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ETFs Are Passing the COVID-19 Crisis Test

BY SHELLY ANTONIEWICZ

Financial markets have continued to churn since our previous post, which examined **mutual fund investors' initial reactions to the COVID-19 crisis**, with the S&P 500 index and yield on the 10-year Treasury bond gyrating wildly.

How have exchange-traded funds (ETFs) weathered the intensifying financial market fallout from the pandemic? In short, even with volatile prices and widening bid-ask spreads in stock and bond markets, trading of ETF shares has been orderly and has contributed to price discovery in the first weeks of March. In addition, net ETF share creations and redemptions, although varying by asset class, have been modest.

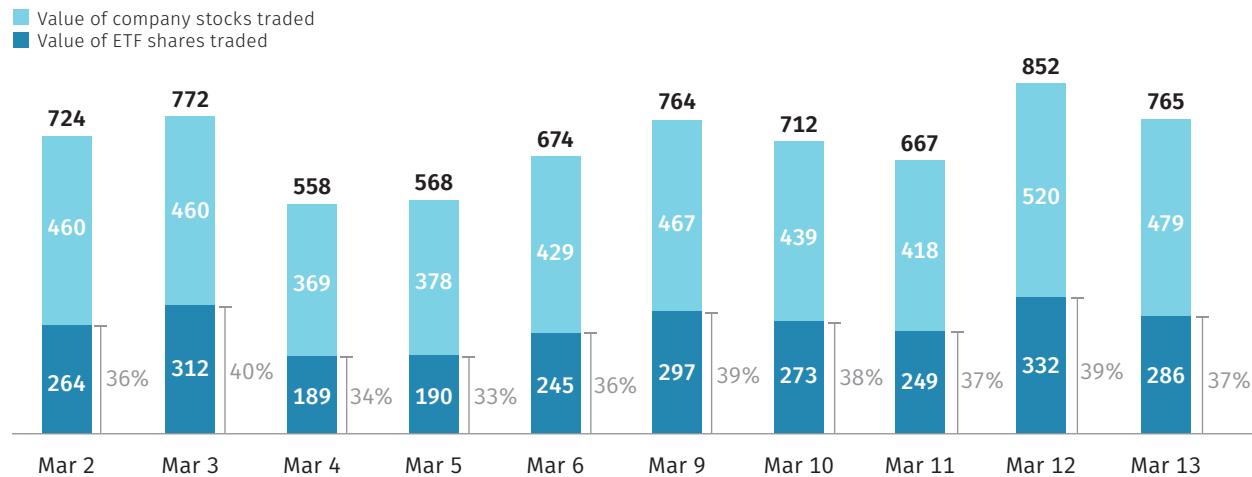
Trading in ETF Shares on Stock Exchanges Has Been Orderly

ETFs provide a mechanism for investors to transfer risk and hedge their exposures quickly and efficiently. Under normal market conditions, trading in ETF shares usually accounts for between 25 to 30 percent of all daily US stock market trading volume in dollars. But during stressed events, we often see investors turn to ETFs. That's happening now: in the first two weeks of March, daily trading in ETFs consistently exceeded 30 percent of total dollar volume and, for several days, was closer to 40 percent (Figure 1).

FIGURE 1

Investors Use ETFs to Quickly and Efficiently Transfer and Hedge Risks in Stressed Markets

Billions of dollars; daily, March 2–March 13, 2020



Sources: Investment Company Institute, Bloomberg, and Cboe Exchange, Inc.

ETFs Have Contributed to Price Discovery

Trading in ETFs can help market participants determine market-clearing prices for underlying stocks and bonds more quickly and accurately. For example, on March 9 and March 12, US equity futures trading was suspended as futures on the S&P 500 index fell 5 percent and hit “limit down” prior to the opening of the US stock exchanges. On both these days, several ETFs that track the S&P 500 index continued to trade in the premarket and the subsequent changes in their share prices—a reflection of market participants’ evolving views—closely matched the change in value of the S&P 500 index at the opening of the stock exchanges.

