Staff second quarterly report on corporate bond market liquidity

Summary

This report[1] describes developments in the liquidity and functioning of corporate bond markets since May. In this update, we use the same measures of liquidity used in the previous report for both primary and secondary market conditions. The main findings are:

1) Liquidity in the primary market – as indicated by the pace of primary corporate bond issuance – continued to be robust in the U.S., on balance. Yields on corporate bonds were up slightly from the time of the last report, on net, and remained at historically low levels. Nonfinancial corporations continued to take advantage of low interest rates and the strong investor demand for fixed-income securities, reportedly using one half of the proceeds from issuance, in aggregate, to refinance existing debt. Corporate bond issuance slowed somewhat in July and August, largely reflecting seasonal factors, and in part, reflecting elevated volatility in the speculative-grade bond market. Issuance rebounded in September, offsetting much of the weakness in prior months.

2) Measures that capture aspects of secondary bond market liquidity – the ability of and cost to investors to easily buy and sell corporate bonds – showed mixed changes since the last report. The average daily trading volume moved up noticeably for speculative-grade bonds in July. However, trading volumes had retraced that move by late August, consistent with reports of a widespread sell-off in the speculative-grade market, as

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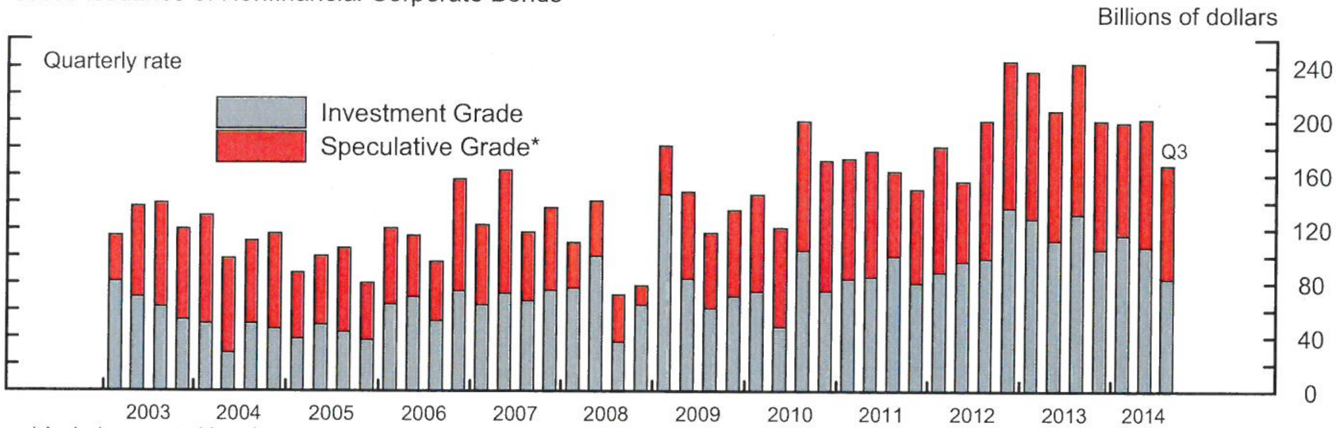
[1] This report has been agreed to by the staff of the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively referred to as the Agencies). The Agencies have expressed no view regarding the analysis, findings, or conclusions contained in this report.

evidenced by sharp outflows from mutual funds that invest in lower-rated bonds. The fraction of very large secondary-market trades – trades that are at least $1 million in face value – increased significantly for speculative-grade bonds around the same time of the sell-off. More recently, both of these measures have returned to levels similar to those at the time of the last report. In contrast, the estimated average round-trip cost of buying and selling corporate bonds in the secondary market remained quite stable through the summer and continued to hover near its pre-crisis level, consistent with reasonable levels of liquidity in the face of substantial flows. Dealers' inventories of high-yield corporate bonds also held fairly steady amid the large swings in mutual fund flows, consistent with market reports that the sales of bonds by mutual funds in response to the retail outflows they experienced were quickly met by purchases from other types of institutional investors.

