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The Inside Market

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Storage to Moving

‘Wave of innovation’ is reshaping the corporate bonds market

Loudly proclaiming that there is a change coming is a sure way to raise interest in any topic, so it is not uncommon to see the periodic pronouncement of a profound shift in the corporate bond market.

While the market has made incremental changes over the years, the seismic shifts being declared in various headlines have not matched reality. This disconnect is not just media hyperbole, but a byproduct of prolonged central bank intervention in fixed income markets. Purposefully muting market volatility through QE tactics has prevented one of the greatest motivators for innovation…discomfort.

The start of Covid-19 (late February 2020), while disruptive from a financial market perspective, was also the potential catalyst for rapid innovation in the US corporate bond market. Unfortunately, the Fed’s emergency direct bond buying program, the Secondary Market Corporate Credit Facility (SMCCF) snuffed out the need for corporate bond market innovation at a time when almost all participants agreed that the traditional model was not functioning properly.

How does direct bond buying impact market structure innovation?

The intention of the SMCCF, as well as other central bank fixed income asset purchase programs, is to stabilize markets by "adding liquidity." However, a key feature of direct bond buying is that only broker-dealers are able to trade with the central bank. Therefore, central banks are not acting as the buyer of last resort to the entire market, instead, they have been functioning as risk warehouses for market makers. By allowing broker-dealers to dump their risk, at a profit, central banks have reduced the urgency to innovate. Why change behavior when the negative consequences of traditional thinking are never realized? No pain…no change.

The Missed Opportunity for Meaningful Change

Material change is driven by necessity, not desire. During late February into early March 2020, fixed income markets were experiencing prolonged, heightened volatility due to Covid-19. This condition was exposing the dangers of a traditional US corporate bond market structure which is heavily reliant on the collective balance sheets of a small network of very large dealers. At the time, many voices were claiming that the corporate bond market was broken and needed fixing (aka change). Then, in an effort to stabilize the market, the Fed announced that they would be directly buying corporate bonds. While working as a temporary panacea, direct bond buying completely stopped the momentum for change:

> *"**Another lesson from March is that the success to date of the Fed's corporate bond program to calm the markets does not suggest that reforms are not needed. Instead, the reforms are even more critical, since the Fed's actions likely raised expectations of such interventions in the future**. It is important that the Fed, through financial reforms or clarifying its own intent for future emergency actions, reduce any perception by private entities that they would not have to bear the costs of their own risk-taking."*

Corporate Bond Market Dysfunction During Covid-19 and Lessons from the Fed's Response - Brookings Institute (October 1st, 2020)

Despite the undeniable breakdown in corporate bond market integrity during the pandemic, the call for meaningful change has gradually gone silent.

"Bear the Costs of Their Own Risk-Taking"

Currently, the shift in Fed priorities from market stabilization to inflation reduction are now causing the market to "bear the costs of their own risk-taking," even though prolonged QE was directly intended to increase risk taking in the corporate bond market:

"The emergence of the prospective fallen angel subsidy amid the Fed's elevated QE purchases isn't a coincidence. Investors with the greatest exposure to QE (through their holdings of securities that were eventually purchased by the Federal Reserve) increased their demand for bonds issued by prospective fallen angels, lowering the financing costs of those firms. ***Investors that tend to hold investment-grade bonds, such as insurance companies, had a more pronounced surge in QE-induced demand****."*

The Making of Fallen Angels and What QE and Credit Rating Agencies Have to Do With It - Liberty Street Economics (February 16th, 2022)

As infuriating as this situation is to some, the current environment is forcing corporate bond market participants to confront a critical question: **Is the current corporate bond market structure able to consistently and efficiently function in a rising rate environment and no Fed support?**

Trouble or Change

There is a direct relationship between market illiquidity and volatility, but as a recent research paper by the IMF explains, the 2020 pandemic exposed a danger that profoundly impacts corporate bond market participants:

...as we write in an analytical chapter of the Global Financial Stability Report. Open-end funds were forced to sell assets amid outflows of about 5 percent of their total net asset value, which topped global financial crisis redemptions a decade and a half earlier.

