Lynx Investment Advisory

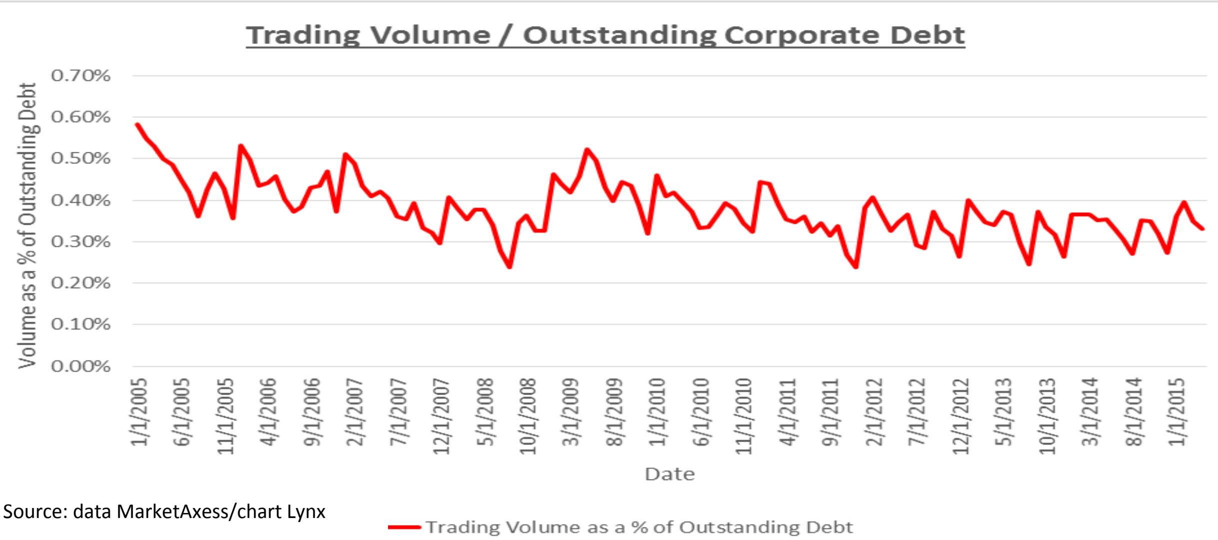
Is the Corporate Bond Market Really Illiquid? How to Invest in Corporate Bonds

Over the last few weeks, corporate bond market liquidity or lack thereof has become a recurring discussion among many market commentators. The commentators attribute the lower liquidity to the new regulatory environment under Dodd-Frank, which prevents dealers from holding more net long positions. We at Lynx Investment Advisory are dissatisfied with these conversations, because if in fact we are experiencing lower liquidity, neither these commentators define what they mean by liquidity, nor do they opine on how to invest in the current environment. In this paper we will examine some measures of bond liquidity to better understand the current health of the bond market, and will then suggest how to invest under these conditions.

Bond market liquidity is not easy to define or measure. We define a liquid bond market as one where investors can buy or sell bonds easily and at reasonable prices. While there is no single measure of liquidity, the three most common measures are transaction volume, net primary dealer positions and the bid-ask spread. Transaction volume measures the total value of transactions over the course of a day, or any specified time period. Measuring transaction volume without adjusting for any growth in bond issuance over time is not the right approach. For this reason we like to see the transaction volume as a percentage of bonds outstanding; the higher this percentage the more liquid the market and vice versa, everything else being equal. The second measure of liquidity is net primary dealer positions. Net bond positions are voluntarily reported to the New York Fed by designated primary dealers, which include banks and securities broker-dealers. The net positions are a measure of primary dealers' inventory, which they use to support the market making function. The third measure is the bid-ask spread. The bid is the price a dealer is willing to pay for a security at a specific point in time, while the ask is the price at which a dealer is willing to sell. Generally, the tighter the spreads the more liquid and efficient the market.