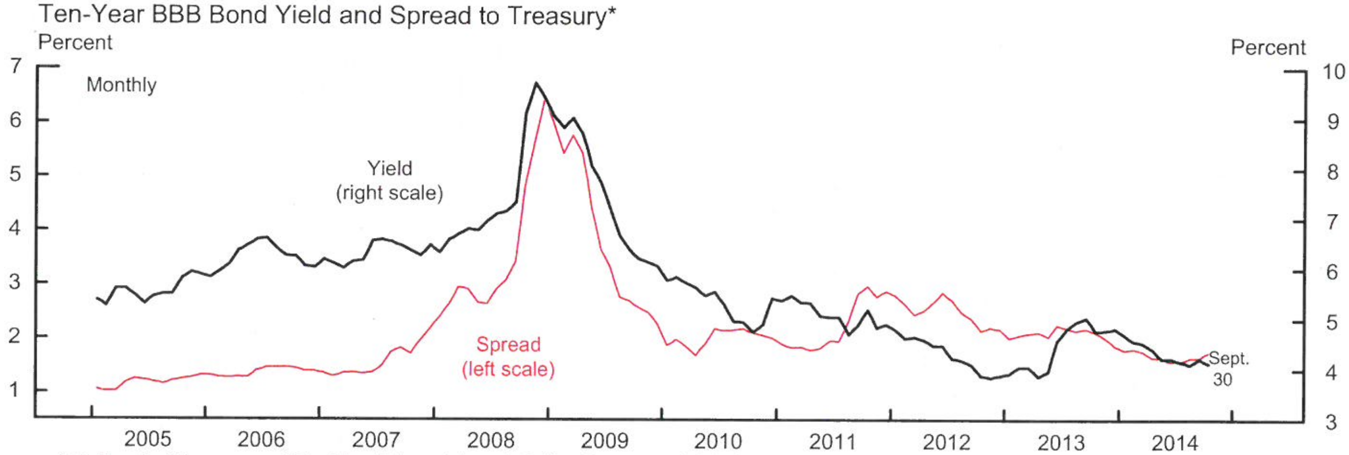
Corporate Bond Liquidity Monitor
Exhibit 1

Gross Issuance of Nonfinancial Corporate Bonds



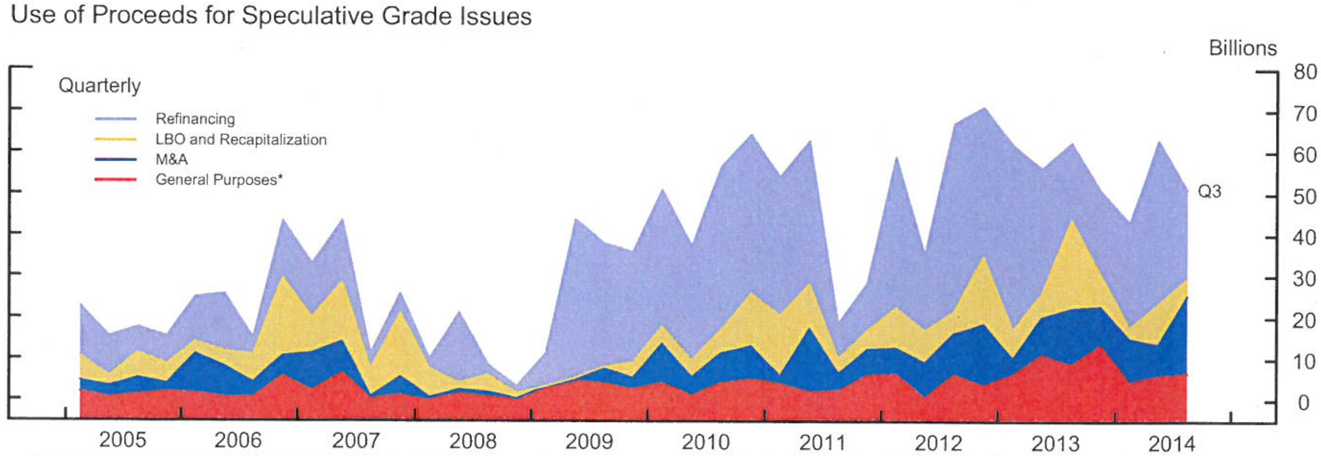
* Includes unrated bonds.
Source: Mergent.

Ten-Year BBB Bond Yield and Spread to Treasury*



* Estimated from curve fit to Merrill Lynch bond yields. Treasury yields from smoothed yield curve estimated from off-the-run securities.
Source: Staff Calculations.

