Liquidity in Fixed Income Markets

Security selection and communication are integral to our approach.

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KEY INSIGHTS

- Liquidity across fixed income markets has been extremely challenged in recent weeks.
- Central banks have begun to address the problem with a range of measures, but it may take time before the market is fully functioning again.
- We are addressing concerns about liquidity through security selection and working closely with our clients.

What is the current state of liquidity in fixed income markets?

Liquidity across fixed income markets, from high-quality government bonds to credit markets, has been extremely challenged in recent weeks. Commercial paper, which is unsecured debt issued by companies to fund short-term obligations, has also been facing a liquidity squeeze. There are a number of reasons for this, including a large number of exchange-traded funds needing to sell. Overall, there is high demand for cash right now, but this comes at a time when work location contingency plans are being implemented and trading desks are being split into different areas. This is not helping the efficient functioning of markets. Furthermore, constrained liquidity has been exacerbated by post-2008 financial crisis regulations that dramatically increased bank capital requirements, discouraging or even preventing securities dealers from holding risk assets on their balance sheets. Such measures have even put a strain on trading activity in Treasuries—the most liquid bond market. The conditions are making it difficult to both buy and sell fixed income securities at present. Bid offer spreads have materially widened as a result, and in some cases, they may not be available.

What are the central banks doing to address the problem?

Central banks are the stewards of liquidity, and they've begun to address the problem quite aggressively. Over the weekend, the U.S. Federal Reserve cut interest rates to a target range of 0% to 0.25%, launched a USD 700 billion quantitative easing program, and announced a series of other measures to enhance liquidity and improve confidence in markets. This included reaching an agreement with five other major global central banks (euro area, Japan, Canada, UK,

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and Switzerland) to enhance the terms of a standing swap line facility. This facility, which had its origins in the 2008 global financial crisis, allows for the borrowing of U.S. dollars in non-U.S. currencies to support the international supply of dollars. Similar to other major central banks, the Fed also reduced the reserve requirement ratio—the minimum amount a bank must hold in reserves—to zero. This is to encourage and support lending to small and medium-sized businesses.

How is T. Rowe Price responding?

We have been managing fixed income portfolios on behalf of our clients for over four decades. We have extensive experience navigating through numerous market cycles and challenging environments. During this crisis, like all the others we have been through, we will stick to our investment process. Integral to this is security selection—we try to be very careful about what we put in our portfolios in the first place. Second, we believe it's important for investors to take a long-term perspective and not do anything rash during periods of disruption. Nonetheless, if our clients need us to take action, we will make every effort to do so in the most efficient way possible.

At T. Rowe Price, we have experienced trading teams across the globe to help us navigate the current market conditions.

We remain focused on:

1. The importance of overcommunication within our trading teams, portfolio managers, and sell-side counterparts as many trading and related functions are currently split among different locations; and
2. Our trading protocols, including high-touch and low-touch trading strategies, to examine how they are reacting to the current volatility.

Over the years, T. Rowe Price's global trading teams have placed great emphasis on building strong relationships with our sell-side counterparts, positioning us well to utilize all channels of execution.

What can we expect in the future?

The action taken by central banks, such as the Federal Reserve, is welcomed, although it may take time before we see the fixed income market fully functioning again. In particular, we need to see improvement in the transmission mechanism of the liquidity that central banks are providing into credit. This may require new programs like what we saw during the global financial crisis, such as the Troubled Asset Relief Program. These can take time to develop and implement, but we are confident that these programs will come with authorities and central banks working together.

Another factor that could play a role in liquidity over the next few weeks is the potential for asset allocation changes. After a strong run in high-quality fixed income markets, it's possible that investors could decide to take profits and allocate into equities. In this type of scenario, fixed income securities would need to be sold in order to meet redemptions, which again could exacerbate liquidity issues. We are monitoring this closely.

Irrespective of conditions, T. Rowe Price continues to stand ready to service the needs of our clients. We expect to invest new inflows as well as finance any possible outflows in the near future depending on our clients' risk appetite and willingness to recalibrate their asset allocation. In a redemption situation, it will be important to communicate and give advance warning. This will be key as we strive to execute as efficiently and as cost-effectively as possible. The ability to work in close partnership will ultimately enable us to best serve our clients.

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