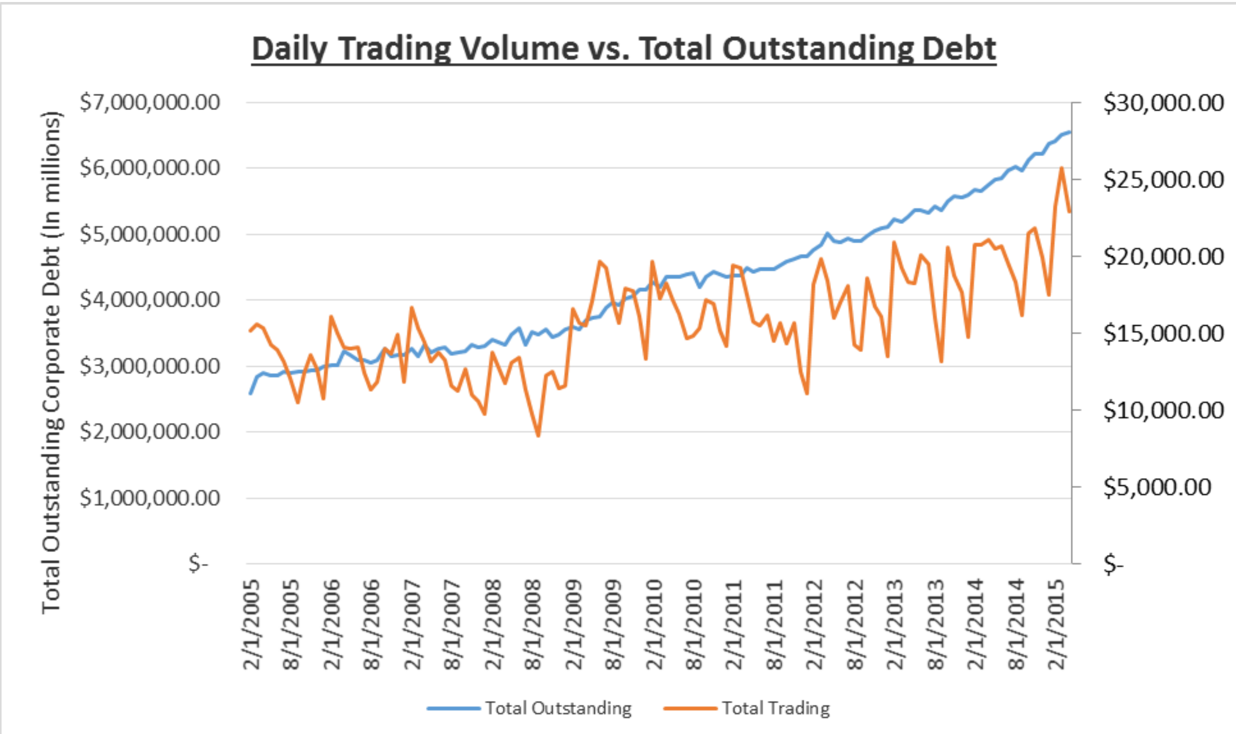
Chart 1 measures the transaction volume as a percentage of corporate debt outstanding. Over the years, the corporate bond transaction volume as a percent of total corporate bonds outstanding has remained relatively steady at 0.3%-0.4%. The transaction volume stability does not appear to indicate a lack of liquidity in the corporate bond market. Additionally, we've provided the growth in total outstanding debt and daily bond volume on chart 1a.

Chart 1



Source: data MarketAxess/chart Lynx

Chart 1a



Source: data MarketAxess/chart Lynx

Chart 2 provides primary dealer inventory, which many commentators have cited as evidence for lack of liquidity. While it is true that dealer inventory has fallen, as depicted by the blue line from $250 billion to $50 billion, which may result in adverse implications, it is our belief that the decline in inventory is directly correlated to the lack of investment opportunities. Looking at the orange line, which charts the 10 year U.S. Treasury bond yield on the Y axis, it becomes apparent that as the yields have declined so too has the inventory. We believe dealers, which include banks, are not willing to extend their balance sheets given that the new regulatory capital requirements make the opportunity set far less attractive. If market makers were to hold more bonds, then likely they would be buying high and selling low given that yields may rise as the Fed prepares to raise rates. Who wants that!

