Credit where Credit's Due

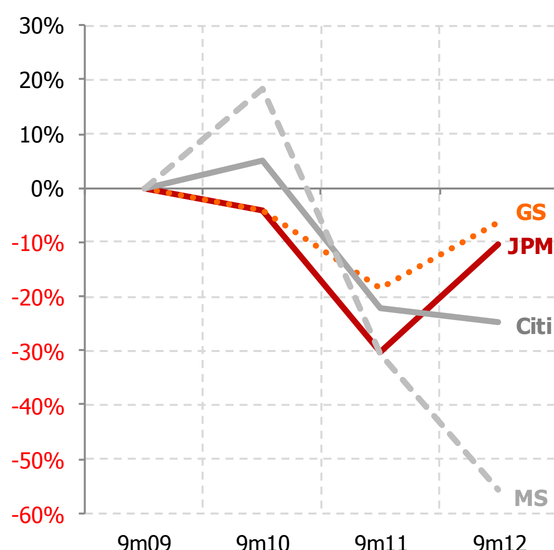
- While overall bond trading inventories are down, there is considerable variance across the market. Using four of our core US banks as an example, GS and JPM have significantly increased their balance sheet holdings in the past year, in contrast to Citi and MS.
- CDS holdings have followed a different trajectory, growing in 9m11/9m10, but then declining/levelling off in the last year.
- Overall, the market has become more concentrated in the hands of a smaller number of dealers, many banks have turned to e-trading to minimise asset holding times
- As a result the overall fall in bond trading holdings is inversely correlated with the rise of electronic trading
- We forecast that multi-dealer platforms will come to dominate trading of the most liquid names while single dealer and voice will be more prominent for less liquid markets.

Corporate Bond Trading and CDS Trading

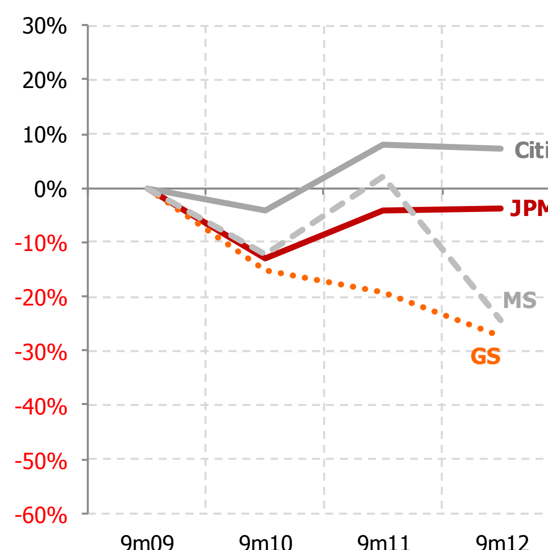
Much has been made by some commentators of data from the Federal Reserve of Bank of New York which shows that the average US Primary Dealer corporate bond inventory fell by 43%, in absolute terms, between end-Sept-09 and end-Sept-12. Our analysis shows that this statistic masks great diversity across different institutions. For example, during the last three years, Goldman Sachs reduced their trading book by only 6%. Morgan Stanley, by contrast, reduced their holdings by 56%.

Credit default swap (CDS) notionals at these institutions were much less volatile over the three-year period. Citigroup increased their notionals, by 7%, while at Goldman Sachs and Morgan Stanley notionals fell by almost 30%.

Change in Corporate Bond Trading Assets



Change in Value of CDS Held



Source: Bank financial reports, Tricumen

Undoubtedly, Basel 3 has been an important contributor to this dynamic. We believe that other important factors have been: the closure of many dedicated credit prop trading desks, the virtual absence of collateralised bond obligation deals (which often require warehousing facilities), the growth of corporate bond ETFs and, more recently, banks favouring European over the US credit markets.

