Coalition Greenwich
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Challenging Credit Markets Are a Call to Action for Traders

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50% of traders in the study want a better way to interact with their counterparties

67% of buy-side traders rely on some form of RFQ to execute corporate bond trades

Executive Summary

Credit markets have come under immense pressure in 2022. A litany of market frictions this year have created new trials and tribulations for corporate bond traders while exacerbating some existing concerns. At the top of the worry list is the need to source liquidity against a backdrop of consistent market volatility. And just when bank counterparties and their capital are needed the most, balance sheets have shrunk and bid-offer spreads have widened to account for new market risks. The knock-on effect is that buy-side traders have lost some of their faith in the market data they have come to rely on over the past decade, with bond prices not behaving as they once did.

The buy-side traders we spoke with for this study echoed these sentiments. Today's trading environment just isn't lending itself to older, traditional electronic trading methods and protocols that have held up well in the past. While request for quote (RFQ) still accounts for over 40% of market volume, that percentage has dropped notably since the pandemic began over two years ago. This research examines these challenges and discusses what actions are being taken to attain a desirable future state in three key areas: the next phase for market data, the role of dealers and their balance sheet and new electronic trading solutions that will help bring it all together.

METHODOLOGY

Between March and May 2022, Coalition Greenwich conducted a series of qualitative interviews with a dozen traders from major buy-side and sell-side institutions in the U.S. Topics discussed included recent challenges associated with sourcing liquidity, given the new macroeconomic regime of higher rates, more volatility, post-COVID impact, and inflation. Additionally, data derived from the Coalition Greenwich 2021 Market Structure & Trading Technology Study based on 30 buy-side participants in the U.S. was leveraged.

