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HEARD ON THE STREET

Liquidity Specter Haunts Corporate-Bond Markets

Corporate-Debt Issuance Is at Records, but Trading Problems Remain a Worry for Investors

By RICHARD BARLEY

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Water, water everywhere, nor any drop to drink.

Corporate-bond markets are swimming in cash. Global investment-grade nonfinancial issuance hit a record $1.79 trillion in 2014, according to Dealogic; high-yield issuance reached $476.2 billion, just $3 billion less than 2013's record.

But the bond-market plumbing is clogged. Investment banks have pulled back from market-making due to regulation that has increased capital charges, making secondary-market liquidity a worry for investors. In the fourth quarter of 2014, U.S. primary dealers reported net positions on average of just $11 billion of investment-grade bonds with a maturity of more than 13 months, data from the New York Federal Reserve show. The share of U.S. corporate bonds where at least half of the outstanding amount is traded over 12 months has fallen to less than 5%, from 20% before the global financial crisis, the Bank for International Settlements said.

So even as corporate-bond markets have sucked in ever more cash, the exit door has shrunk. That raises big concerns about what happens if bonds fall from favor—if, for instance, the much-discussed "great rotation" into equities from bonds were actually to take place.

Some argue this isn't a new worry. Credit markets have a history of illiquidity, particularly at times of strain. Others say that secondary-market liquidity before the 2008 crisis was abnormal, driven by overtrading related to credit derivatives and leverage. But the situation in the bond markets could be dangerous. Ultraloose monetary policy has acted as a magnet for money to flow into fixed-income markets. The growth of vehicles such as exchange-traded funds that allow investors to yank their cash quickly raises worries about liquidity mismatches, where the underlying investment is far less liquid than the cash funding it.

Some novel solutions are being proposed. Fund manager BlackRock, for instance, has suggested increased standardization of corporate-bond issuance. That would make company debt look more like government or agency bonds, with common maturity dates and regular issuance, allowing for consolidation and creating more-liquid single issues. This is likely to work only for the very biggest issuers, however. These issuers may change over time, too, since for most companies the biggest borrowing requirements are related to relatively rare events such as large mergers and acquisitions. For smaller, less well-known borrowers, this might even make the problem ofliquidityworse.

Other efforts include platforms where investors can trade with each other directly. But that requires asset managers to become willing to make prices in the way that investment banks have in the past, a new challenge. Investment banks might not be willing to contribute prices to these services if investors simply use them to trade with each other.

So far, illiquidity in secondary markets has been a source of frustration for investors more than a real risk. But the environment is changing; volatility and uncertainty are rising. A change in U.S. monetary policy could prove a test. Investors should watch corporate-bond market conditions closely for signs of trouble.

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