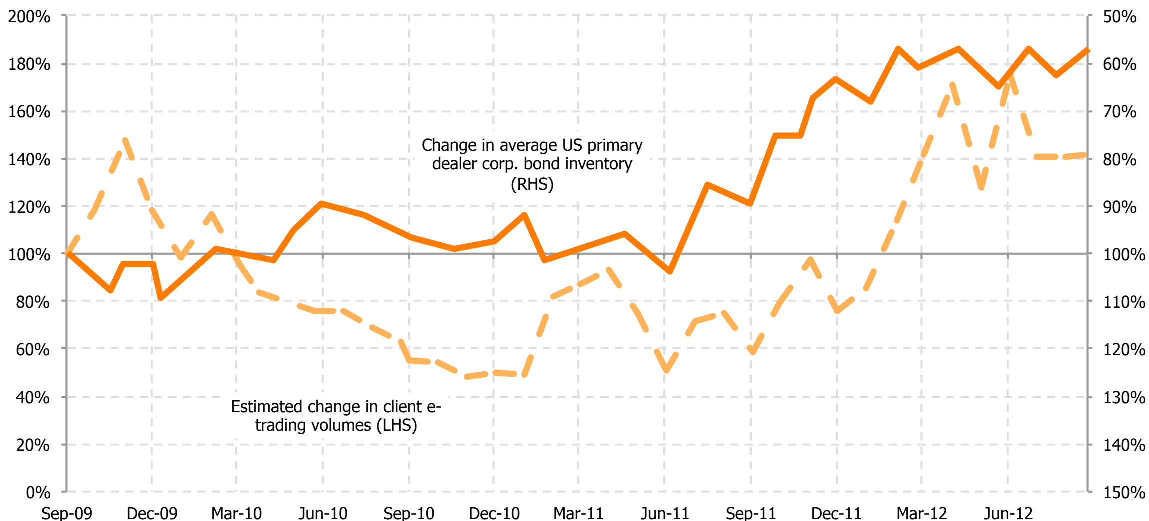
As some banks curtail their ambitions, the credit markets are increasingly dominated by a small number of remaining players. Some see this as an opportunity to grow their business. Citigroup, for example, plans to grow its European sales and trading staff by 5%. The bank is hiring in high grade trading and distressed debt[1].

[1] *EMEA distressed credit 'team' – which previously comprised one lonely employee in London – hired 5 full time staff in 3Q12; two of these will focus full-time on distressed assets at other banks. By contrast, in NYC, ex-Head of Distressed Debt Trading Rohit Bansal left in Jan-12 (before resurfacing in a similar role at Jefferies, in Apr-12); and Marc Heimowitz, ex-Head of Credit Special Situations (headcount of 17, trading portfolio $2bn as of mid-1Q12) went to the Carlyle Group earlier in 2012.*

Electronic Markets

For banks that have been reducing their corporate bond inventory, one solution to keep a visible presence in the market is to focus on e-trading. We believe this can be seen thorough the inverse correlation between dealer inventories and e-trading volumes. The graph below shows the decline in average corporate bond inventories (left-hand scale) and the rise in electronic trading volumes (right-hand scale, inverted).

Primary dealer inventory and multi-dealer e-trading volumes



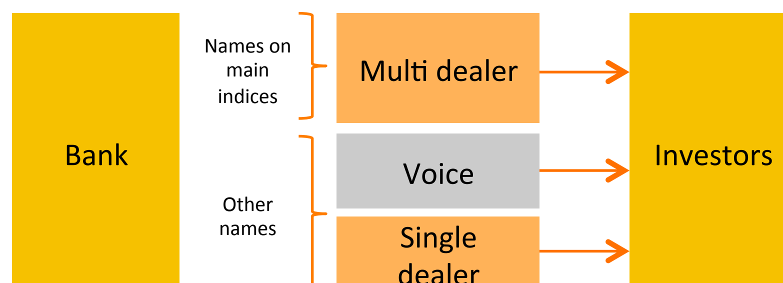
Source: Federal Reserve Bank of New York, Tricumen

Often the names most traded on multi-dealer platforms are those that make up the main credit indices: the very bonds that banks reducing reduced balance sheets are most likely to focus on. The result is that such bonds see good liquidity and tight bid-offer spreads.

Outside the main indices, the story is very different. Liquidity is lacking and bid-offer spreads are wide. Dealers that are fully committed to the credit markets can maintain a decent inventory and so benefit from greater business. Balance sheet constrained banks are more challenged and have been trying to provide liquidity while minimising the time that they hold onto assets. One approach has been to develop new single dealer e-platforms. Morgan Stanley has launched their *BondPool* platform to match buyers and sellers and Goldman Sachs has taken a similar approach with *GSessions*. While such single dealer matching platforms will have an impact, they face a new challenge from the buy-side in the form of platforms like Blackrock's Aladdin. If independent market trading fora come to dominate all parts of the credit markets, then the only long term option will be for banks will be to try to provide a "one-stop service" across the full trading cycle; execution to settlement (as we set out on our paper on *The Bank of the Future* published in Sep-12).

In summary, we anticipate a growing bifurcation of the credit markets into areas of high and low liquidity; and the corresponding split between multi-dealer and voice-/single-dealer offerings.

Possible Future Model for Credit Trading



Source: Tricumen

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