The future of corporate bond market liquidity

In 2011, investors were concerned about a perceived lack of consistent liquidity in the corporate bond market. Perhaps worse, they were worried about a seemingly negative trend in the liquidity that Wall Street provides as part of its market-making function. These concerns were magnified during the volatile capital markets environment in the fall of 2011, when volatility was driven by various issues, including concerns of weaker global growth, the U.S. debt ceiling debacle, S&P’s downgrade of the U.S. sovereign debt rating and the ongoing chaos in the eurozone, to name a few.

In this article, we attempt to provide some context around corporate bond market liquidity on a few different dimensions, and we’ll discuss the investment implications of this more challenging environment. We believe there will continue to be investment opportunities, but investors will need to be prepared for greater volatility in the corporate bond market.

Reduced inventories at primary dealers mean greater spread volatility

Primary dealers are banking entities designated as trading counterparties of the Federal Reserve Bank of New York in its implementation of monetary policy. The absolute number of firms that meet the New York Fed’s requirements and standards (per their Primary Dealer Policy) has shrunk over time. There were 30 primary dealers in 1999; the universe declined to 16 in 2009, and it stands at 21 as of November 1, 2011. Notable recent terminations include Bear Stearns, Countrywide, Lehman Brothers and MF Global. While it’s true that an entity doesn’t need to be designated a primary dealer to be a secondary market maker and counterparty in the trading of the various sectors of the fixed-income arena, it is safe to say that the primary dealers capture the lion’s share of trading activity across fixed-income sectors.

With that important background in mind, Federal Reserve Bank of New York weekly statistical releases of Primary Dealer Positions includes a line item titled “Corporate
securities due in more than 1 year.” This line item primarily includes corporate bonds (both investment grade and high yield) but also includes some non-corporate securities such as collateralized mortgage obligations, real estate investment corp. securities and interest only/principal only strips issued by entities other than federal agencies or government-sponsored enterprises. These non-corporate security positions are believed to be small in this report, such that this data is considered a fairly accurate barometer of the corporate bonds that the primary dealers hold in inventory for their market-making operations.

Exhibit 1 details the history of this weekly statistical release from the New York Fed going back to 2001. From a market liquidity perspective, the important takeaway from this data is that the willingness or ability of the primary dealers to hold corporate bond inventory is currently a shadow of its former self. From a peak level of $235 billion in October 2007, primary dealer corporate bond inventories have shrunk by almost 80% to $51 billion in early November 2011. This is a level not seen since the middle of 2003.

In contrast, the size of the combined investment-grade and high-yield markets as roughly defined by Barclays Index inclusion rules has more than doubled since the end of 2001. This shrinking of secondary market-making liquidity, in the context of a market that has doubled in size, has far-reaching implications in an over-the-counter market. There is no centralized exchange to trade corporate bonds, so an investment manager’s ability to navigate markets is often driven by their success in coaxing a bid or an offer out of a Wall Street trading counterparty — often based on long-standing relationships or past business dealings with individual traders and their firms.

Exhibit 1: Corporate bond level ($)

There is most definitely a bit of the chicken versus the egg notion here, but there is also a definite correlation between reduced Street market-making and increased spread volatility. As a result, we don’t see the level of volatility falling precipitously any time soon.
Proposed legislative changes are also affecting liquidity and volatility

The Volcker Rule is an important part of the Dodd-Frank legislation (Wall Street Reform and Consumer Protection Act), and it is intended to lower the risk of financial firms by limiting proprietary trading. Given the complexity of the topic, and difficulty in defining what is meant by “proprietary trading,” there is enormous uncertainty regarding market-making activities, securities underwriting and how firms will be able to manage risk. The expectation is that broker-dealers’ ability to profitably trade with clients and provide liquidity will be adversely affected. In addition, as the cost of capital goes up for broker-dealers, modestly profitable activities such as market-making in high-quality assets will diminish and negatively affect the efficient functioning of markets.

There has been a dramatic shift in the structure of markets over the last five years. In many types of markets, Wall Street firms historically had been able providers of liquidity to investors, buying and selling with them using their own balance sheets. This served to blunt movements in markets, as broker-dealers would take the other side of customer trades and make a reasonable profit on that activity. This tended to reduce the volatility of markets, compared to situations where a broker-dealer needed to find another customer for a trade.

The ability of Wall Street to fill this role has been severely constrained, both through the economics of the business model and regulation. Even more dramatically, the growth of the alternative asset industry (private funds) has served to increase market volatility just as the Wall Street market-making model is being limited. The strategies of most private funds tend to be pro-cyclical and short-term focused, which only accentuates market movements. While investors might think these strategies are long-term focused, the actual management of the money is very short-term in nature. This is profoundly influencing financial markets, making them much more susceptible to extreme moves, which can be seemingly out of context with fundamental events.
**Investment implications**

We believe that market volatility in corporate bonds will remain elevated for an extended period, largely due to these structural changes taking place in the global financial system. Extreme movements in the global stock and bond markets are not merely a short-term problem caused by the European debt crisis or the substandard pace of economic growth.

Investors, in our view, therefore need to stick with longer term strategies built on fundamental insights, resist making dramatic portfolio changes in response to short-term market movements and properly understand the shifting nature of the investment landscape. Even though we expect a higher level of volatility going forward, we continue to find investment opportunities within the corporate bond universe. This is supported by solid underlying credit fundamentals and attractive relative valuations versus U.S. Treasuries.

The Barclays Capital U.S. Corporate Bond Index (investment-grade) consists of publicly issued U.S. corporate and specified foreign debentures that are registered with the Securities and Exchange Commission and meet specific maturity, liquidity, and quality requirements.

There are risks associated with fixed income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is more pronounced for longer-term securities.
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