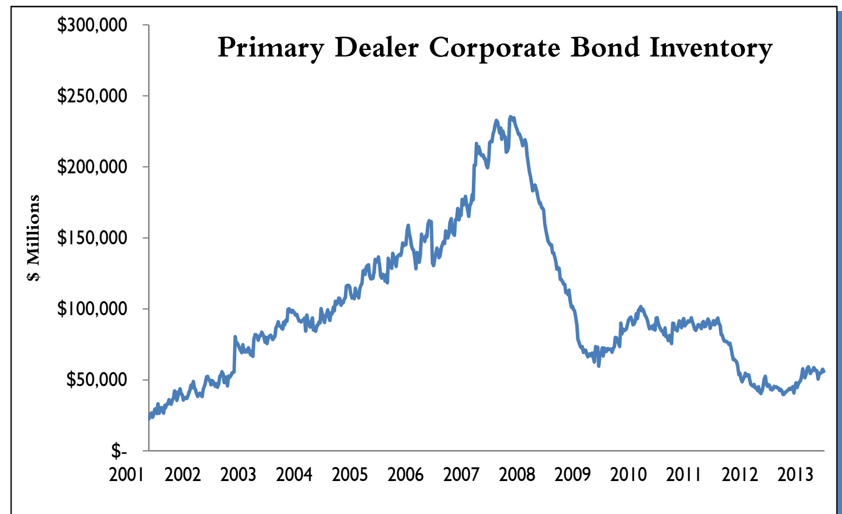
RICHMOND CAPITAL MANAGEMENT
Experience, Knowledge, Service

Corporate Bond Liquidity: Going, Going, Gone?

It is hard to believe that it has been five years since the collapse of Lehman Brothers and the resulting credit crisis. Since that time there have been fundamental changes to the financial system. One of the most important changes is that big banks have gone into a "de-risking" mode. Having nearly faced bankruptcy, they have built up capital levels and reduced the amount of risky assets on their balance sheets. As a consequence, this new mindset has led to a decrease in the amount of capital banks are allocating to their fixed income trading desks. In fact, since 2007, primary dealer corporate bond positions have decreased by 76% (see Chart 1). With the drop in capital, the number of employees trading and selling fixed income has also fallen significantly.



Source: Federal Reserve Bank of New York

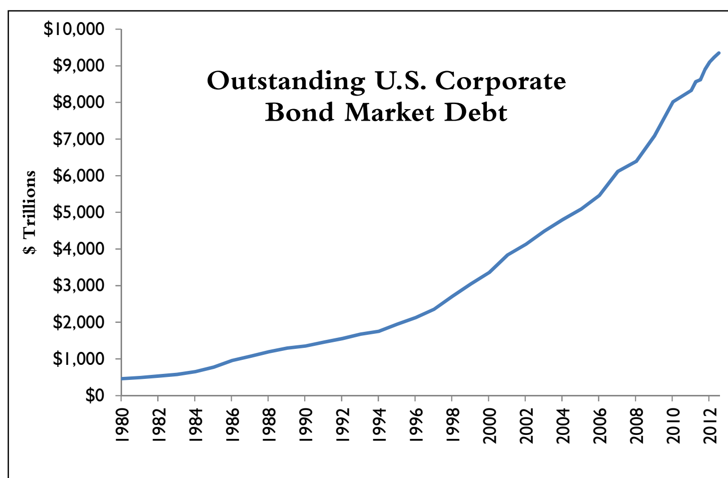
Chart 1

Another driving force that is causing banks to downsize their risk profile is new regulatory developments. Chief among these is the introduction of rules by international and U.S. bank regulators aimed at preventing a new financial crisis. For instance, the Basel committee of bank supervisors has mandated banks worldwide, under new Basel III requirements, to hold more regulatory capital against their riskier assets. This makes it more expensive for banks to keep assets like corporate bonds on their balance sheets. Also, U.S. regulators are implementing supplemental leverage ratios for banks, forcing them to set aside extra money to cover all the assets - regardless of riskiness - on their balance sheets. This will result in banks further reducing their activity in the repurchase (repo) market where banks loan out their securities in exchange for cash. The repo market plays an important role in balance sheet finance so the reduction of this market will further limit liquidity. The repo market is already down significantly from 2008 levels and could be further reduced once these leverage ratios are put into place. To further exacerbate the liquidity problem, because of the impending Volcker rule, banks are no longer trading for their own accounts. Trading desks are now focused on facilitating transactions on behalf of their clients, rather than taking proprietary risk.