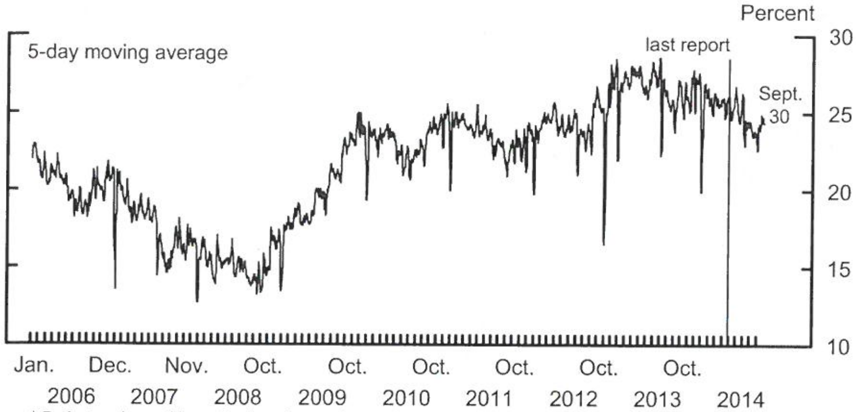
Use of Proceeds for Speculative Grade Issues

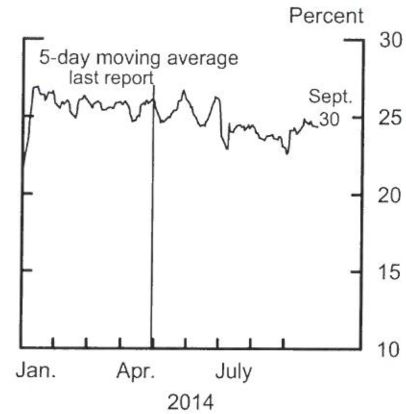


* General Purposes includes capital expenditures and other purposes not included in the designated breakdown.
Source: Standard and Poor's.

Corporate Bond Liquidity Monitor
Exhibit 2

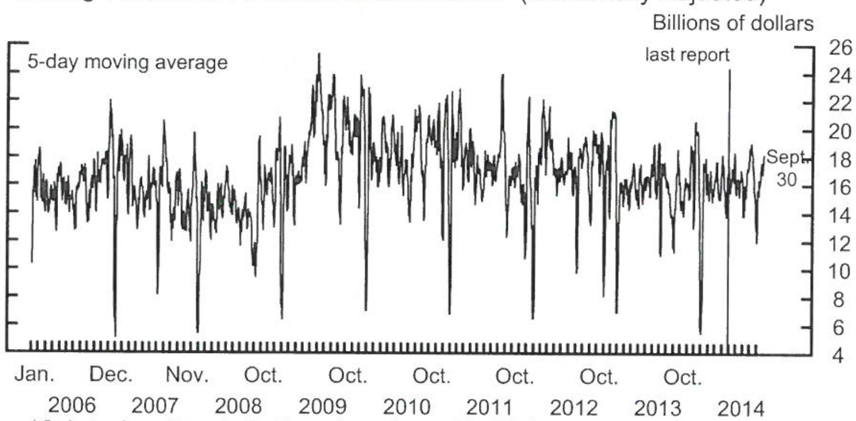
Number of Traded Bonds as a Fraction of Total Disseminated*

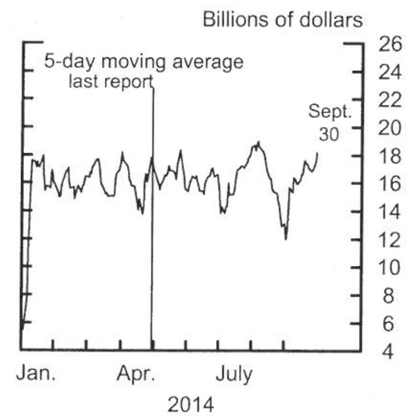




*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds.
Source: FINRA, Mergent, Moody's DRD.

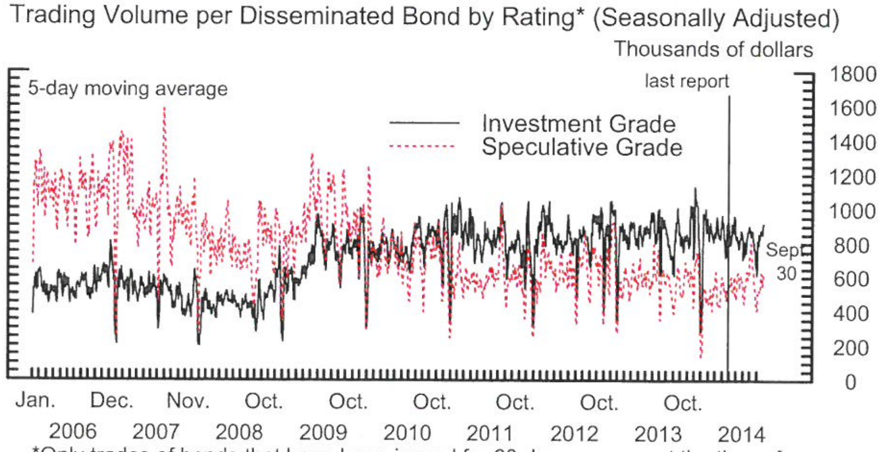
Trading Volume for All Disseminated Bonds* (Seasonally Adjusted)

