Staff third quarterly report on corporate bond market liquidity

Summary

This report[1] describes developments in the liquidity and functioning of corporate bond markets since October 2014. In this update, we use the same measures of liquidity used in the previous reports 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 investment-grade corporate bonds increased some compared with the time of the last report, on net, but remained near historically low levels. Amid those relatively low interest rates and the strong investor demand for fixed-income securities, nonfinancial corporations continued to issue sizable volumes of bonds, with about 40 percent of the proceeds from issuance, in aggregate, reportedly being used to refinance existing debt. Issuance of bonds by speculative-grade and unrated corporations decreased somewhat in the final quarter of 2014, particularly in the month of December, reflecting relatively volatile conditions in the market for speculative-grade bonds, particularly bonds in the energy sector where falling oil prices appeared to weigh on investor demand.

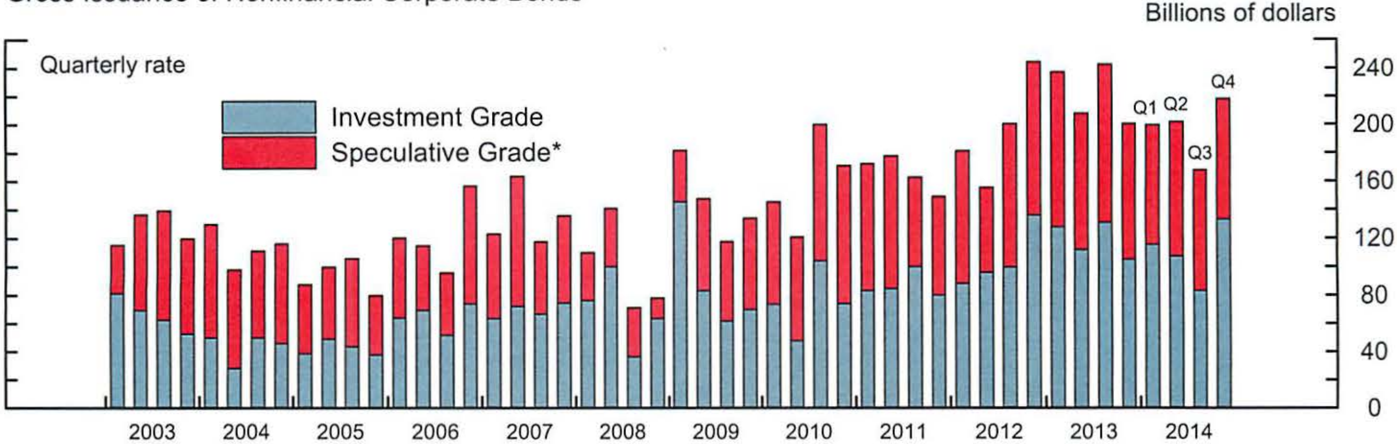
2) Measures that capture aspects of secondary bond market liquidity – the ease and cost with which investors can buy and sell corporate bonds – showed some tightening of liquidity

[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.

conditions near year-end. The average daily trading volume moved up noticeably for both investment- and speculative-grade bonds in November and December 2014, before falling sharply around year-end. As indicated in Exhibit 2, a significant drop-off in trading volume has occurred nearly every year-end since 2006. Accompanying the decline in trading volume, bid-ask spreads for speculative-grade bonds increased near year-end 2014. As indicated in Exhibit 3, an increase in bid-ask spreads for speculative-grade bonds near year-end also is a typical seasonal pattern, although the increase was more pronounced this time than in other post-crisis years. Exhibit 3 also illustrates that apart from year-end spikes, bid-ask spreads for both speculative- and investment-grade bonds have trended downward since the crisis to levels not seen since 2006. The fraction of very large secondary-market trades – trades that are at least $1 million in face value – remained stable for both investment- and speculative-grade bonds. In addition, dealers' inventories of corporate bonds held fairly steady in the third quarter of 2014 (latest available data).

