We see liquidity in Asian USD Bonds improving

Martin Brennan

Head of Risk Control

Mr. Brennan has been a member of the Double Haven team and legacy firms since 2002, in the role of Head of Risk Control. Martin entered finance/investment banking in 1990 in risk management holding multiple positions including Mitsubishi UFJ Hong Kong, Head of Risk (2000-2002), Lehman Brothers, Head of European Fixed Income Risk Management (1998-2000), ABN Amro, Head of Equity Risk, London Trading (1996-1998), and UBS, Senior Risk Manager (1990-1996). Prior to his investment banking career Mr. Brennan was a mathematician working for the British government (1985-1989). He graduated with a B.Sc. Mathematics Paisley University, Scotland (1984); Post Graduate Diploma, Pure Mathematics, Dundee University, Scotland (1985); Master's Degree, Statistics, Birkbeck College, University of London (1993).

Q1: How do liquidity conditions look in Asia currently and how do they differ from those in US and Europe?

The main difference is that bank inventories in the US and Europe have fallen due to increased regulatory constraints post Global Financial Crisis. Though a lot of western banks pulled back from Asia following the global financial crisis, they have been replaced by regional and local institutions and a rapidly developing Asian USD bond market. So, I would say that liquidity is improving in Asia.

By way of illustration, from 2015 to 2016 we have seen a 20% increase in the number of our cash trading counterparty lines. In 2011 we had cash trading relationships with 20-25 brokers active in Asian bonds and now we have over 50. Market trading activity has increased as the average number of quotes we receive for investment grade names is up 60% year on year and for sub-investment grade names is up by 100%. The depth of the market has improved markedly as we have seen firms able to trade in size increase - from 10 on average in 2015 to 18 today.

"I would say that liquidity is improving in Asia"

Q2: Have you seen significant changes in bid-offer spreads over the past few years, especially since 2H2015?

It is worth bearing in mind that bid offer spreads do vary quite a lot over time and market conditions. However, our proprietary liquidity tracking algorithm shows that bid offer spreads from Q1 2015 to Q2 2016 have tightened. For example single A rated USD bonds and above have tightened by 41.6%, BBB- by 10.6% and BB+ below by 7.1%. Though this is a single comparison it does speak to the rather active secondary market in Asia.

Q3: How do you calculate liquidity? How do you ensure that the estimates are appropriate for your liquidity monitoring?

We have developed our own proprietary models to monitor liquidity and risk. The models take account of bid/offer volatility, position size, price momentum, spreads and other variables. The models produce daily liquidity estimates that are calibrated against external, independent liquidity assessments. In short, we estimate the time required to liquidate any given position and portfolio. The Risk Control team cross checks this data with input of our traders and data from third party providers. I think we have a fairly accurate and robust measure on the liquidity of the portfolio and in the market.

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"When put to the test in real market conditions, the Risk Control Team's models proved to be very accurate"

"US rate rise is likely to have a muted impact upon Asian USD bond markets"

Q4: How do you manage liquidity in both normal markets and under stressed conditions?

We carefully monitor liquidity, concentration and gearing. We have a number of tools that we use to monitor liquidity conditions to ensure that there is no indication that liquidity is going to fall away. We also stress test our funds under numerous scenarios to understand how our liquidity profile will behave. The Risk Control team computes a liquidity runoff table – our positions are ordered by liquidity, bid/offer, size, and rating and by brokers' historical volume in each name. All of this forms the foundation of a liquidation strategy for when markets are stressed – we always know which names we can sell, in what order, at what cost, to whom etc.

Q5: Theories and estimates aside, do the models and tools work in practice?

Yes. The Risk Control Team's models were strenuously tested in 2008 GFC and across a wide range of subsequent market conditions and scenarios.

When put to the test in real market conditions, the Risk Control Team's models proved to be very accurate.

Q6: What is the outlook for market liquidity in Asia given concerns over rate hike in the US?

Over the last eight years we have seen an increase in the importance of Asian regional investors. In 2009 almost half the market were European and US investors - today that number is 29%, yet the market issuance has grown three fold. So the region is much less dependent on foreign inflows and outflows. We call this the "Asiafication" of the Asian USD bond market. US rate rises are likely to have a muted impact upon the Asian USD bond market. The Asian USD credit market is not really correlated to other USD markets. For example from 2010-2015, the JACI's daily correlation to UST (5-year) and the Barclays Aggregate Bond Index was 0.07 and 0.11, respectively.

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