ARTIFICIAL INTELLIGENCE (AI) KEY TO BOOSTING CORPORATE BOND LIQUIDITY AS RATES RISE

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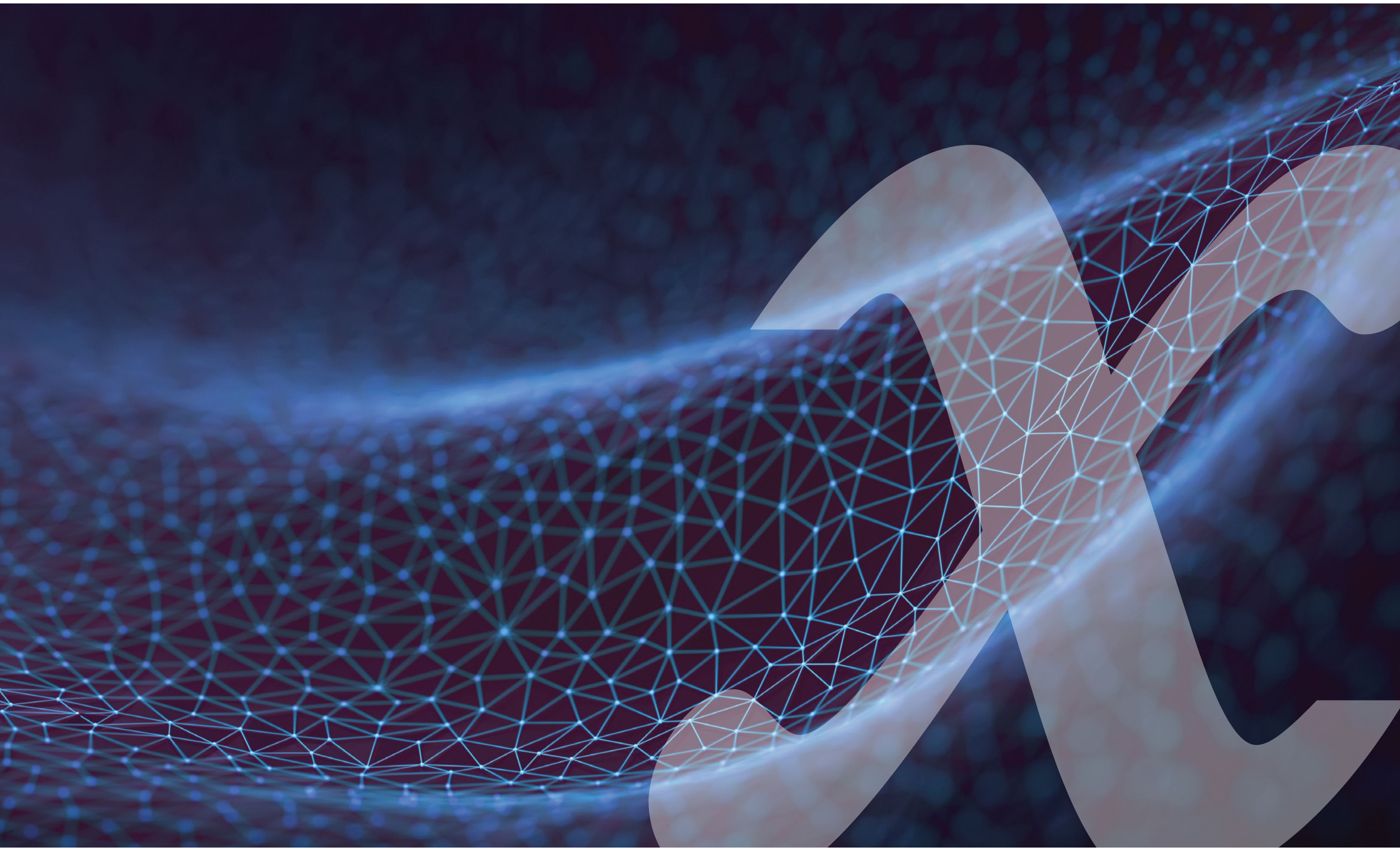

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INTRODUCTION

This past December many across the financial markets viewed the largest increase in inflation in almost four decades as a clear signal for an accelerated end to accommodative monetary policy. Then, in March, the Federal Reserve approved the first interest rate hike in more than three years and indicated six more hikes through the rest of 2022.

