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# Liquidity, Derivatives Raise Red Flags in the Corporate Bond Market

The U.S. corporate bond market remains aggressively bid, with investment-grade spreads-to-Treasuries (the additional yield over a comparable-maturity U.S. Treasury bond) at or near all-time lows. Despite some softening in recent weeks, junk bond spreads also continue to be near historic lows. Additionally, volatility in domestic credit markets has been low over the last two years, obscuring the potential for significant risk due to changes in market dynamics.

New issuance in the U.S. corporate bond market is currently on pace to set an all-time record in 2014, following record years in 2012 and 2013. Companies are racing to borrow while Fed-induced low rates remain available. The bulk of the new corporate debt issues has been concentrated in financial firms, as well as very large issues by technology and telecomm companies (e.g., Apple, Verizon). Investors are desperate for yield, so these new issues are being well received by the market. At the same time, demand for yield has been so strong that it has driven holdings in U.S. bond funds over the $4 trillion mark for the first time in July 2014, up from approximately $1.5 trillion during the low point of the financial crisis.

Despite this strong demand for bonds, liquidity in the domestic corporate bond market has shrunk to historic lows by a number of measures. According to figures published by the Wall Street Journal and the Securities Industry and Financial Markets Association (SIFMA), the volume of trading in U.S. corporate bonds dropped to an all-time low in the first quarter of 2014. Only 1.8% of the par value of all bonds outstanding traded on a daily basis during the quarter, the lowest level in the last 18 years. Another measure of liquidity, dealer inventories of U.S. corporate debt, has dropped to levels not seen since 2002, and is fully 75% below the highs recorded in 2006 and 2007. Since the financial crisis, dealers are less willing (due to risk management) and less able (due to regulation) to commit capital to corporate bond trading. This impairs the ability of investors to actively buy and sell U.S. corporate bonds, creating an underlying risk that is not visible to many investors. However, when interest rates rise and volatility reemerges, this lack of liquidity will likely become a significant problem for bond investors.

Another change in market dynamics is the rise in the use of credit derivatives as a replacement for bond holdings by mutual funds and other large institutional money managers. Credit default swaps (“CDS”) are contracts that guarantee payment of bond principal in the event that a company defaults on its debt. CDS premiums, like equity options, are actively traded and change in value as investors' perception on the financial strength of the company change. CDS can not only replicate credit exposure, they can also easily amplify this exposure via their inherent leverage. Paying just a nominal premium to purchase, CDS can allow investors to effectively control a much larger face value of the underlying bond. The most common size of CDS trades are for notional values of $10 - $20 million. CDS are also used as a vehicle for taking leveraged short positions on a credit issuer.

Following the financial crisis, which was precipitated in part by the CDS losses at entities such as Lehman Brothers and AIG, trading volumes in CDS contracted dramatically. Just as in the bond market, when rates remain stable and volatility low, CDS markets typically remain stable and liquid. However, as rates rise, or if companies begin to face credit headwinds (e.g., recession, M&A activity, headline event risk, etc.), pricing can change rapidly, and willing counterparties can leave the market abruptly. When the stock market hit lows in early 2009, CDS of both financial and industrial companies jumped as much as 700%, netting gains for those that bought the insurance and large losses for those that were on the other side of the contract. For some companies, CDS spreads widened even more in August 2011 (the showdown over the debt ceiling) than in 2009. Since 2012, CDS trading volume has again begun to grow rapidly. Bloomberg recently reported that trading in single-company investment-grade CDS grew 80% in the second quarter of 2014 versus the previous year.

We believe the combination of large flows into bond funds, low liquidity and inventories, and the rise in use of CDS creates a potentially dangerous environment. Conditions that push rates higher, or threaten individual or general corporate credit quality can rapidly create instability in thin markets. These risks are largely invisible to investors, who now see only stable to rising bond prices. As we saw during the financial crisis and again on a smaller scale during the "taper tantrum" in late May and June of 2013, markets can lock up and yields can become extremely volatile when investors attempt to exit bonds en masse. Funds facing outflows are forced to make sales, further driving down prices, which can lead to more investors pulling money from funds, which drives even more sales. For investors looking to their core fixed income allocation to be the foundation of their portfolio, these risks may produce an unexpected and unwelcome surprise when market conditions change. We believe a well-structured portfolio of individual high-quality bonds is largely insulated from these market risks. Holding individual bonds removes exposure to the volatility associated with leverage or changing derivatives values and investors and managers are able to hold bonds to maturity, mitigating liquidity risk and insulating investors from realizing losses driven by funds being forced to sell investments to meet redemptions.

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