Unfortunately, for investors, less dealer inventory translates into a reduction of liquidity. Liquidity is the heart of any well-functioning market. It gives investors the ability to easily get in and out of positions without significantly moving the price of the securities they are buying or selling. So a reduction in liquidity results in greater volatility and a widening of bid-ask spreads. It is also important to remember that one of the major factors that caused the global financial crisis to be so severe was the sudden absence of liquidity.

What makes the downsizing of trading desks further troubling is that changes in the investor base have actually increased the need for liquidity at the same time. With strong company fundamentals, higher yields and less sensitivity to interest rates relative to government bonds, corporate debt has become an attractive option for many investors. Investors have responded by pouring money into the corporate bond market. Witness the $100 billion in orders for Verizon's recent

$49 billion debt issue. Since 2008, the corporate debt market has grown over 46% to $9.3 trillion (see Chart 2) as companies have been eager to refinance debt at low historical interest rates. In the first eight months of 2013 alone, over $863 billion in new corporate debt has been issued.



Source: SIFMA

Chart 2

However, the demand for new issue corporate bonds in the primary issue market has not carried over to the secondary market. Daily trading volume, which reflects secondary liquidity, currently averages only $18.2 billion - a fraction of the $9.3 trillion size. By comparison, the $11.3 trillion Treasury market has seen average daily trading volume of $551.4 billion. It appears that newly issued corporate debt is being comfortably stowed away in investors' portfolios.

At the present time, the low level of secondary trading volume does not present a problem. But what happens if circumstances were to change? What if corporate bonds lost their popularity? Given the reduction in dealer corporate inventories and the rise in investor holdings of corporates, the liquidity risk in corporate bonds has essentially been shifted from the banks to investors. The ramifications of an exodus could be particularly challenging for large investors with corporate debt positions worth billions. The record setting $49 billion Verizon deal saw two investors purchase more than 25% of the debt sold. Earlier this year, the top 10 buyers received more than 25% of Apple's $17 billion debt offering. Who will be there to purchase this debt when these large investors decide to sell?

There are no easy solutions. Discussions between large institutional corporate investors and primary dealers have only resulted in the acknowledgement that something needs to be done. BlackRock's call for a more standardized corporate market, which would closely replicate the U.S. Treasury market and result in larger benchmark issues, has gone nowhere. Attempts by various firms like Morgan Stanley, BlackRock and Goldman Sachs to set up electronic platforms that could trade large blocks of bonds have so far fallen flat. Larger asset managers may be forced to increase their use of derivatives in managing their credit exposure but this alternative brings about its own set of risks.

Despite the negatives, this new environment presents opportunities for active bond managers. For instance, these managers (and investors) unconstrained by liquidity concerns will have the ability to earn higher spreads by buying less liquid off-the-run issues. Also, the increased regulatory environment and lower inventory levels may lead to a more order-driven market, putting a premium (through lower spreads) on the largest issuers. This will benefit managers who can purchase smaller issuers with solid credit fundamentals but are passed over due to limited liquidity. Those managers with a critical mass of assets, solid depth of relationships, and the most experience will be able to exploit the new order in corporate bonds.

Fixed Income Data Bank

Index Returns

	Qtr.	1 Yr.	3 Yr.
Barclays Aggregate	0.57%	-1.68%	2.86%
Barclays Int. Aggregate	0.76%	-0.71%	2.58%
Barclays Govt/Credit	0.36%	-1.96%	2.89%
Barclays Int. Govt/Credit	0.62%	-0.50%	2.42%
Barclays 1-3 Year G/C	0.40%	0.62%	1.08%
Barclays 1-10 Year TIPS	0.92%	-3.90%	3.08%

Source: Barclays *As of September 30, 2013*

Treasury Market Yields

	9/30/13	6/30/13
3 Month	0.01%	0.03%
2 Year	0.32%	0.36%
5 Year	1.38%	1.39%
10 Year	2.61%	2.49%
30 Year	3.69%	3.50%

10800 Midlothian Turnpike, Suite 217, Richmond, Virginia 23235-4700
Telephone: (804) 379-8282 Fax: (804) 379-9362
Website: www.richmondcap.com
Marketing Contact: Elizabeth M. Harris