For corporate bond market participants, rising rates generally mean less liquidity. As the Fed, the largest borrower in the world, backs away from purchasing assets, that leaves more price-sensitive traditional buyers facing supply and demand conditions primed to generate volatility.

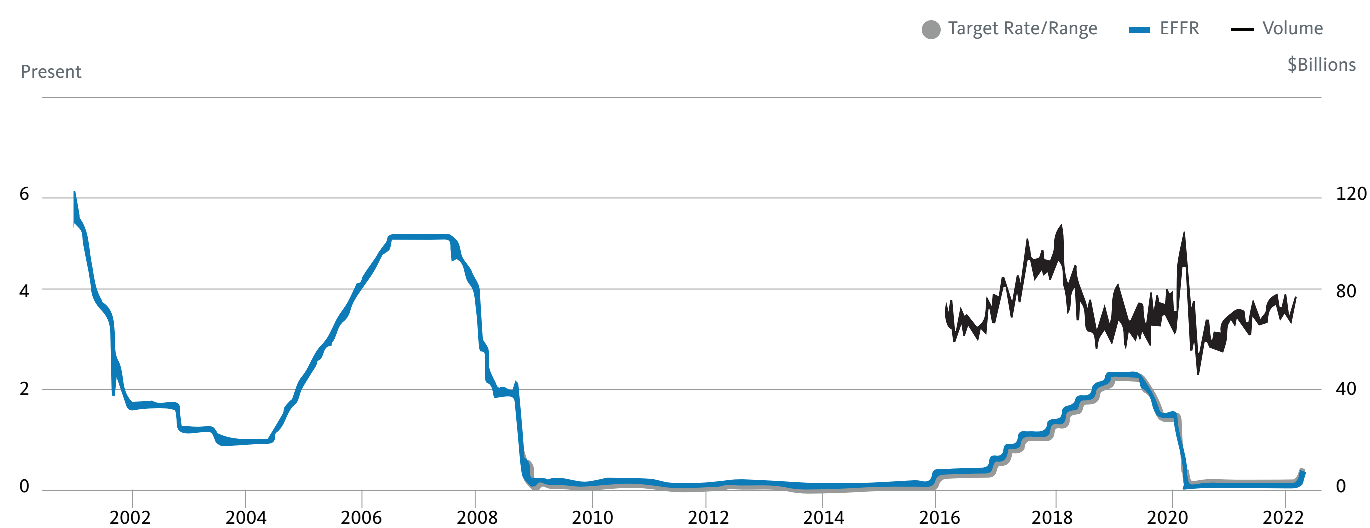
In a market that's mostly opaque, illiquid and still reliant on antiquated processes, finding natural buyers and sellers in the secondary market is difficult even under optimal conditions, particularly for larger block trades and older bonds. Indeed, over the last three months, nearly 60% of total trading volume was from bonds issued in the last two years.[1] But powerful tools that use artificial intelligence (AI) can help aggregate natural liquidity and improve transparency and price discovery, thereby unlocking trading opportunities in an expected environment of increased volatility and liquidity scarcity.

RISING RATES WILL CREATE CHALLENGES IN AN ALREADY ILLIQUID MARKET

Rising rates could discourage some investor selling to avoid recording a loss of principal. In mid-2005, after around a year of Fed rate hikes, trade counts and trading volume fell off significantly.[2] We are approaching a similar point in the credit cycle, but there are a few differences from 2004-2006. The corporate bond market today is more than two times bigger than it was then, with $4.6T principal outstanding at the end of 2005 vs $10T at the end of 2021.[3] Rates are also starting from a significantly lower point, with the 10Yr just below 2.4% in April 2022 vs 4.1% in early 2004.

As rates fall, trading intermediaries at banks — dealers —are willing to hold inventories of corporate bonds for longer time periods in the hope of eventually finding buyers for the CUSIPs they own at higher prices. But as interest rates rise and bond prices fall, dealers will be less likely to add to their inventories. They will likely look to unload those bonds from their inventories faster as the bonds lose value. Compared to prior rate hike cycles, capital constraints introduced in the aftermath of the credit crisis may leave dealers with even less flexibility to provide liquidity if buy-side demand decreases due to rising rates. This market dynamic often narrows liquidity and increases volatility for all participants, creating a premium on connecting natural buyers and sellers.