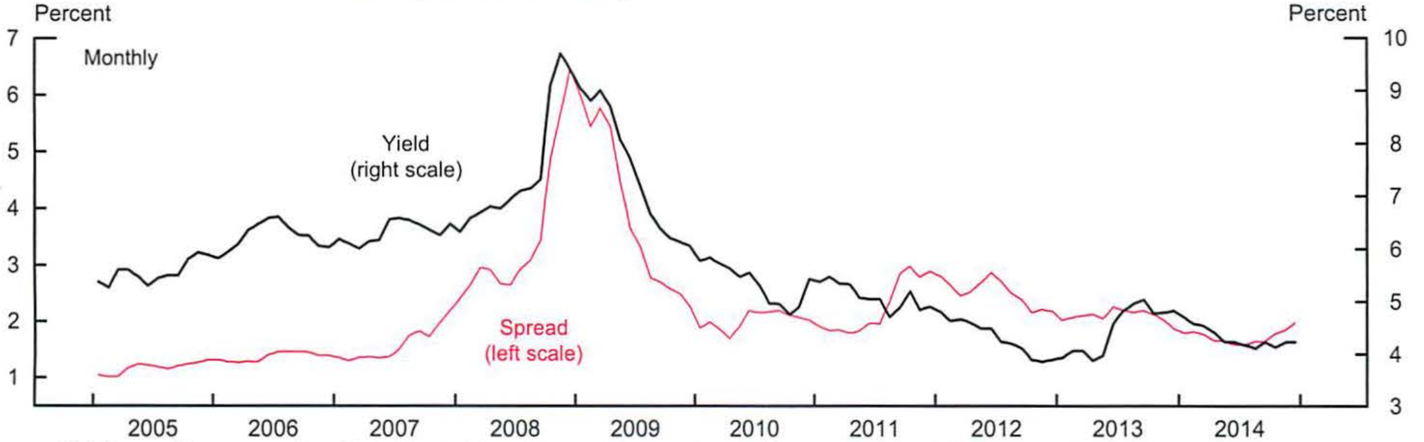
Corporate Bond Liquidity Monitor
Exhibit 1

Gross Issuance of Nonfinancial Corporate Bonds



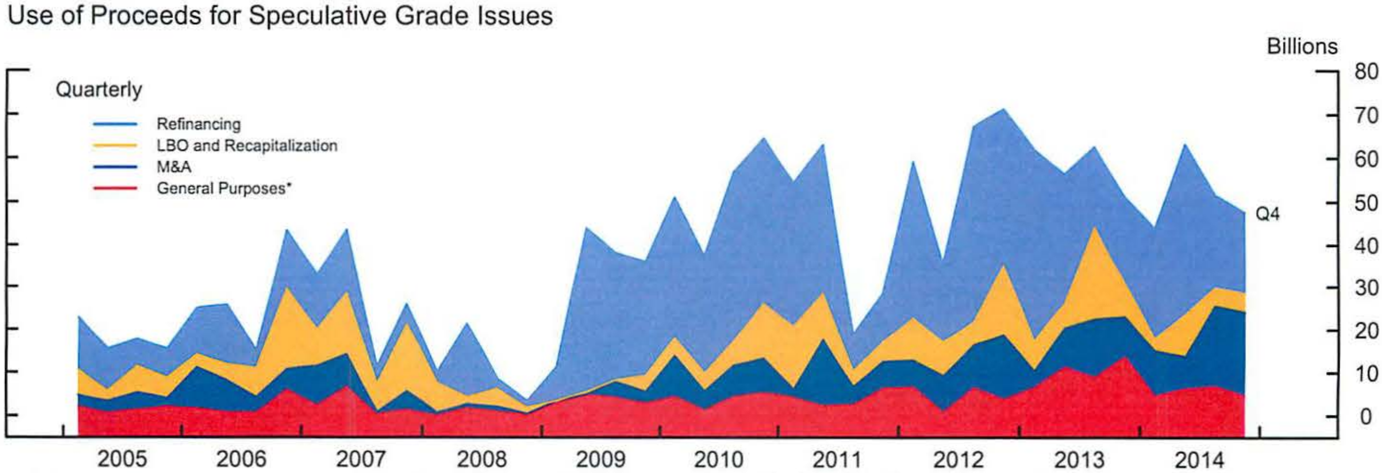
* Includes unrated bonds.
Source: Mergent.