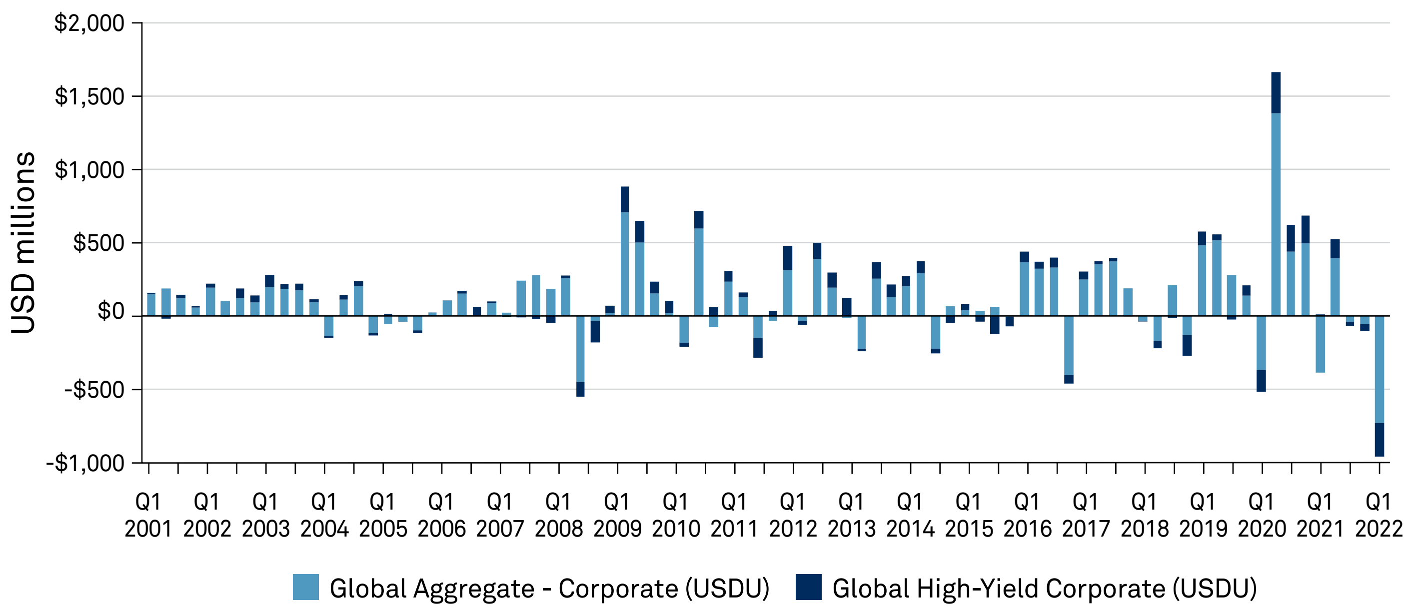
Today's Credit Markets Are Ugly

According to data compiled by Bloomberg, the U.S. corporate bond market has realized the biggest dollar decline since records began more than 20 years ago. There is a long list of factors influencing outflows, but persistent inflation concerns and further losses are top-of-mind for credit investors.

Even though there's been a correction in the market, bonds may still get cheaper, as central banks continue their hawkish stance and rates back up. The worldwide pool of investment grade (IG) corporate debt shrunk by US$805 billion during the first quarter of 2022, while the high-yield (HY) market lost US$236 billion.[1] To put these declines in perspective, the slump marked the largest total return loss since Lehman Brothers' collapse of high-grade bonds and the worst performance since the start of the pandemic for HY.

Hard Landing

Global credit indexes shed about $1 trillion in market value in Q1 2022



Note: Index market value, quarterly change.
Source: Bloomberg Indexes

[1] https://financialpost.com/investing/corporate-bonds-lost-1-trillion-and-theres-more-trouble-ahead

The trader's wish list is long. Current conditions have fostered strong opinions around exactly what traders are after to navigate choppy waters. Based on our conversations over the past quarter, the buy side has a laundry list of wants that have only grown in 2022.

What Buy-Side Traders Want

Wish list item	Current state	Desired future state
Actionable pre-trade data	Unreliable pre-trade data is mixed with misleading interest, which decreases the probability of successful risk transfer while increasing the chances of information leakage	Reliable price discovery combined with "safe" trading conditions/ minimized market impact
Reliance on dealer balance sheets	As market volatility ticks higher and macroeconomic frictions abound, sell-side balance sheet real estate becomes more dear and the unwillingness to make prices grows	Aggregation of liquidity, firm commitments on both sides of the market, and connecting with natural counterparties/leveraging dealer networks
Workflow inefficiencies	Fixed-income markets lack efficiency connecting the pre-trade, execution, and post-trade processes—leading to inadequate risk management, processing and reporting	Better flow of data and other information pertinent to portfolio management decisions, execution choice and post-trade activities
Transaction cost analysis (TCA) and best execution	A dearth of effective pre- and post-trade data and streamlined processes may lead to less impactful uses of TCA and other analytics	The culmination of better information and processes ultimately leads to better execution

Note: Based on 12 respondents.
Source: Coalition Greenwich 2022 U.S. Credit Markets Traders Study

Data is a Top Challenge

Although the importance of good data can't be understated, traders we spoke with indicated it can be a fickle friend. This is especially true in opaque markets, where there is a dearth of pre-trade transparency, misleading interest and slippage is commonplace. Many investors simply lack confidence in fixed-income data and believe about half of it is really reliable. Additionally, they've come to accept the inverse relationship between volatility and usable data, describing it as "par for the course." For those traders who believe they have access to the "right" information, the complexity of today's markets is concerning, since there aren't many historical regimes to guide stressed portfolio behavior.

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Data is creating winners and losers. There are a growing number of non-traditional players that are able to figure out how to intelligently consume and use available data. "The ones that know have a clear advantage," states a trader at a large U.S. asset manager, pointing to the likes of Jane Street and other ETF market makers. A trader at a large U.S. bank concurs and adds there are simply too many pricing sources and inaccurate information. This trader believes other types of information, like dealer runs that aren't showing what people actually want to trade, contribute to the excess of trash data the market has to deal with. Dynamic pre-trade data that reflects real-time contra-interest on a per-bond basis could provide more value.

Robust data is lacking in several areas. The ability to use data as a liquidity indicator was mentioned by several traders as being the most relevant use case. If liquidity is the foundation of a trade, real-time, dynamic liquidity metrics are crucial to understanding the probability of execution. Further, the ability to efficiently execute on a real-time indication of liquidity is just as important. Buy-side traders agree we just aren't there yet.

