Liquidnet Listed Derivatives

Fixed income futures liquidity returns

Was 2022 as bad as it seemed?

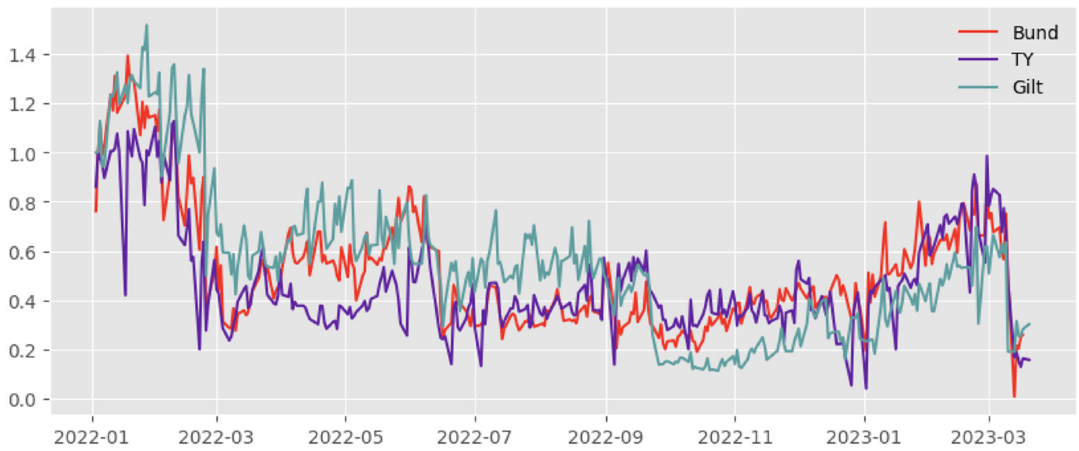
If you were to take a glance at Figure 1 below, you might suppose that 2022 was a write-off for the fixed income market. Higher volatility and geo-political risk certainly hurt liquidity.

Touch liquidity as a measure of liquidity

Needless to say when looking at touch liquidity—which obviously exists on very different scales for different countries, so we've standardised it here—the impact of Russia's invasion of Ukraine is clear with liquidity quickly dropping 40-50%.

It remained at subdued levels throughout spring and summer, and in October 2022 was ~60% lower than at the start of the year. Throw in the "mini budget" and things only got worse for the UK immediately after, with touch liquidity, at its worst, down more than 80%.

Figure 1
Liquidnet ETD's main tracker for touch liquidity[1]



Source: BMLL Data Lab

The start of 2023 saw a noticeable improvement, but that stopped abruptly as the financial sector's vulnerabilities bubbled to the surface and touch liquidity quickly fell back to the lows seen last year.

Traders need to be aware of the possibility of a long hangover periods. It took a long time for liquidity to recover from the impact of the Russian invasion. Figure 1 also shows the impact of Truss's policies on liquidity, which lingered long after her departure and was still visible in February this year.

Even if current volatility passes, it seems unlikely we'll see a rapid recovery in liquidity.

So, was as bad as it all seemed?

It is a question worth asking. The size at the touch is one way to measure liquidity but it doesn't capture "hidden" volume.

If market structure changes, there might be less size shown on the touch—for example if high frequency trading plays a greater role—but if that volume churns more quickly, a trader might be able to trade the same volume with a similar impact on price.

[1] A measure of the size (in terms of number of contracts) one can trade on the bid or offer, averaged over the course of the day.

To this end, we looked at volumes on large market moves. We split trading into one minute buckets and, on each day, we took the top quartile of price moves, considering volume over that period.

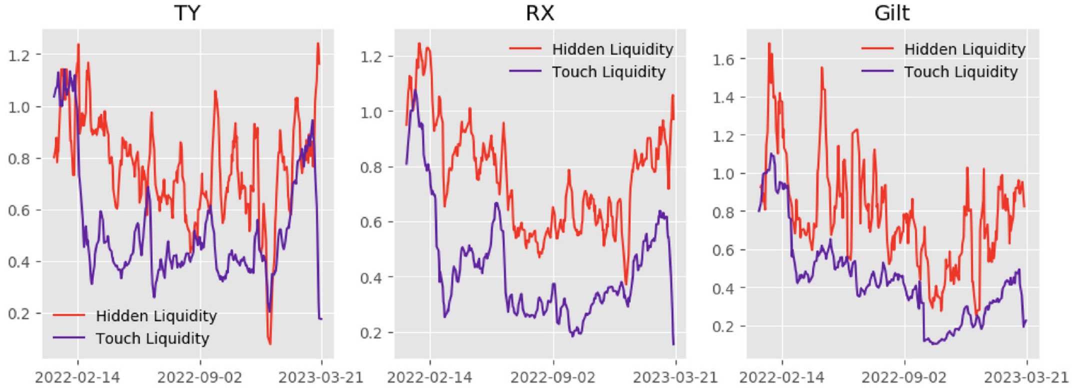
Put simply, we asked how much volume does it take to push the market? What we found is that where it takes a smaller trade size it points to worse liquidity and where that volume is larger, markets are clearly deeper.

This led us to the following conclusion, **"real" liquidity last year wasn't as bad as it looked and has held up remarkably well in current market volatility**.

If we look at Figure 2 below, we can still see a drop in liquidity during 2022, but one which was 10ppt less severe than the drop seen in the more simple touch liquidity measure. Additionally, any drop in recent sessions is scarcely noticeable. This points to something of a change in liquidity structure, offsetting the drop in touch liquidity.

Figure 2

Standardised volume to price ratio for the TY, RX, and Gilt contracts



Source: BMLL Data Lab

Short outlook to round it off

What does this mean going forward and what might we expect for 2023?

There are two things to take from this for the remainder of the year.

Firstly, a liquidity hangover can see a deterioration in liquidity perpetuate over the long period of time. The impact of the Ukraine war and the UK mini budget lasted for a number of months and the possible challenges presented by financial sector vulnerabilities will disappear quickly.

Secondly, this highlights the importance of capturing liquidity conditions as a whole. Markets are often more liquid than they appear on screen but the challenge is to prove it. Don't always take touch liquidity at face value, it can diverge substantially from market sensitivity.

Questions? Wondering why we are emailing you about Listed Derivatives?
For more information, please contact us.

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