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Financial Times

Liquidity is terrible': poor trading conditions fuel Wall Street tumult

Small trades are triggering outsized price swings in the world's biggest capital markets

Liquidity across US markets is now at its worst level since the early days of the pandemic in 2020, according to investors and big US banks © FT montage/Bloomberg

Traders' ability to seamlessly buy and sell stocks, bonds and other financial products on Wall Street has deteriorated sharply this year, adding fuel to the big swings on the world's biggest and deepest capital markets.

Liquidity across US markets is now at its worst level since the early days of the pandemic in 2020, according to investors and big US banks who say money managers are struggling to execute trades without affecting prices.

Relatively small deals worth just $50mn could knock the price or prompt a rally in exchange traded funds and index futures contracts that typically trade hands without causing major ripples, said Michael Edwards, deputy chief investment officer of hedge fund Weiss Multi-Strategy Advisers.

He added: "Liquidity is terrible."

The fraught conditions have collided with a big shift in the global economy that has caught many portfolio managers off-guard: a growth slowdown, rising interest rates and intense inflation. Unprepared for the turn in sentiment, traders have abruptly repositioned their portfolios.

The liquidity drought is also affecting vital markets that companies use to fund themselves and governments tap to finance public spending. Minutes from the US central bank's latest policy meeting published last month showed that officials were concerned with the problems being created in the Treasury and commodities market by weak liquidity.

The trading landscape changed dramatically after policymakers in Washington and Brussels sought to safeguard Main Street from Wall Street in the wake of the 2008 financial crisis. Through a series of regulations introduced over the past 12 years, banks are now required to hold bigger capital cushions to protect their balance sheets against major swings.

It has meant banks now hold far fewer assets, like stocks and bonds, making them less nimble at responding to investors' requests to buy or sell, and gumming up the pipes that connect buyers and sellers.

"People \[banks\] are not willing to commit capital," said Edwards.

In debt markets, holdings of corporate bonds among the primary dealers that underwrite the US government's debt have gradually declined over the past decade, according to data from the New York Federal Reserve, taking another leg lower this year.

Banks have pulled back, in particular, from holding debt that is more vulnerable to rising interest rates, cutting their net positions in higher-quality bonds with a maturity of 10 years or longer into negative territory. Meanwhile, the health of the US government bond market — a benchmark for trillions of dollars in assets globally — is at its worst since the March 2020 market meltdown, according to a Bloomberg index.

“It is a frustration,” Jordan Sinclair, a research director at hedge fund Capstone, said of the lack of liquidity. “The global financial crisis was a failure of the banking industry. They took too much risk and gave too much leverage and it made sense for the regulators to make sure that could not happen again. But there are consequences.”

That has manifested in choppier trading. Sinclair estimated that the Vix index, a gauge of volatility in the US stock market, had jumped more than 5 points on a single trading day nine times in the 15 years before the financial crisis. In the 15 years after the crisis, it has happened 68 times.

And yet during that period, trading losses incurred by major US banks have been manageable and not threatened the overall financial system. It is a fact not lost on traders and investors, particularly after the fallout from the collapse of family office Archegos last year was broadly contained.

High-frequency trading firms like Citadel Securities and Jump Trading have filled part of the gap left by big Wall Street banks, but investors said the algorithms that help execute trades through those types of operators often meant that trading capacity was automatically reduced when stocks began to swing violently.

In May, investors hoping to trade e-mini futures on the S&P; 500 — one of the most important contracts that big money managers use to bet on the direction of the market — saw tiny offers to buy and sell when looking at their trading screens. Goldman Sachs registered that on some days less than $2mn worth of the contracts could be bought or sold at the price actively quoted in the market, the lowest level since March 2020.

Separate data from JPMorgan Chase underscore the fragility of the system. The bank measured how much of an order imbalance — the difference between buy and sell orders in S&P; 500 e-mini futures — it took to move futures 1 per cent in a five-minute period.

It took an order of around $900mn to move futures by that amount in May, around 67 per cent smaller than the size of a trade imbalance that would have been required from 2017 to 2019. The bank’s strategists found that a similar phenomenon occurred in futures tracking US government bonds, warning that “liquidity recently started declining again, and the market depth over the last three months is now the lowest since March 2020”.

The weak liquidity has amplified volatility in the stock market, investors say. In back-to-back trading sessions last month, Walmart and Target suffered their biggest declines since 1987 after each warned about intensifying cost pressures. The slides wiped $71bn from the pair’s market valuation.

Outsized daily moves in shares have also been recorded in Facebook-owner Meta, Amazon and Netflix, while measures show the volatility of blue-chip companies like Apple, Microsoft, Visa and Coca-Cola has surged.

“There is plenty of trading happening but in terms of order size it has been smaller in recent months,” said Mary Phillips, the head of Dimensional. “I think that if you were the kind of asset manager trying to do large block trades quickly and you’re really specific about what you want to trade you could face liquidity challenges.”