However, fixed-income data is set to become more useful. There are a series of adjustments that are taking place that both buy- and sell-side traders believe will change credit markets. There's still a belief that fixed- income data will become more useful and markets will become more closely tied to this information. One buy-side trader mentioned the resilience of algos during the worst of COVID-19 as a path that should be further improved and sharpened in our markets.

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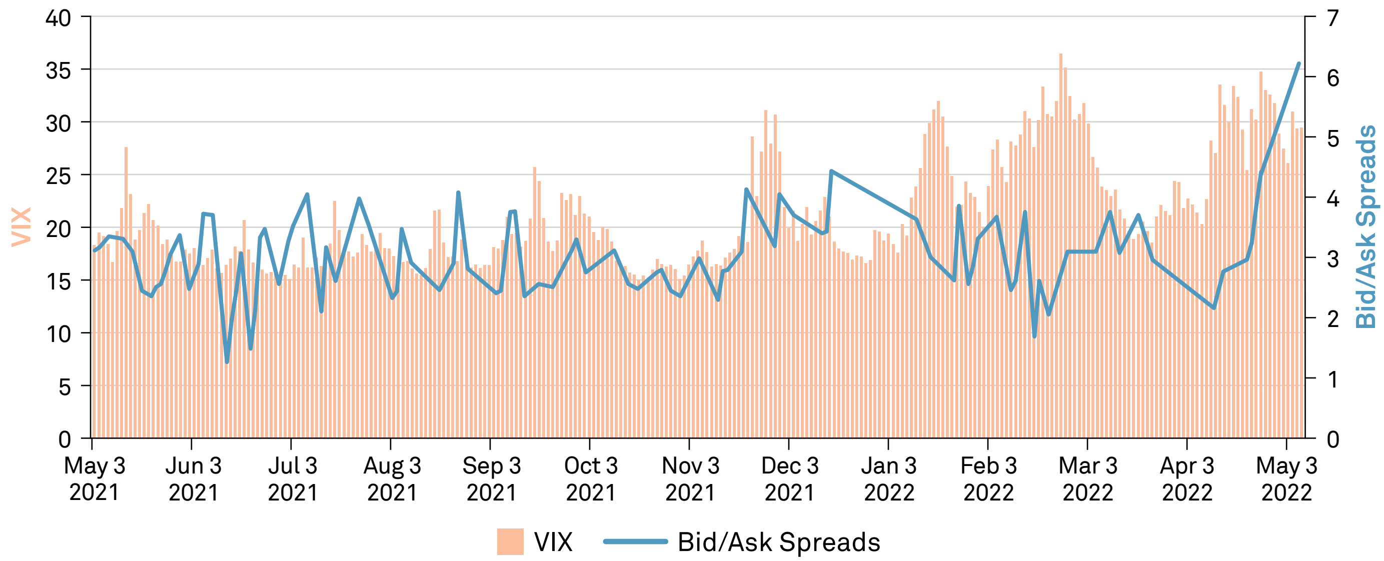
Reliance on Counterparties Falls Short of Expectations

This year welcomed in a new regime of market frictions, including large volatility spikes, wider bid-offer spreads and exploding equity volumes against a backdrop of macro factors. The financial press headlines seemed to never end. As equity liquidity soared, the opposite held true for many bonds—some sectors completely dried up, while others remained tradable. Dealer risk concerns tied to their balance sheets began to mount. As directional risks increased, banks pulled away from the most illiquid markets, and even some of the more-liquid ones, depending on their appetite for intermediate risk transfer on behalf of their clients.

Spreads Increase with Volatility

Increasing Spreads, Rising Volatility



Source: Bloomberg

Unfortunately, dealer balance sheets and liquidity are set to remain under pressure for a number of reasons tied to the global economy and micro market structure.