*Consequently, **assets such as corporate bonds that were held by open-end funds with less-liquid assets in their portfolios fell more sharply in value than those held by liquid funds**. **Such dislocations posed a serious risk to financial stability, which were addressed only after central banks intervened by purchasing corporate bonds and taking other actions**. Looking beyond the pandemic-induced market turmoil, our analysis shows that the returns of assets held by relatively illiquid funds are generally more volatile than comparable holdings that are less exposed to these funds—especially in periods of market stress. For example, **if liquidity dries up the way it did in March 2020, the volatility of bonds held by these funds could increase by 20 percent.***

How Illiquid Open-End Funds Can Amplify Shocks and Destabilize Asset Prices - IMF (October 4th, 2022)

Consistent liquidity at a reasonable price is a challenge that the corporate bond market faces even in tranquil times. As the IMF points out in their research, the mismatch between liquidity offered to investors and available liquidity in the market is a “serious risk to financial stability,” so **what needs to change in the corporate bond market to prevent disaster?**

More Market Making Less Problems

Just the announcement of the SMCCF program brought stability back to the corporate bond market because it was the promise of liquidity. Similar to the hoarding of essential goods in anticipation of a hurricane, people will panic if they think something they will need in the future will not be available. However, if you know there is a truckload of supplies being delivered, you are less anxious, even if those supplies are not on the shelves. We are now in a situation where it is highly unlikely that the Fed will act as a backstop for the corporate bond market, and volatility is increasing. **So, how does the corporate bond market generate more liquidity without the Fed as backup?**

Electronic trading seems to be the default answer to the liquidity question, but there is little evidence that technology alone creates meaningful, sustainable liquidity, especially in institutional markets. Platforms create the connection between market participants, but it is market makers that are the fundamental providers of liquidity in the corporate bond market. This is especially the case for institutional trading, which makes up 80% of average daily corporate bond volumes. The fact remains that active broker-dealers are critical to a

well-functioning institutional corporate bond market. **To address the instability predicted by the IMF, we need a larger community of corporate bond market makers that have adapted to the new environment.**

Moving on from Storage

The core function of a market maker is to provide opportunities for buy-side clients to trade. Ideally, this service is carried out as efficiently as possible with limited risks to the market maker. In reality, being a legitimate market maker in markets that have low transaction frequency, like the corporate bond market, requires the warehousing of inventory. Traditionally, the lengthy amount of time a corporate bond dealer must hold an item in inventory has been accepted as an unavoidable consequence. The cost of doing business if you will. Aged inventory reports and increased capital charges are designed to motivate a reduction in inventory holding times, but these punitive measures have not been adequate to shift the business from what is essentially a storage model. Now, the increased volatility brought on by rapidly rising rates has created an environment where a broker-dealer's warehouse of inventory can quickly lose material value. As long as these conditions persist, the traditional approach to market making will be unsustainable. Adapting to the new market environment requires corporate bond broker dealers to shift from a storage service to a moving service.

Moving Needs Data

The metric used to determine if you are operating a storage business or a moving service is inventory turnover velocity (how quickly is the corporate bond market making desk able to trade in and out of the positions they acquire). To increase institutional inventory turnover, broker-dealers need to commit to a data-driven approach to market making with a focus on these specific areas:

1) **Market Data Access**

Institutional pre-trade data is an essential ingredient to shifting a corporate bond market making business from storage to moving. Without seeing real-time pricing data it is impossible for a trader to consistently position their markets to attract risk-reducing order flow. A dealer holding

a large position in an individual bond needs to know, at all times, where their offer is relative to other dealers. This knowledge will allow them to increase the probability of trading out of the position by maintaining a competitive offer.

2) Market Data Integration

Just having data is not adequate for reducing inventory holding times. Corporate bond broker-dealers must have the tools and solutions to combine key data sets and present them to traders and sales people. Pre-trade data, TRACE data, desk inventory, client inquiries, and client portfolios are extremely valuable, but questions like this need quick and reliable answers throughout the trading day:

How many of the bonds that we have in inventory are we the best offer and there is a potential match with a client inquiry or portfolio?

Armed with this information, sales people will undoubtedly improve inventory turnover by targeting the right clients with the right situations at the right time.

3) Market Maker Performance

One of the least talked about, but most valuable aspects of corporate bond electronic trading are the comparative dealer analytics produced by the platforms. Objectively, dealers can know what areas of the market they are strong in, and which areas need improvement. This analysis can be applied to a sector, a name, or even an individual client. Dealers have been using these data for years to fine tune their electronic market making strategies.

In contrast, the institutional market has alarmingly little comparative analytics for corporate bond dealers. While industry surveys have been helpful, objective data about institutional distribution performance has been missing. Without these data, market makers cannot measure, monitor, and improve their institutional market making strategy. **Identifying which bonds, which clients, and which market making practices lead to sustained profitability will define the next generation corporate bond broker-dealers.**

- Chris White, CEO - BondCliQ