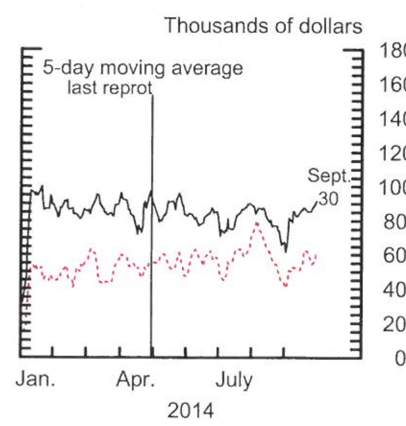




*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds.
Source: FINRA, Mergent, Moody's DRD.

Trading Volume per Disseminated Bond by Rating* (Seasonally Adjusted)

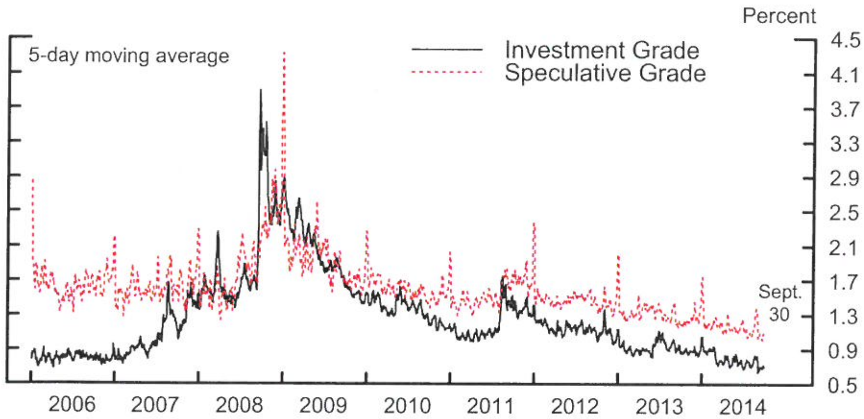


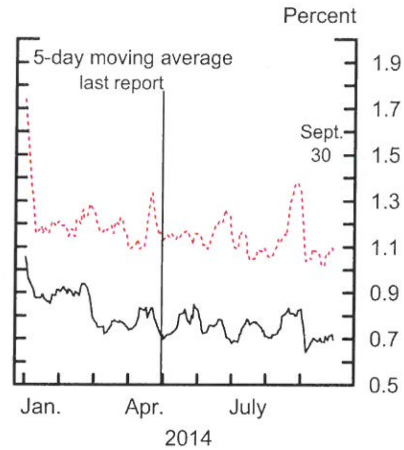


*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds.
Source: FINRA, Mergent, Moody's DRD.

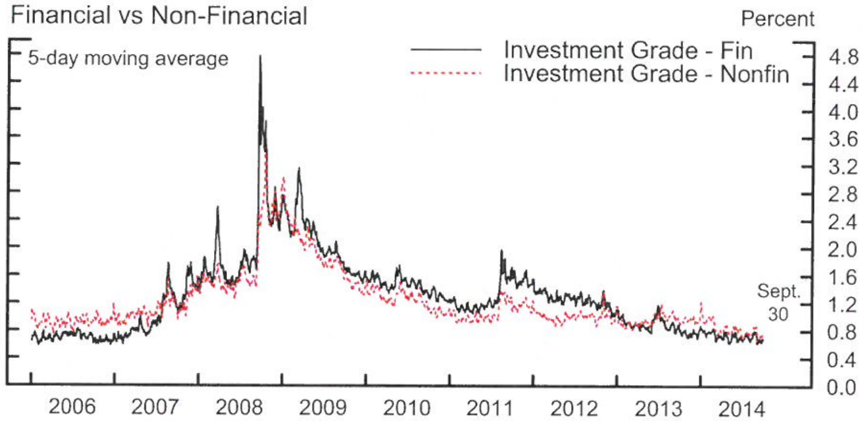
Corporate Bond Liquidity Monitor
Exhibit 3

