Liquidity Black Holes

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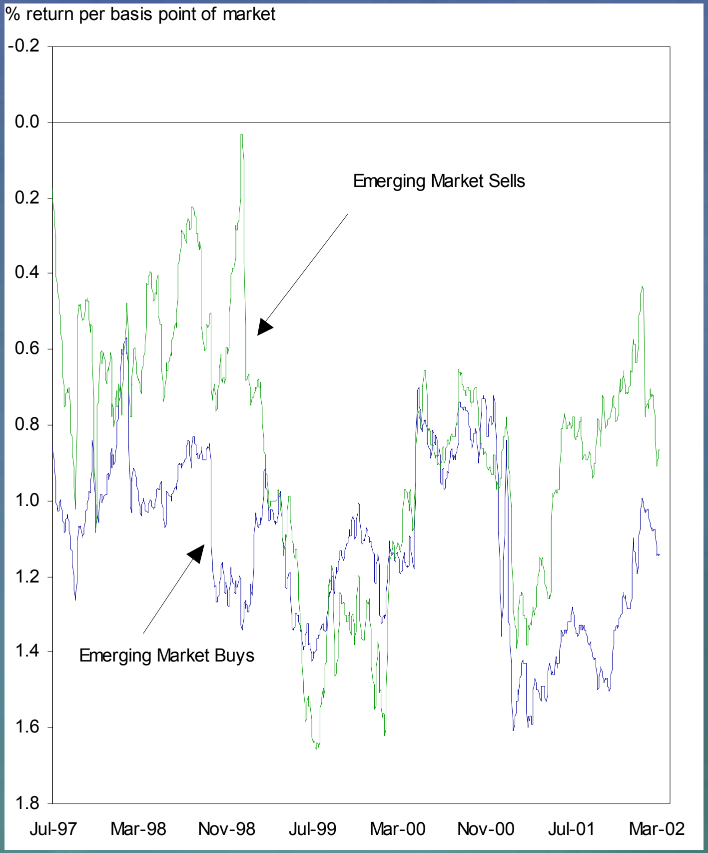
What is liquidity and why does it matter?

- Speed, ease and cost of transacting
- *Recorded* spreads are a poor measure
- Poor liquidity is associated with volatility

Price impact of trading

- Big price-impact = low liquidity
- Liquidity is not one number
- Liquidity is variable and this matters



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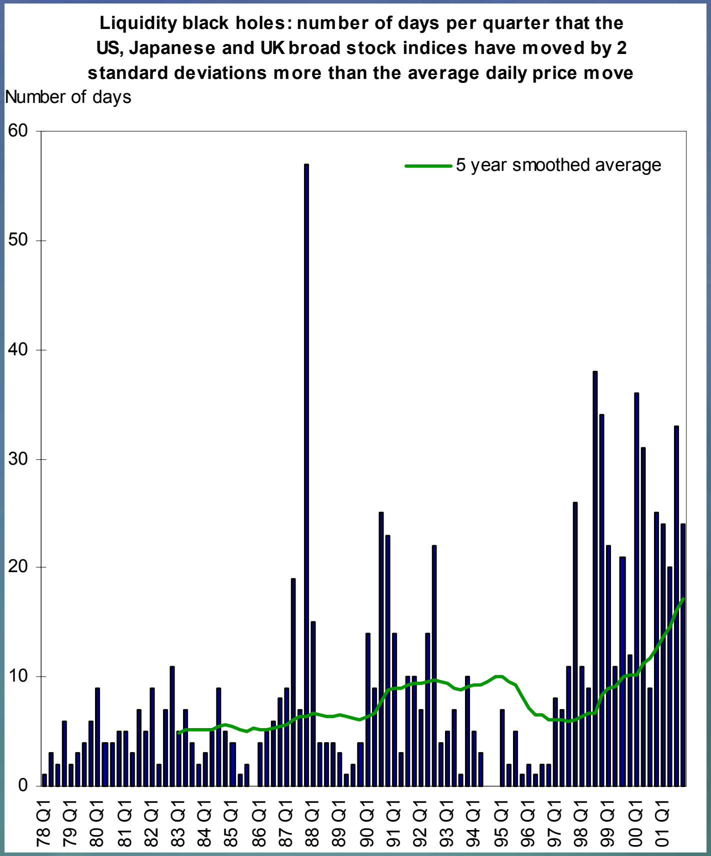
Liquidity Black Holes

- There are episodes in which liquidity disappears and then returns
- Liquidity *black holes* are becoming more frequent
- Some markets are getting bigger and yet thinner



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Liquidity needs diversity

- There is less diversity because
  - Information costs have fallen
  - Less diversity within and between firms
  - Switch to market-sensitive risk management systems

Liquidity needs losers

- Regulators are encouraging these trends
- Defending diversity means accepting losses
- Financial system needs more freedom

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Avoiding liquidity black holes

Average number of Liquidity Black Holes per quarter		Change from the last bubble to the previous
FTSE 100	2.594	4.100
UK 10 year bond	2.784	-1.958
JP 10 year bond	2.986	-2.175
S&P500	3.078	3.133
Toronto SE	3.156	6.092
Topix	3.289	3.783
$/Yen	3.445	3.608
US 10 year bond	3.580	-1.667
$/CHF	3.742	-2.575
$/£	3.766	-5.500
Euro/$	3.898	-0.950

Conclusion

- Liquidity black holes matter
- Liquidity needs diversity and losers
- Different asset classes have distinctive liquidity trends