

# Dual Threat: Illiquidity and Inflation

Stockholm (HedgeNordic) – With yields hovering near all-time lows, some investors are understandably concerned about the impact of a potential pickup in inflation on bond prices and yields. With 2020 – a year to forget for most of us – coming to an end, there is one additional worry for bond investors: falling liquidity around year-end. European fixed-income ETF provider Tabula Investment Management is telling investors to hope for the best but prepare for the worst, warning of the potential double threat from lower liquidity in the bond markets at year end, and a change to the decade-long trend of low and stable US inflation.

According to Tabula, bond market liquidity may be drying up towards the end of the year, when investors need it most. Bond markets often see lower liquidity towards year end, with the sell-side preparing to trim balance sheets and the buy-side closing its books. The heightened uncertainty due to the coronavirus pandemic and its economic repercussion means that liquidity in the bond markets could prove even worse than in recent history.

“The current slew of negative factors means markets may experience more than just a seasonal liquidity slump this year,” says Tabula’s CEO, Michael John Lytle. “As European lockdowns ease, there is a risk of a third wave of cases in the middle of winter. In addition, there is increased focus on rising debt levels and expectations of worsening economic data is beginning to grow. All of these have the potential to temper the recent vaccine-led relief rally and lead to further defaults. It seems like we have had all the good news.”

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The illiquidity associated with the normal over-the-counter (OTC) bond market trading infrastructure is leading bond investors to look for alternatives in the fixed-income exchange-traded fund (ETF) space. Whereas assets held in ETFs are accounting for a small slice of the overall bond market, ETF adoption among bond investors is gradually increasing. “Growth in fixed income ETFs was inevitable, given the huge shift towards passive products and the success of ETFs in equities,” Michael John Lytle said at the beginning of November.

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Tabula, for instance, runs the Tabula iTraxx IG Bond UCITS ETF (London Stock Exchange: TTRX), which tracks a benchmark index reflecting the performance of a basket of EUR-denominated corporate investment grade bonds and replicates the credit risk profile of the iTraxx Europe Index. iTraxx Europe, as the most liquid European investment-grade corporate credit instrument, covers 125 liquid European investment grade entities and used as a reference for both long and short credit default swap positions.

## The End of Low and Stable US Inflation

Inflation is also an escalating concern among institutional investors. The US Federal Reserve has committed to a new inflation regime, allowing inflation to run ahead of its historic two percent

target, with the incoming Biden administration expected to be more supportive of an accommodative monetary policy and to increase inflationary pressure. Biden's pick for Treasury Secretary of ex-Fed chair Yellen suggests a close tie-up between fiscal and monetary authorities, points out the team at Tabula. According to the European fixed-income ETF provider, "these factors, combined with the demand/supply fallout from COVID-19, mean that, medium term, inflation is once again on the agenda."

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"This year, we have witnessed extraordinary monetary stimulus, which when combined with loose monetary policy, introduces impetus for future inflation," says Michael John Lytle. "The Federal Reserve Board balance sheet has doubled in six months, and global narrow and broad money supply are up 22 percent and 14 percent respectively this year – annual growth rates last seen in 1993 and 2008 respectively," he continues. "Changing Central Bank mandates and new fiscal policies are also putting pressure on inflation. The incoming Biden administration is committed to further COVID-19-related stimulus, including more direct payments to households," says Lytle. "This, combined with what the Fed does next, could significantly affect the long-term outlook for US inflation."

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"It's becoming ever more likely that the era of stable developed market inflation is coming to an end," said Lytle in early November. The prospect of higher inflation increases the attractiveness of Treasury-inflation-protection securities, or TIPS. Tabula, the London-based asset manager focused on fixed income, recently launched the Tabula US Enhanced Inflation UCITS ETF (London Stock Exchange: TINF; Borsa Italiana: TINE), to provide exposure to both realised and expected inflation in a single index.

"Currently, the ETF market offers a choice between traditional inflation-linked bonds, delivering realised inflation, and more sophisticated products offering exposure to inflation expectations but with no real yield," Lytle explained the rationale behind Tabula's US Enhanced Inflation UCITS ETF. "Our conversations with investors revealed that most want exposure to both realised and expected inflation, ideally in the same product."

The ETF combines a TIPS portfolio with exposure to US inflation expectations, tracking the new Bloomberg Barclays US Enhanced Inflation Index, which Tabula co-developed with Bloomberg. The index delivers realised US inflation via exposure to US Treasury Inflation-Protected Securities (TIPS) across a wide range of maturities. The ETF tracking the index takes exposure to 7-10-year US TIPS, in combination with a short position in 7-10-year US Treasuries, which provides reactive but liquid exposure to medium-term inflation expectations.

*This article featured in HedgeNordic's report Alternative Fixed Income Strategies.*