Bond Market Liquidity
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Views expressed are those of the author and not necessarily those of UBS
Intermediaries are shrinking...

IB fixed income revenues down by about 20% relative to 2010 to 2012 period

IB front office headcount in fixed income down about 25% from 2010 to 2014

Source: Coalition
... with implications for balance sheets and business strategies

McKinsey estimates that increases in capital and other costs are reducing RoE for IB fixed income businesses from ~19% (2010) to 5~8%, depending on when new rules come into force, and prior to responses by firms

Firms will continue to respond by selectively scaling back businesses and operating them differently

Source: Flow of Funds
Can we see an impact?

• Significant trend toward credit indices
• $6\sigma$ move in UST markets (Oct 2015)
• Reductions in inventories in face of higher volatility (e.g., TIPS, below IG credit)
• Reduced ratios of trading volumes to amounts outstanding (e.g., MBS)
Corporate bond markets

• Investment grade
  – Median daily turnover down from peak of $20 mm to $3-4 mm
  – Bid-ask spreads back to pre-crisis levels ~44bp

• High yield
  – Median daily turnover down from peak of $7mm to $2.5 mm
  – Bid-ask spreads ~100bp (as of Q4 2014)

• But aggregate liquidity picture may mask pockets of illiquidity
  – Energy sector bid-ask spreads have decoupled since December, particularly in HY
  – CCC vs other HY
  – Corporate credit ETFs – discounts to NAV

• To what extent will alternative fund managers provide liquidity if market overshoots?

Source: UBS Global Research