Thursday, April 07, 2022

Matt Levine is(n't) worried about liquidity

Matt Levine is one of the best finance writers in the world. His daily "Money Stuff" is one of the most-read and most-appreciated write-ups on Wall Street. Bros and nerds love him in equal measure. His piece is comedy, but it always goes deep into the weeds on interesting topics in an expert way and his combination of in-group jokiness and expert-level analysis make it an informative and entertaining read.

One of Matt's ongoing jokes over the years has been to title a section: "People are worried about liquidity," or "People are worried about bond market liquidity" and so on.

It's become a David Letterman style joke where the more you say it, the funnier it gets, and it's a standard joke on Wall Street. You can see someone at the FT riffing on it in the headline at right. The strong implication of the joke is that the market is chronically worried about liquidity and perhaps overly worried. Bad liquidity is fun to talk about, but often overstated as a risk. And liquidity is hard to measure accurately.

I was thinking about this because yesterday I did a Zoomer with a large US real money client and the question of liquidity came up, as it often does. On the call, I discussed how I am currently bearish risky assets into May 4 FOMC because I think the market is very slow to visually process the light of the oncoming QT train. I got a few questions about possible stress points in the market and then was asked: "How is liquidity?"

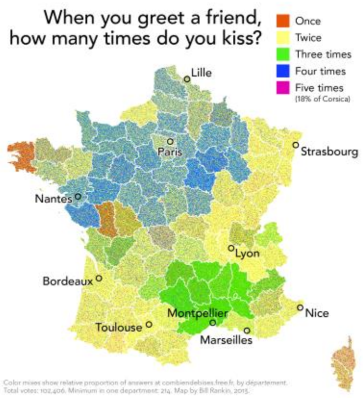
There are popular charts that show (for example) top of book in S&P futures is super thin compared to what it used to be. The implication is that liquidity is worse than ever. I am not so sure. My general view on liquidity is:

1. Liquidity is much more fragmented and hidden than it used to be and as such, top of book is not a great way to measure liquidity. In 2012, EBS might show EURUSD as 1.1005/06 in 28X41 million. Now, the price might look more like 05/06 in 4X12. Does this mean EURUSD is less liquid? Not really. It means:
   a. There are **more platforms** and ECNs than there used to be.
   b. Almost all orders are fully **iceberg'**d. This was not always the case. In OTC FX markets, most electronic and human traders show only 1 million and hide the rest behind via iceberg. If mot orders are iceberg'd, top of book data is almost meaningless.
   c. **Dark pools** are more popular than they used to be. Dark pool liquidity is not visible.
   d. There is **more internalization** than there used to be. If EURUSD is 22/23 and you hit a single dealer platform for 100 million euros at 21.. The hedging algorithm is not going to join the 23 offer on EBS. It's going to shift its stream from 22/23 to 21.5/22.5. Every buyer in the world with that bank's stream will pay the 22.5 if they want euros and the bank will slowly get out of the 100 million euros it's long without ever leaving an order in the market. Internalization became a massive priority for market makers over the past five to seven years. e-FX platforms try as much as possible to avoid the external market when hedging. They use it, but much less than they used to.