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

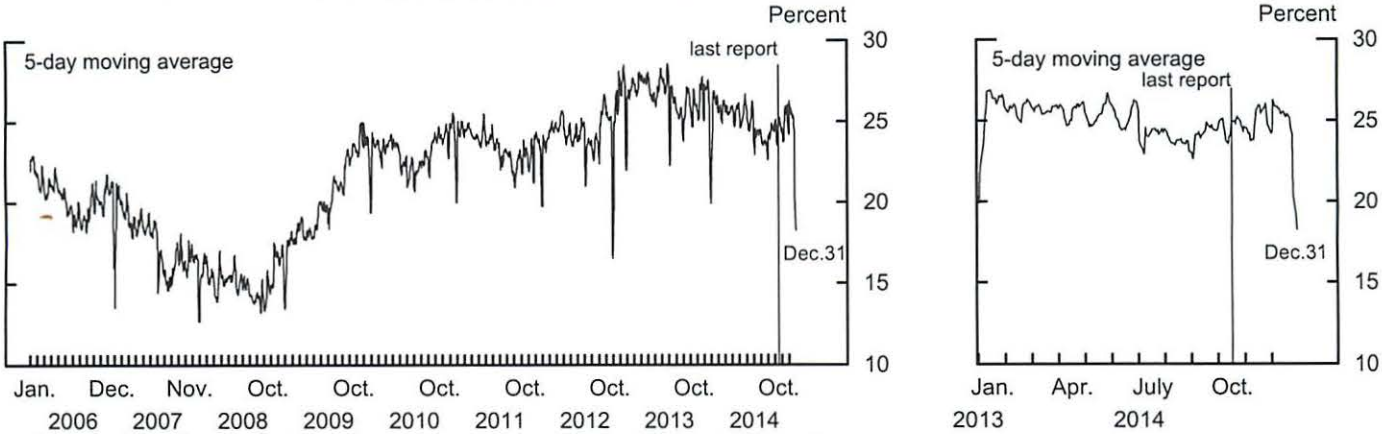


* General Purposes includes capital expenditures and other purposes not included in the designated breakdown.
Source: Standard and Poor's.

Corporate Bond Liquidity Monitor

Exhibit 2

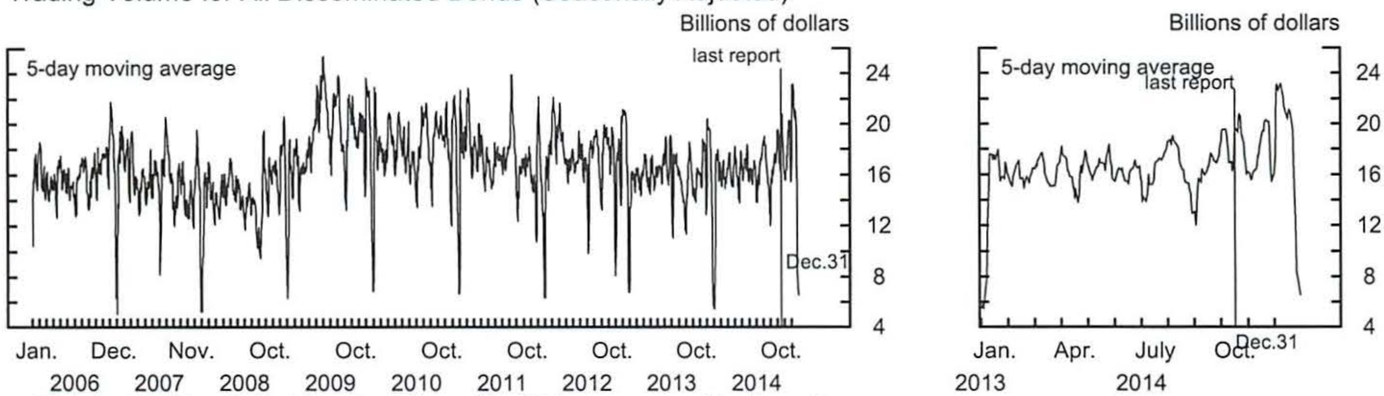
Number of Traded Bonds as a Fraction of Total Disseminated*



*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.