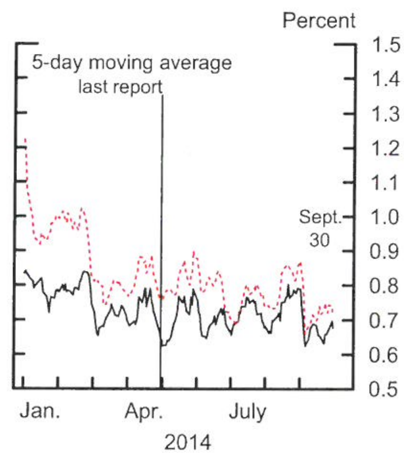
Effective Bid-Ask Spread for All Bonds



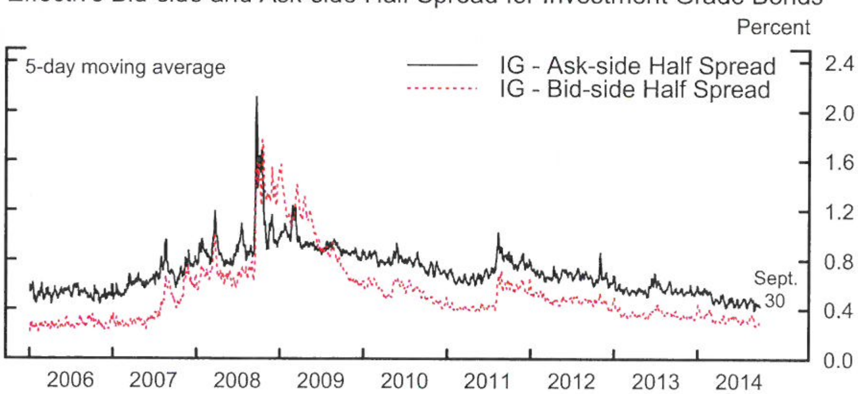


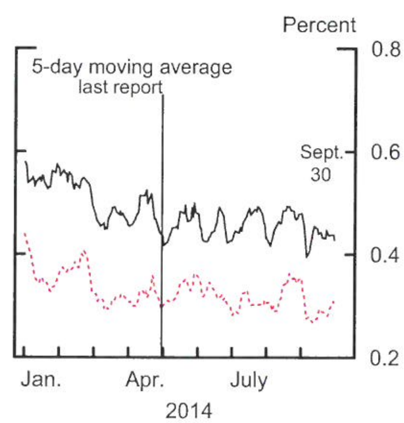
Effective Bid-Ask Spread for Investment Grade Bonds:
Financial vs Non-Financial





Effective Bid-side and Ask-side Half Spread for Investment Grade Bonds





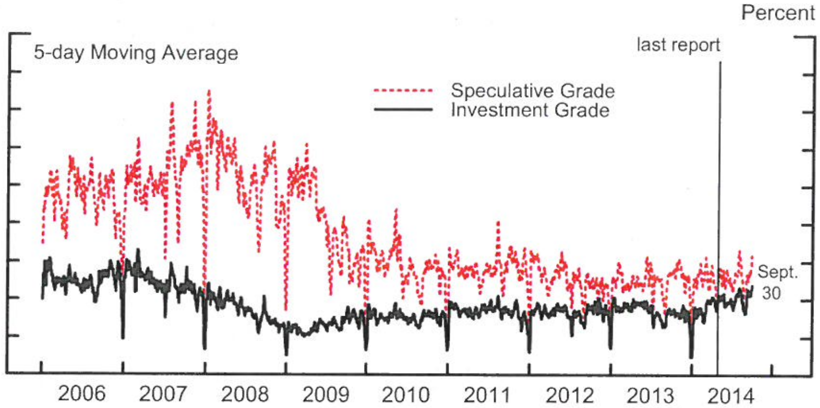
*All measures are computed for non-defaulted bonds on the secondary market that have traded at least 10 times between 10:30am and 3:30pm.

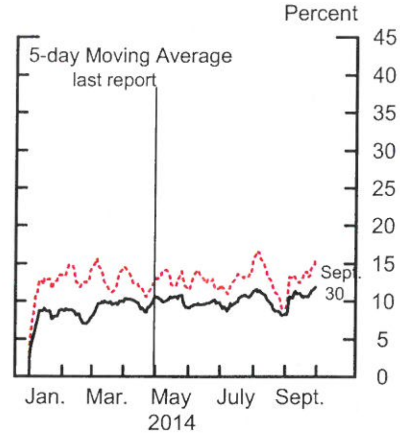
Effective Bid-Ask spread is the difference between weighted average dealer bid prices and ask prices

Source: FINRA, Mergent, Moody's DRD.