- **Rampant inflation:** U.S. inflation printed at 40-year highs this March.
- **Geopolitical conflict, coupled with a COVID-19 hangover,** has important implications for global supply chains and prices, particularly in commodity markets.
- **Central bank rate increases,** driven by inflation and supply chain issues, have begun to pop up in conversations, and recession may be looming in 2023.
- **Sanctions** around the world are set to continue to impact countries' and corporations' ability to repatriate dollars.
- **Reluctance to make markets,** due to frictions tied to higher volatility, market and counterparty credit risks, may steer investors into new issues (as well as other products like private credit) rather than secondary ones, further thinning liquidity.

Just stop playing games. The buy side strongly believes axe quality needs to improve alongside price efficiency. In a market that lacks transparency and keeps participants in the dark about pricing, there are still many games being played for price discovery's sake, according to one trader. The buy side needs the sell side to find a means to more effectively share their inventory and interest, and the buy side needs to find more efficient ways to deal with it. Likewise, one sell-side trader believes locking down balance sheets isn't the right path to ensure long-lasting relationships with clients. Clearly, both sides have many ideas of what's needed to improve markets in uncertain times. After a long period of inertia, recent market challenges could be the catalyst for the adoption of new technologies that facilitate true positive change.

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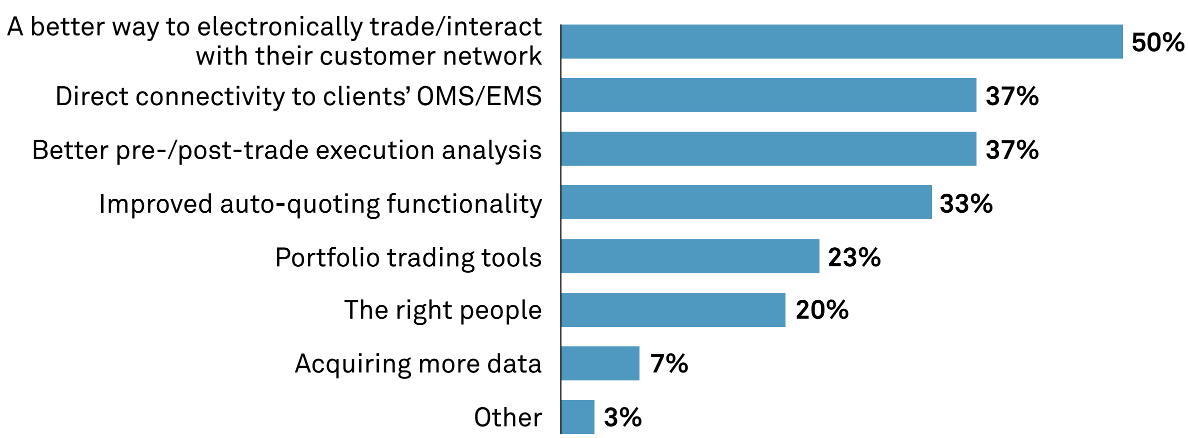
Workflow Efficiencies Are Lacking

Numerous sources of pre-trade data, particularly pricing information, are being used, including axe runs, calls with dealers, streaming prices, and more. Of course, the buy side has their opinions about what liquidity providers need to prioritize and invest in the near term. A "better way to electronically trade and interact with clients" tops the wish list of wants (see table on p. 3). Again, in the laundry list of mixed processes, better pre- and post-trade execution analysis and direct connectivity to clients' order management system/execution management system (OMS/EMS), as well as improved auto-quoting, received notable mentions.

What Should Corporate Bond Liquidity Providers Invest in Next?



Note: Based on 30 respondents.
Source: Coalition Greenwich 2021 Market Structure & Trading Technology Study

Seamless integration is the key. Several buy-side traders and nearly 40% of study respondents said that seamless integration with their OMS/EMS providers is crucial for e-trading platforms to gain critical mass and make true progress toward more electronification and automation in corporate bond trading. By embedding pre-trade data in portfolio management workflows and providing flexible new execution protocols to traders within their OMS/EMS, platforms can offer innovation and efficiency within existing workflows without sacrificing precious screen real estate.

