapse"](#) 06-22-15 ZH

Recently, it's become readily apparent that some of the world's top money managers are getting concerned about what might happen when a mass exodus from bond funds collides head on with a completely illiquid secondary market for corporate credit.

Indeed, bond market illiquidity is *the* topic du jour and has almost become something of a cliché among pundits and mainstream financial media outlets years after we first raised the issue in these pages. But just because something has become fashionable to discuss doesn't mean it's not worth discussing and indeed, we're at least pleased to see that the world is suddenly awake to the fact that a primary market supply bonanza catalyzed by rock-bottom borrowing costs and yield-starved investors could spell disaster when paired with shrinking dealer inventories.

For illustrative purposes, here's a look at turnover in corporate credit...



Chart: Barclays

...and a snapshot of shrinking dealer inventories and ballooning bond funds...

Problem with rising rates — MF assets too large vs. dealer inventory



But there are other investors — corporate holdings by investor type

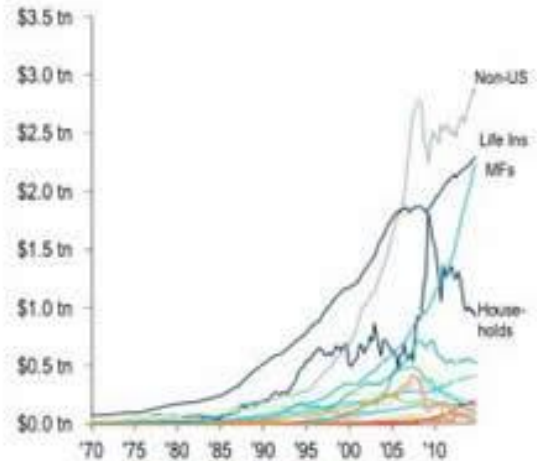


Chart: Citi

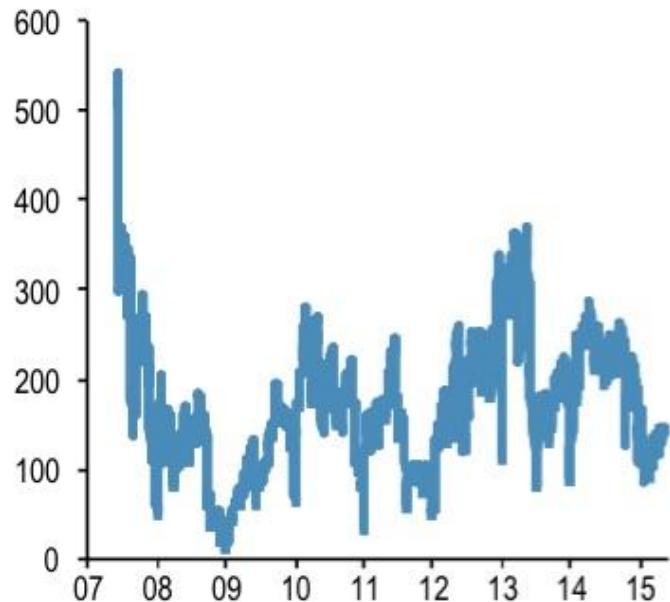
...and finally, here's UST market depth...

What all of these charts show is that whether you're talking about corporate credit or "risk free" government debt, liquidity simply isn't there and as was on full display last October, wild swings in illiquid markets will be exacerbated by the presence of parasitic HFTs.

Meanwhile,

- Treasury market participants are [shifting to futures](#) and,
- Corporate bond fund managers [are using ETFs](#) to offset "diversifiable" outflows,
- A phenomena which prove investors are actively avoiding credit markets by resorting to derivatives, a practice **which only serves to make the underlying markets still more illiquid.**

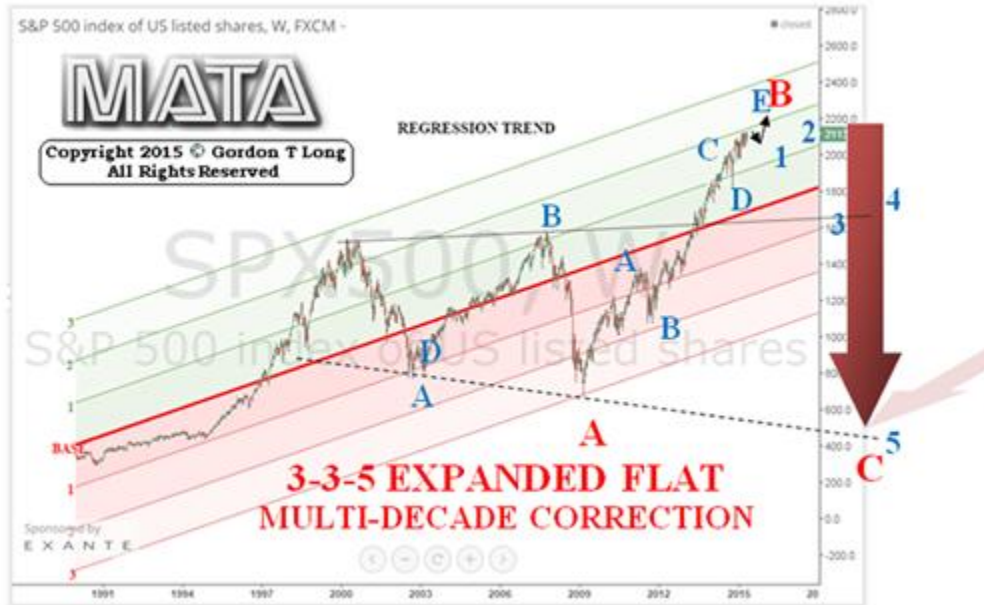
Figure 7: Market depth in 10y US Treasuries  
5-day average of tightest three bids and asks each day, measured in \$mn for 10y US Treasuries



Source: J.P.Morgan

A SCARE COMING WHICH WILL FORCE CENTRAL BANKS TO THE NEXT LEVEL

## OUR BIG PICTURE



## DRILLING DOWN

*There is major support at the converging Long Term Trend Channels  
In Q3 2015 annotated by the red circle.*



### YOUR READING HOMEWORK:

1. THE ILLUSION
  - [Don't Fight The Market](#) 06-21-15 Alhambra Investemtn Partners
  - [All Their Eggs in Janet's Basket](#) 06-22-15 John Hussman
2. THE EQUITY MARKET PROBLEM - One of Them
  - ["Debt Gone Wild" - Debt Funded Stock Buybacks Soar](#) 06-22-15 Lance Roberts
  - [The Long Expansion](#) 06-22-15 Ed Yardeni
3. THE BOND MARKET PROBLEM
  - [-\\$140 Billion Bond Fund Goes To Cash As It -Braces For Bond-Market Collapse](#) 06-22-15 TCW Group / JP Morgan via ZH
4. NERVOUSNESS
  - [The "Smart Money" Just Sold The Most Stocks In History](#) 06-23-15 BOAML via ZH
  - [Pop Goes The Bubble](#) 06-23-15 *Dmitry Orlov via ClubOrlov blog,*

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