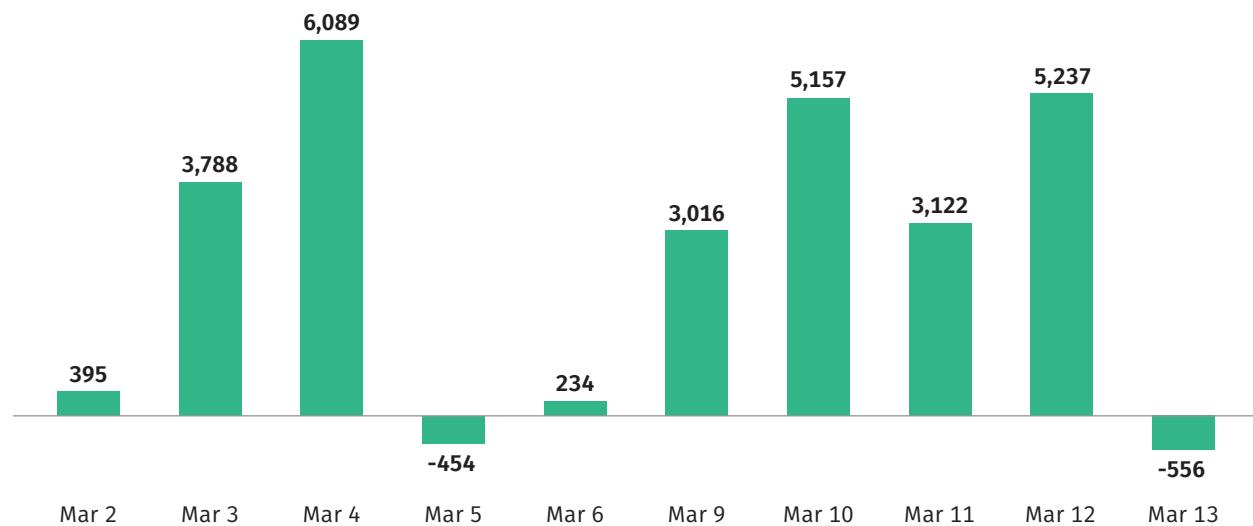
Net Creations and Redemptions of ETF Shares Have Been Modest

Domestic equity ETFs are estimated to have had inflows (net creations of shares) on eight out of the first 10 trading days of the month, with a cumulative total of \$26 billion (Figure 2). The vast majority of domestic equity ETFs conduct in-kind transactions—creating and redeeming primarily in baskets of securities, not in cash. So these inflows required market participants to buy stocks to assemble the ETF creation baskets—thus supporting the underlying market.

FIGURE 2

Domestic Equity ETFs Received Inflows in First Two Weeks of March

Millions of dollars; daily, March 2–March 13, 2020



Memo:

» Total net issuance of domestic equity ETFs from March 2 to March 13: **\$26.0 billion** (inflow)

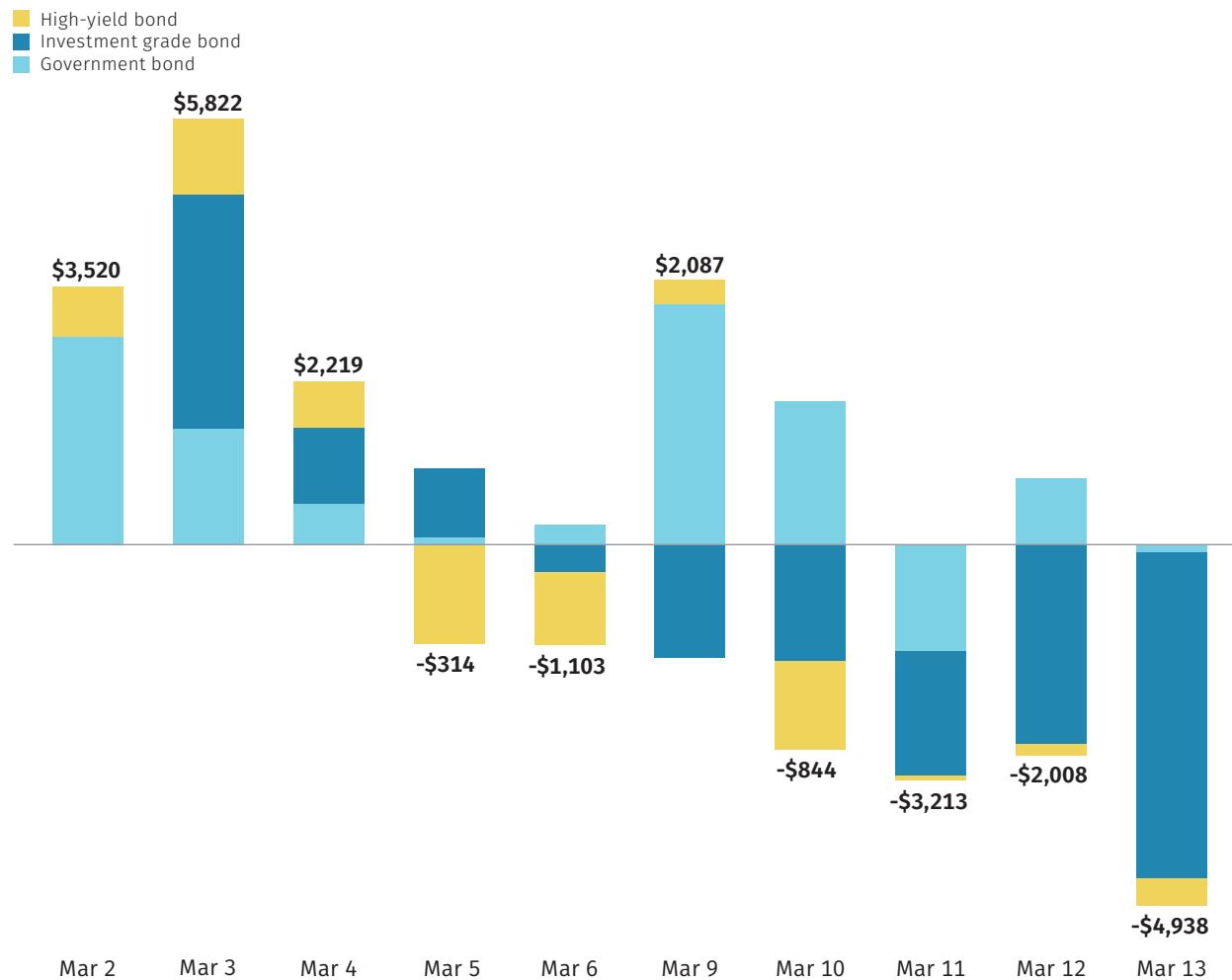
Sources: Investment Company Institute and Bloomberg