Based on our interviews, the direction of travel is more direct connectivity and smart order routing (SOR) to a variety of liquidity sources, all supported by many dealers. While equity and fixed-income market structure remain notably different, it's hard to ignore the increased adoption of "equity-like" technology and workflows. Conversely, one trader we spoke with believes the optimal market should consist of the top 10 dealers and top three alternative trading systems (ATSs)—a market quite different from equity markets of today.

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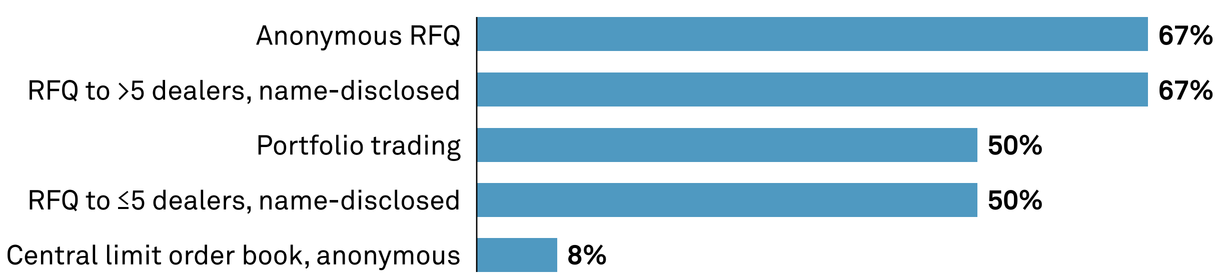
Taking a more strategic view will also lead to greater efficiency. Traders are also spending more time working with investment teams to figure out exactly what they want to do and the best way to achieve that goal. This may mean more strategic ways of dealing instead of "running things through the machine." For example, new protocols that allow for aggregation of liquidity and allocation across multiple participants could positively change the way large blocks are traded. Staying flexible and using rules-based methods, RFQs, voice, and high-touch, while keeping one toe dipped in the all-to-all waters and other alternative venues, seems to be the flavor of the day.

What Protocols Do You Use to Execute Your Corporate Bond Trades?



Note: Based on 30 respondents.
Source: Coalition Greenwich 2021 Market Structure & Trading Technology Study

Thinking out of the box matters. Investors aren't staying the usual course and are looking to make more substitutions in what they need to trade. There's concern about which bond is a good fit for a portfolio now that intermediation is more risky and there's more to do around packaging risk and protocols. Additionally, from a credit trading perspective, one trader notes that "Treasuries are an investible asset class again," since investors may not want to deal with credit risk and will instead lock in some yield and go home. All of this points to the desire for better workflow streams.

Conclusion

The first half of 2022 has proven ugly for credit markets. Buy-side traders are struggling with key challenges tied to data accuracy, their reliance on dealer balance sheets and implementing new, more-automated workflows to bring it all together. Given the plethora of market frictions born out of macroeconomics, geopolitics and the aftermath of COVID-19, participants are keen to find proactive ways to make lemonade out of illiquid lemons.

Finding liquidity is tougher now than ever. It feels like there are a million reasons why this is the case, as each trader has their own experience. However, it's clear that several drivers have created today's conditions. Traders we spoke with have changed their thinking in order to trade what they want, when they want—and that includes turning to new protocols and mixing and matching how they engage the markets.

Shrinking dealer balance sheets certainly haven't helped matters. A reluctance to provide competitive, firm prices and quality axes has left some traders wanting to tap into other liquidity-seeking methods. As such, following a long period of inertia, recent market challenges will be the next catalyst for the adoption of new technologies that facilitate true positive change.

On the data front, traders have indicated that vast amounts of fixed-income data have become even less reliable, with volatility spikes and liquidity getting spotty. This means data is creating haves and have nots, as some market participants struggle to figure out ways to aggregate and consume information more effectively and to separate out the good from the bad. Overall, there's still a belief among bond investors that fixed-income data will, over time, continue its march forward via improved accuracy and timeliness.

Change is in the air, as traders want to achieve better ways to trade electronically with more emphasis placed on workflow efficiencies. How quickly the buy side gets to this state will depend on the willingness of traders to accept that some of the workflows and methods they've relied on in the past just don't cut it anymore, and that it's time to try something new.

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