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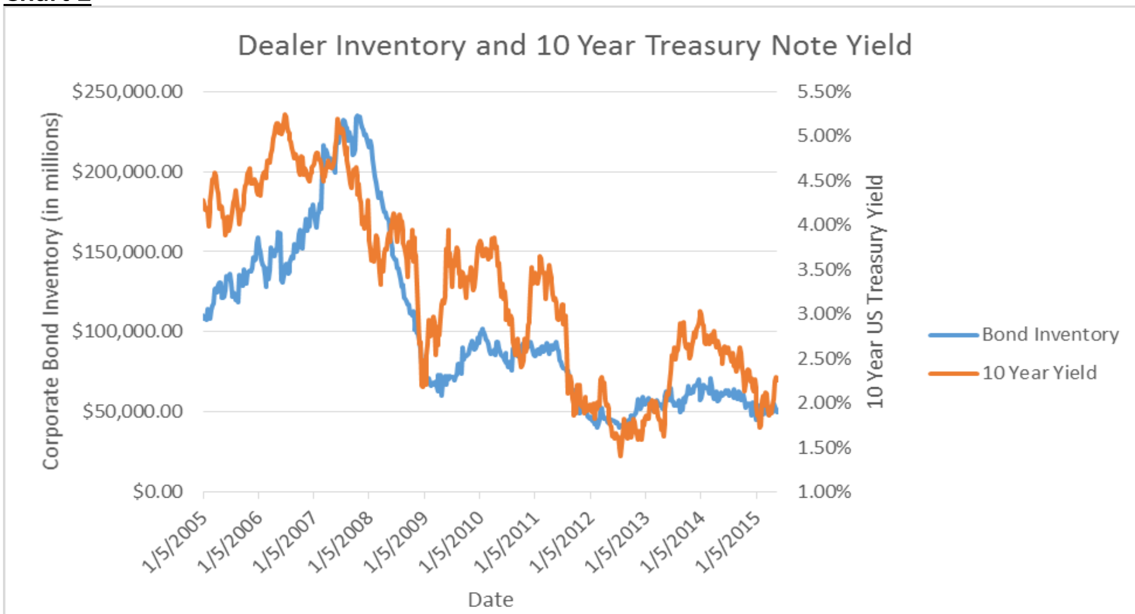
Chart 2



Source: data Bloomberg/chart Lynx

Chart 3 looks at the Bid-Ask Spreads Index (BASI) to ascertain the liquidity in the corporate bond market. BASI tracks a subset of 1,000 corporate bonds selected on a quarterly basis to represent the most actively traded issues as determined by a rank ordering process. The chart indicates a tight spread of 6 basis points (as of June 8) and the index has not worsened over the last few months. Compare this to November 2008 when BASI was at 40 basis points.

Chart 3

Source: MarketAxess

In conclusion, we believe that while dealer inventory has fallen, the suggestion of bond illiquidity is not reflected in the other two measures. While we take issue with market commentators regarding liquidity in the bond market, we do not discount the importance of dealer inventory, as we believe it has critical investment implications.

In today's environment of lower dealer inventory, intra-day price discovery mechanisms may become unreliable, especially for corporate bonds that are traded infrequently. In our opinion, the intra-day price volatility of the ETF is likely to increase going forward. If an investor wants bond exposure, we believe they should stay away from corporate bond ETFs such as LQD, CRED, CIU and invest in bonds through separate accounts or active mutual funds.

Going forward we will continue to analyze and observe all measures of bond liquidity in order to fully appreciate the market's health.