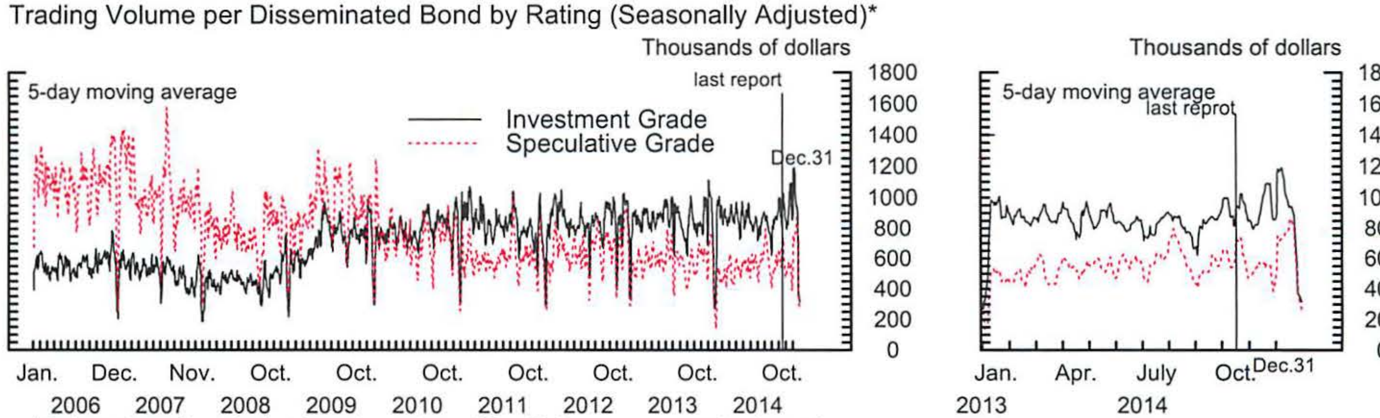
Trading Volume for All Disseminated Bonds (Seasonally Adjusted)*



*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds. Series adjusted for monthly seasonality.

Source: FINRA, Mergent, Moody's DRD.

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

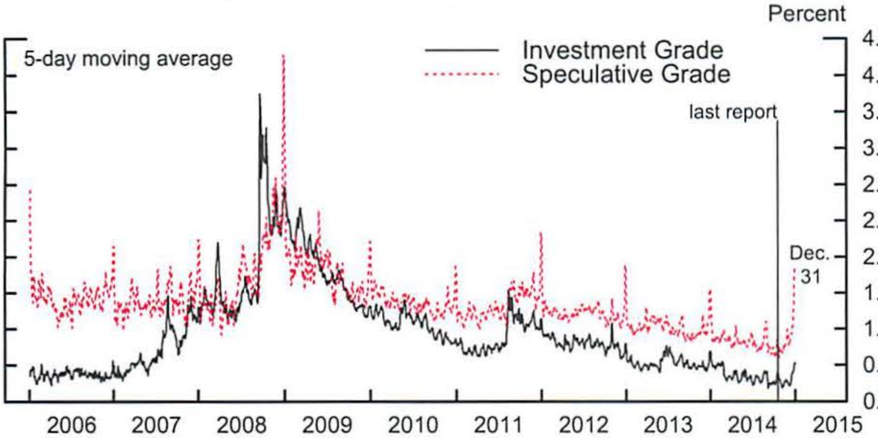


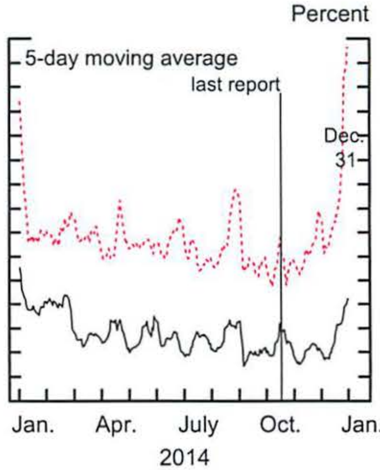
*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds. Series adjusted for monthly seasonality.

Source: FINRA, Mergent, Moody's DRD.

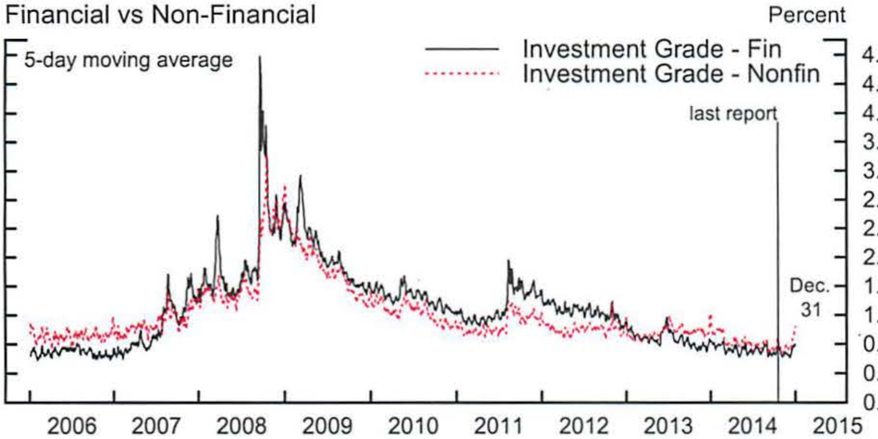
Corporate Bond Liquidity Monitor
Exhibit 3