amFX

Brent Donnelly

bdonnelly@spectramarkets.com
(212) 398-6230



http://www.radicalcartography.net/index.html?frenchkisses

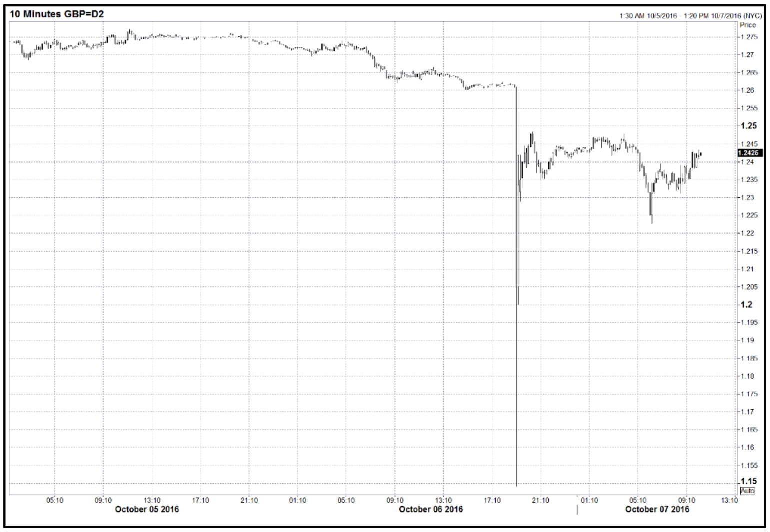
Current Views

Short EURUSD at 1.1000
Stop loss at 1.1201
Take profit 1.0755

Short GBPUSD at 1.3215
Stop loss at 1.3353
Take profit 1.2811

2. Liquidity is in some ways better now than it was before ~2017 because algorithms are programmed better. There was a series of flash crashes as the algos came of age. Some algorithms were poorly programmed and triggered chaotic order cascades that resulted in flash crashes. Algos behaving badly caused or exacerbated some historic crashes in markets including:
    a. May 2010 equity flash crash. Here's my story of that day
    b. October 2014 bond market flash (up) crash. Report here
    c. January 2015 EURCHF crash (SNB own goal, not liquidity problem)
    d. October 2016 GBPUSD flash crash (see chart below)
    e. Cross/JPY flash crash on Apple's profit warning in January 2019

GBPUSD 10-minute chart on the day of the flash crash (y-axis is 1.15 to 1.28)



I was long 40 million GBPUSD at 4:30pm that day and decided to square up before I left. Good miss!

Flash crashes were hotter than Hansel in the mid-2010s; I was asked to speak about the topic at a conference (here's the piece I wrote for the conference). Central banks hosted many meetings to discuss solutions after the GBP dirtnap. Crash risk was the big question on most client calls for a while.

Now, flash crashes are less common. The events in the mid-2010s led to a series of regulatory and internal investigations that changed algorithmic behavior to avoid future repeats. Training, speed bumps, fat finger protection, and regulation of human traders were all buttoned up significantly. It has worked, somewhat. There was still some crashy stuff happening during COVID, but few algorithms now have brute force "sell at market" logic that can potentially trigger a waterfall of stop losses at absurd, non-economic levels. Traders know not to just hit SELL SEND SELL SEND SELL SEND when they are panicking. Markets are always somewhat fragile, but I don't think they are more fragile now than they were in the past. If anything, some of the causes of past flash crashes have been fixed.

3. Finally, liquidity is non-linear and regime sensitive, so: asking “how’s liquidity?” will not give you much information unless you are about to transact imminently. *Liquidity is always there, until it isn’t*. Whether liquidity is good or bad right now is not super indicative of whether it will be there when you need it. Hope for the best and prepare for the worst.

A summary of today’s am/FX so far

“How’s liquidity?”

“Liquidity is fine. But it might not be fine later. But it probably will be.”

END OF SUMMARY

Extra credit homework

If you’d like to read an interesting paper about liquidity, check this out: CME Group: Assessing liquidity – revisiting whether book depth is a sufficiently representative measure of market liquidity. Super interesting. Key excerpt:

> As pointed out in Figure 2, the book depth decreased by 90% and this fact in isolation could lead one to incorrectly conclude that the market in mid- to late-March 2020 was “illiquid”, and few transactions were able to occur. However, record volume was still able to be transacted, in fact at a rate of nearly twice as much as late January 2020. Given this, it is hard to argue that the market was “illiquid” in some absolute sense. The “fill quality” did degrade but not to the extent that looking at book depth would lead one to believe – or indicate an inability to access the market or manage the risk required.