Corporate Bond Liquidity Monitor
Exhibit 4

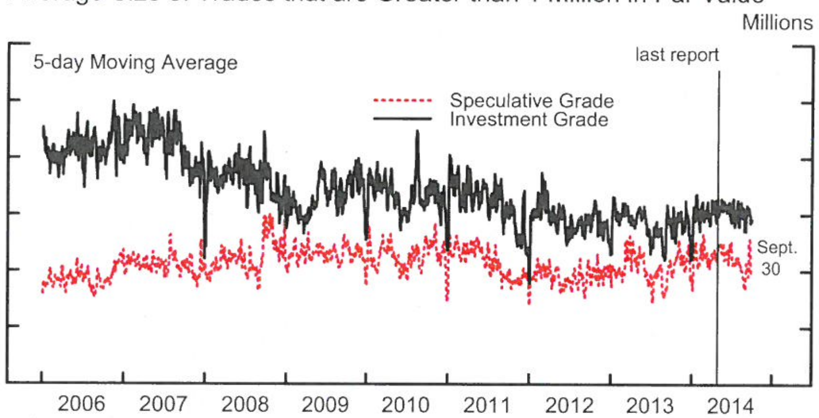
Percentage of Trades Greater than 1 Million in Par Value*

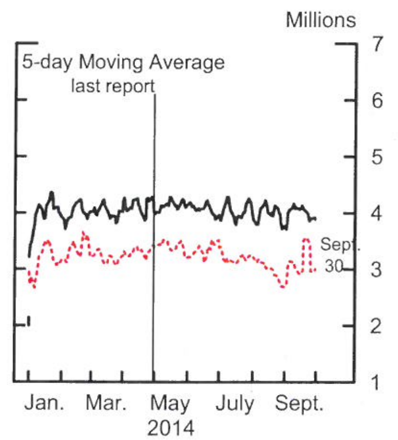




*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds.
Source: FINRA, Mergent, Moody's DRD.

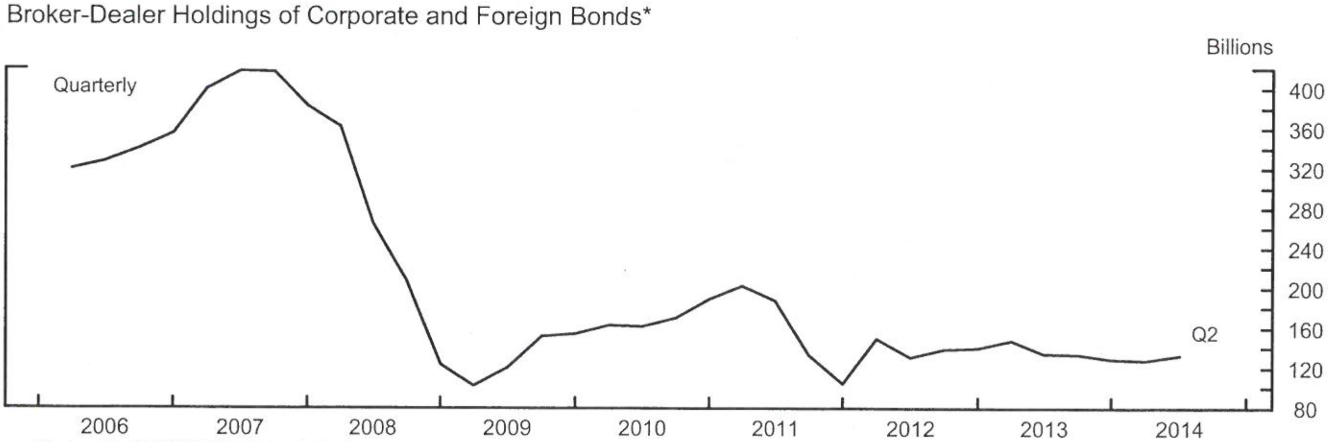
Average Size of Trades that are Greater than 1 Million in Par Value*





*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds.
Source: FINRA, Mergent, Moody's DRD.

Broker-Dealer Holdings of Corporate and Foreign Bonds*



*Series FL663063005.Q is plotted.
Source: Federal Reserve Flow of Funds Account.