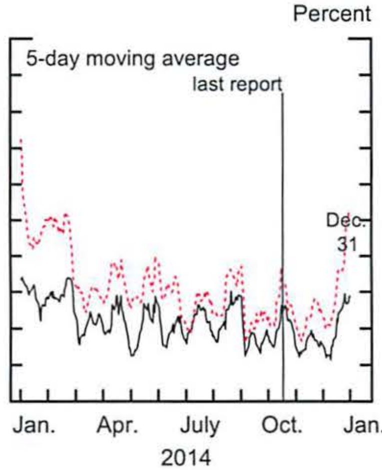
Effective Bid-Ask Spread for All Bonds



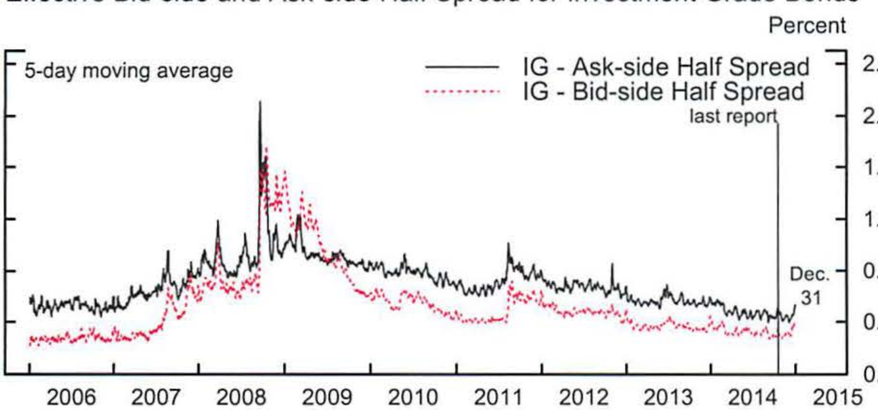


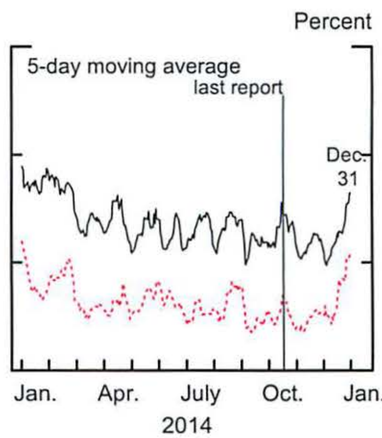
Effective Bid-Ask Spread for Investment Grade Bonds:
Financial vs Non-Financial





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.

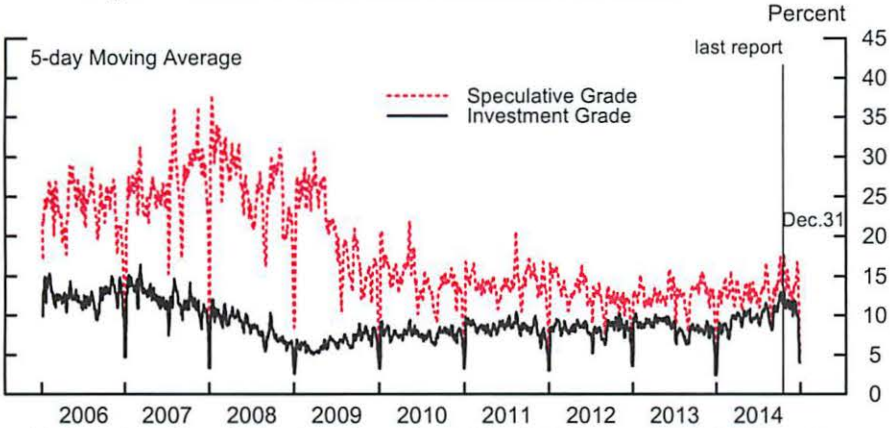
Effective Bid-Ask spread is the difference between weighted average dealer bid prices and ask prices

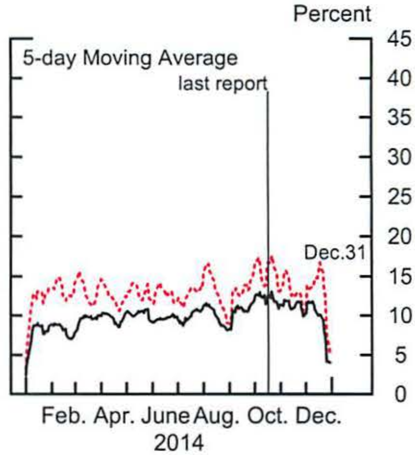
Source: FINRA, Mergent, Moody's DRD.