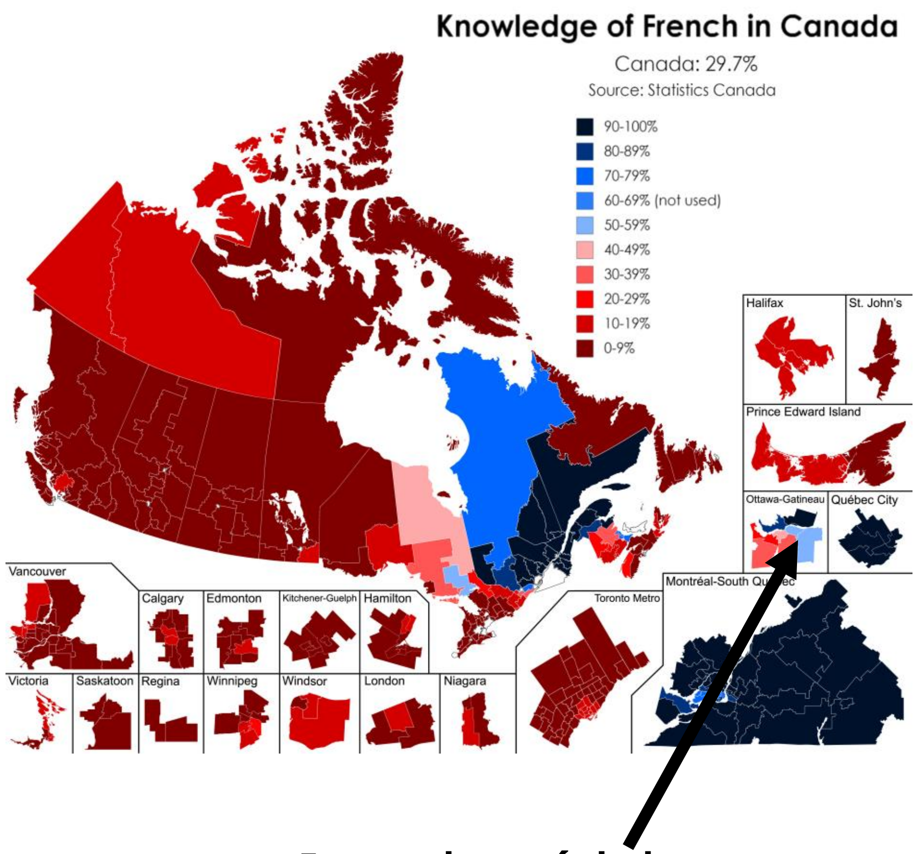
An exciting chart

This is the weekly USDJPY chart. With Japan barely pushing back on JPY weakness, a break higher to 135.00 over the next few months isn’t hard to envision.

Closing thoughts

Punk 6529 on how short life is. Have a bonne day.

good luck ⇅ be nimble



Je suis né ici

Click here to subscribe to am/FX

Markets and Trading Commentary Disclaimer

This material has been provided by Spectra Markets, LLC ("Spectra Markets"). This material is confidential and therefore intended for your sole use. You may not reproduce, distribute, or transmit this material or any portion thereof to anyone without prior written permission from Spectra Markets.

This material is solely for informational and discussion purposes only. Spectra Markets is not a registered investment advisor or commodity trading advisor. This material should not be viewed as a current or past recommendation or an offer to sell or the solicitation to enter into a particular position or adopt a particular investment strategy. Spectra Markets does not provide, and has not provided, any investment advice or personal recommendation to you in relation to any transaction described in this material. Accordingly, Spectra Markets is under no obligation to, and shall not, determine the suitability for you of any transaction described in this material.

To be clear: Your individual circumstances have not been assessed. You must determine, on your own behalf or through independent professional advice, the merits, terms, conditions, risks, and consequences of any transactions described in this material. Securities described in this material may not be eligible for sale in all jurisdictions or to certain categories of investors. This material may also contain information regarding derivatives and other complex financial products. Do not invest in such products unless you fully understand and are willing to assume the risks associated with such products. Neither Spectra Markets nor any of its directors, officers, employees, representatives, or agents, accept any liability whatsoever for any direct, indirect, or consequential losses (in contract, tort or otherwise) arising from the use of this material or reliance on information contained herein, to the fullest extent allowed by law.

The opinions expressed in this material represent the current, good faith views of the author at the time of publication. Any information contained in this material is not and should not be regarded as investment research or derivatives research as determined by the U.S. Securities and Exchange Commission ("SEC"), the U.S. Commodity Futures Trading Commission ("CFTC"), the Financial Industry Regulatory Authority ("FINRA"), the National Futures Association ("NFA") or any other relevant regulatory body. The author is currently employed at a trading desk. The opinions may not be objective or independent of the interests of the author. Additionally, the author may have consulted with various trading desks while preparing this material and a trading desk may have accumulated positions in the financial instruments or related derivatives products that are the subject of this material.

Spectra Markets does not guarantee the accuracy, adequacy or completeness of the information presented in this material. Past performance and simulation data do not necessarily indicate future performance. Predictions, opinions, and other information contained in this material are subject to change continually and without notice of any kind and may no longer be true after the date indicated. Any forward-looking statements speak only as of the date they are made, and Spectra Markets assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results could differ materially from those anticipated in forward-looking statements. The value of any investment may also fluctuate as a result of market changes.

Spectra Markets is affiliated with Spectra FX Solutions LLC, an introducing broker that is registered with the NFA; Spectra FX Solutions LLP, which is a registered entity with the U.K.'s Financial Conduct Authority; and SpectrAxe, LLC, a swap execution facility that is currently in the process of registering with the CFTC. The disclosures for Spectra FX Solutions LLC and Spectra FX Solutions LLP related to the separate businesses of Spectra FX can be found at http://www.spectrafx.com/.