The three major categories of bond ETFs (government, investment grade corporate, and high yield) are estimated to have had inflows of about \$1 billion from March 2 through March 13 (Figure 3). Likely reflecting a substantial widening in credit spreads and a move to quality by investors, inflows to government bond ETFs (\$10 billion) more than offset outflows from investment grade bond ETFs (\$7 billion) and high-yield bond ETFs (\$1.5 billion). The shift away from investment grade credit exposure, however, was modest, as the \$7 billion in outflows from investment grade bond ETFs represented only 1.7 percent of the assets in these funds as of the end of January.

FIGURE 3

Inflows to Government Bond ETFs Offset Outflows from Corporate Bond ETFs in First Two Weeks of March

Millions of dollars; daily, March 2–March 13, 2020



Memo:

- » Total net issuance of government bond ETFs from March 2 to March 13: **\$9.9 billion** (inflow)
- » Total net issuance of investment grade bond ETFs from March 2 to March 13: **-\$7.3 billion** (outflow)
- » Total net issuance of high-yield bond ETFs from March 2 to March 13: **-\$1.5 billion** (outflow)

Sources: Investment Company Institute and Bloomberg

High-yield bond ETFs had mild outflows totaling only \$1.5 billion (2.2 percent of January assets) in the first two weeks of March. Indeed, primary market activity of high-yield bond ETFs—creations and redemptions that directly involve underlying high-yield bonds—accounted for a small share of the daily trading that occurred in high-yield bonds from March 2 through March 13 (Figure 4). Even on March 3, when high-yield bond ETFs had \$1.8 billion in estimated primary market activity, these transactions represented less than 10 percent of total dollar volume traded in underlying high-yield bonds.

FIGURE 4

Primary Market Activity of High-Yield Bond ETFs Was a Small Share of High-Yield Bond Trading

| Date | High-yield bond ETF primary market activity* | Value of all high-yield bonds traded | Primary market activity as a share of high-yield bonds traded |
|--------|--|--|---|
| | Billions of dollars | Billions of dollars | Percent |
| Mar 2 | \$1.3 | \$17.0 | 7.6% |
| Mar 3 | 1.8 | 18.5 | 9.7 |
| Mar 4 | 1.0 | 20.6 | 4.9 |
| Mar 5 | 1.4 | 20.9 | 6.7 |
| Mar 6 | 1.1 | 16.1 | 6.8 |
| Mar 9 | 0.8 | 15.6 | 5.1 |
| Mar 10 | 1.4 | 18.4 | 7.6 |
| Mar 11 | 0.5 | 19.4 | 2.6 |
| Mar 12 | 0.4 | 19.1 | 2.1 |
| Mar 13 | 0.5 | 17.4 | 2.9 |

*Primary market activity is estimated as the sum of creations and redemptions.

Sources: Investment Company Institute, Bloomberg, and FINRA

Overall, in the past two weeks, ETFs have acted as a relief valve for the underlying stock and bond markets by allowing investors to gain or shed risk exposure to various asset classes. ETFs did not experience mass redemptions, nor did they create any knock-on effects in the underlying markets.

We have often heard that ETFs haven't really been tested. So far, despite the COVID-19 pandemic, it looks like ETFs are healthy and robust.

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