Corporate Bond Liquidity Monitor

Exhibit 4

Percentage of Trades Greater than 1 Million in Par Value*

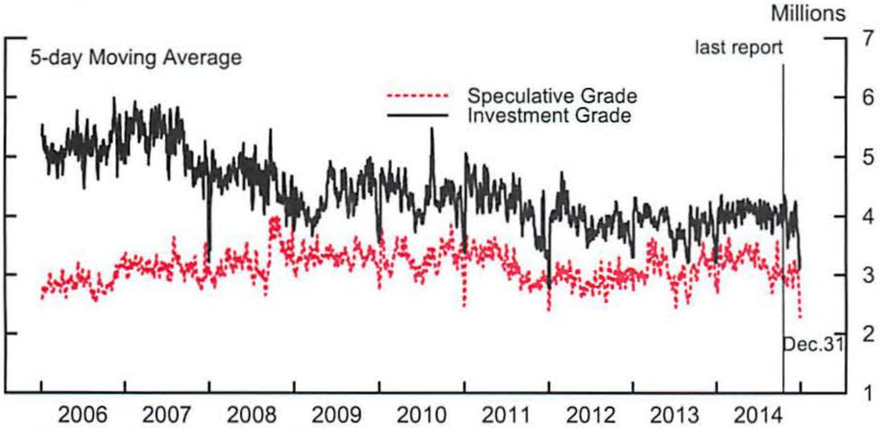


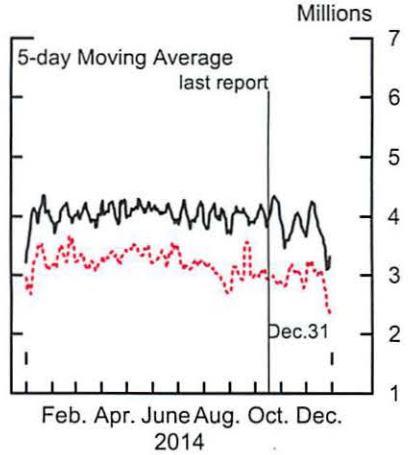


*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds.

Source: FINRA, Mergent, Moody's DRD.

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

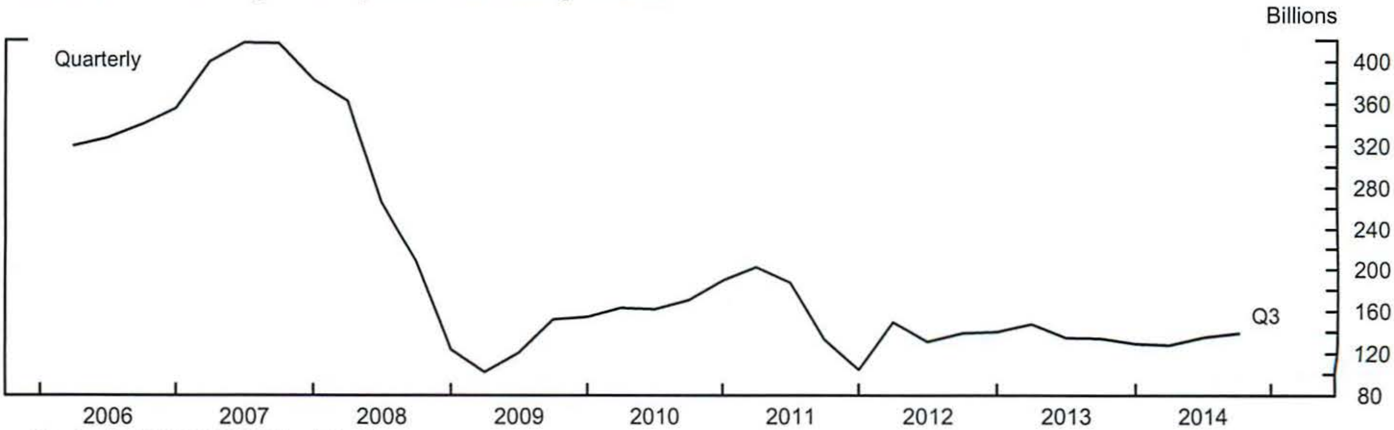




*Only trades of bonds that have been issued for 60 days or more at the time of trading are included. Excluding 144a bonds.

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.