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Bipolar markets

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May, being Mental Health Awareness Month, provides a perfect opportunity to assess the current state of the market and identify potential symptoms of its existing imbalances and disorders. To do this, we must first conduct health checks on the market structure, its key players, and their motives, enabling a better understanding of potential sources of distress. Then, we can explore available specialized treatment options.

Since the 1970s and the collapse of the Bretton Woods arrangements, which had governed the world's financial order for almost three decades, the over-the-counter (OTC) market emerged as a dominant force. Commercial financial institutions, such as commercial and investment banks, became its backbone, shaping the financial world's order for another four decades. At its core was LIBOR (London Interbank Offered Rate), a reference rate used globally to price the cost of capital flowing around the world from capital-rich countries like Japan or Belgium to those in need.

It's fair to say that in the 1990s, the funding market remained relatively balanced, with major disruptions arising mainly from emerging markets. At that time, emerging market debt represented one of the few 'non-traditional' financial investment sources offering potentially extraordinary high rates of return, attracting increasingly speculative inflows. These inflows were significant enough to compress risk surfaces and improve risk parameters, allowing even more inflows and larger exposures to be built. However, nothing can last forever, especially 'too good to be true' stories. Reality checks, such as assessing fundamentals versus valuations, led to sharp capital outflows and a series of 'local' crises.

Some of us remember the 'journey' from the Mexican crisis in 1995 through the Asian crisis in 1997, culminating in the Russian crisis in 1998. The 1998 crisis was by far the most serious, involving investors from all major financial centers, including the central bank of central banks, the FED, which orchestrated the rescue plan for one of the most esteemed financial institutions, Long-Term Capital Management Fund (LTCM). This single event is perhaps the most significant factor influencing investment philosophies in the years preceding the Global Financial Crisis (GFC), characterized by a 'buy now and worry later' mentality, assuming the Fed would handle any fallout.

Before delving into the role of central banks, let's first examine the repercussions of the GFC on the market. With the collapse of Lehman Brothers, one of the market's largest investment banks, the interbank market ceased to function almost instantly and has yet to fully recover. This singular event severely disrupted the natural flow of capital, sending the market into a state of paralysis.

The only entities equipped with sufficient resources and credibility to restore order were the central banks. Among them, the Federal Reserve (Fed) stood out, taking decisive action by deploying numerous unconventional monetary tools to revive the market, albeit with limited success. Consequently, markets found themselves heavily reliant on central banks not only as providers of liquidity but later as absorbers of liquidity as well.

Furthermore, on the regulatory front, central banks have sought to increase supervision. However, their credibility suffered a setback last year with the crisis among regional banks in the USA. One particularly unwelcome consequence of overregulation has been the unprecedented growth in areas subject to less restrictive regulatory rules, such as the private capital funding space. Market reports suggest that these investors are employing disproportionately high leveraged investment strategies, raising concerns about potential market instability when positions are forced to be liquidated.

When discussing market infrastructure, it is impossible not to mention the deteriorating secondary market liquidity. Since the GFC, key market makers have been reducing the size of liquidity pools, resulting in wider bid/offer spreads and, in many cases, the absence of one side of the price. Additionally, notable changes have occurred on the buy-side, with passive investment strategies experiencing rapid growth. The global Exchange-Traded Fund (ETF) industry is now valued at $10 trillion, underscoring its undeniable impact on the market.

To summarize, the GFC has opened a new chapter for the market, with central banks now directly supporting its key functions. Despite the launch of new products and solutions, the market structure has not changed much and still relies on the old OTC model supported by advanced high-tech solutions such as algorithm-based trading platforms. Valuations of OTC products have been affected by the above-mentioned factors. Probably excess liquidity induced by central banks over the years following the GFC is the one of the worst, leading to imbalances manifested by outbursts of volatility.

Going forward, it seems we must learn to live with the market's disorders while central banks' interventions remain the only effective treatment. In the end, many are convinced that there is no effective cure, as those (i.e., central banks) who have been saving the market are also responsible for creating these disorders in the first place.

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Important notes