According to most expectations, 2022 should mark the start of a challenging environment for corporate bond traders as the Fed tightens policy. Dealers may have some flexibility to hold on to positions for a while, but the need for issuers to replace maturing debt in a higher rate environment will require close attention. Dealers will have to be quicker and smarter about channeling risk and facilitating customer inquiries and may need to find multiple buyers for each seller.



Federal Funds Chart[4]

Note: Chart is a reproduction of the EFFR chart

SMARTER TRANSPARENCY WOULD ENABLE A MORE EFFICIENT MARKET

The corporate bond market has recorded large price movements and losses so far in 2022 in reaction to the Fed's policy shift. This year, first quarter investment-grade U.S. corporate bonds lost 7.8%, according to Bloomberg index data.

Smarter transparency into contra-interest on specific bonds and more ways to identify and connect natural buyers and sellers can help the corporate bond market operate more efficiently. But the market's very structure — lacking a central limit order book or a requirement for real-time reporting on executed trades — hinders transparency, keeping buyers and sellers in the dark about each other's interests.

In fact, the market still relies on decades-old pricing and trading infrastructure based on the Request for Quote (RFQ) model, a protocol designed to work well for liquid instruments, such as U.S. Treasuries. But RFQ wasn't designed to aggregate liquidity or facilitate price discovery. In a rising rate environment, the limitations of RFQ will be increasingly felt by market participants.

Even as trading advances further onto electronic platforms — less than 40% of IG corporate bonds trade electronically in the secondary market[5] — progress to improve liquidity around any given bond will remain challenging. Volatility will bring increasing uncertainty around pricing, and with virtually no visibility into how other buyers and sellers are thinking about prices, market conditions could lead to many missed trading opportunities unless an alternative to RFQ with "smart transparency" is sought. "Smart transparency" means optimizing how information is shared among market participants to lead to an efficient market clearing price while minimizing information leakage.

TECHNOLOGY EMPOWERS THE DEALER AND BENEFITS THE BUY SIDE

In situations of rising rates and volatility when dealers are less willing to use their own balance sheet, buy-side market participants need to be able to connect with one another. As liquidity depends on buyers and sellers finding one another, it's crucial for dealers to have visibility into their client networks to locate interested counterparties, a growing challenge in a vast marketplace with so many CUSIPs. But AI and other new technologies will enable dealers to identify natural buyers and sellers from within their own customer networks more efficiently.

Furthermore, dealers can aggregate liquidity from multiple buyers and sellers, making it easier and faster to trade larger blocks electronically.

Essentially, these technologies empower the dealer to utilize their customer network — often consisting of hundreds of institutional investors — as a vibrant liquidity pool. So, whether it's finding one buyer or multiple buyers for one seller, using AI to discover and aggregate liquidity leads to more informed trading and better execution for buy-side clients.

In addition to liquidity aggregation on the part of their dealers, these new trading tools enable a new level of best execution for the buy-side — one which is more in line with other asset classes. "Smart transparency" includes the use of AI to invite only the right participants to a trade, and the condition that only participants who commit capital can get transparency into real-time price formation. Like the bidding process in the real estate market, potential home buyers and sellers can interact with each other by improving their prices to arrive at the market-clearing price. This flurry of activity can also wake up the market, prompt action, and even facilitate competition. Through this lens, it is clear that without price discovery and price improvement, best execution cannot be achieved.

ADVANCING MARKET STRUCTURE

Rising rates throughout 2022 will make holding positions in corporate bonds for longer periods of time more challenging for banks. Consequently, the ability to discover natural buyers and sellers and aggregate liquidity around a bond in this environment becomes critical for an efficiently functioning secondary market.

Scarce liquidity continues to create costly and time-consuming challenges for corporate bond market participants. But innovative data science and a new trading protocol with "smart transparency" will help advance market structure by facilitating liquidity aggregation, price discovery, and price improvement.

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[1,2]Based on TRACE data from FINRA: https://www.finra.org/filing-reporting/trace/trace-fact-book

[3]https://www.sifma.org/resources/research/research-quarterly-fixed-income-outstanding/

[4]https://www.newyorkfed.org/markets/reference-rates/effr

[5]https://www.greenwich.com/market-structure-technology/february-spotlight-regulatory-proposals-and-cds-volume-signal-change

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