DEBT CAPITAL MARKETS

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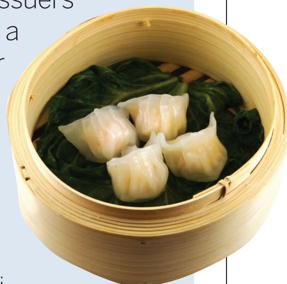

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Drastic funding transfusions risk leaving banks hooked

Richard Milne and **Michael Mackenzie** examine the fundamentals behind radical injections of finance by leading central banks

A four-letter word has cast a powerful spell over debt capital markets this year: LTRO.

The European Central Bank's longer-term refinancing operation, its name for cheap three-year loans to banks, has been seen as the continent's version of the quantitative easing, used by the US Federal Reserve and the UK's Bank of England to buoy markets.

The power of the LTRO in large part stemmed from its shock nature. Nobody expected the ECB to take such a bold step. The timing was also powerful, as capital markets were in a deep funk towards the end of last year as everybody was preoccupied with a possible euro disaster.

All that has allowed the LTRO to act as rocket fuel for markets this year, bringing a bonanza for issuers and investors alike. Indicators of stress, such as Italian and Spanish government bond yields, have enjoyed a remarkable rally.

And US investment-grade companies now have their lowest borrowing rate since records began in 1973 – 3.27 per cent in early March, according to Barclays Capital.

"The LTRO is definitely a game changer," says Jim Leaviss, head of retail fixed income at M&G, one of Europe's biggest investors. "You don't have to worry about day-to-day liquidity or the funding of banks. Beyond liquidity, it will impact solvency a little bit too."

European banks took more than €1tn in the two LTROs in December and late February. Many used it to shore up their funding needs for the next three years. Others, particularly in Italy and Spain, have reinvested the proceeds in high-yielding government debt.

Peter Fisher, head of fixed income at BlackRock and a former undersecretary of the US Treasury, says: "If you are a bank chief financial officer, 12 quarters is a long time. So the LTRO is very helpful in reducing strains on bank funding."

MEESON

The thaw has extended to most parts of debt capital markets. European banks, unable to issue anything except for covered bonds for much of last year, have managed to sell senior unsecured debt despite the boost from the LTRO.

The fillip for the markets has also been heightened by better than expected economic data from the US and a commitment from the Fed to keep rates low for several years.

But, for all the euphoria around the start of the year, reservations abound about how long-lasting the effects of the LTRO will be. Many believe the effect of the cheap loans will soon wear off and

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Waiting for the Fed: markets are as unclear on whether a third round of intervention will come as the US Federal Reserve apparently is
Bloomberg

Twist keeps QE on back burner

US quantitative easing

Economic contagion or stagnation could spark action by the Federal Reserve, reports **Michael Mackenzie**

Uncertainty over the trajectory of US economic growth in the coming months has left open the option of a third round of quantitative easing (QE) by the Federal Reserve.

After two prior bouts of QE and the current policy of Operation Twist, the US central bank remains determined that the country will not emulate Japan's long experience of deflation and lacklustre growth ever since its property and financial bubble burst in the early 1990s.

But with overnight rates in a near-zero band since late 2008, the US is experiencing a protracted process of writing down the debts incurred during its own mortgage and credit bubble that peaked in 2007.

Furthermore, the Fed's current prescription of low interest rates is hurting the ranks of savers, particularly the growing number of retiring baby boomers who can no longer rely on their savings accounts to produce an income that exceeds the inflation rate.

This, in turn, makes it difficult for the economy to prosper, say some economists. The curtailing of personal spending is miring the US in a classic liquidity trap, where low rates cannot spark a sustainable recovery.

To some, the Fed's intervention via QE represents "financial repression", a term coined by Carmen Reinhart, a US economist, to describe using captive domestic investors to keep interest rates low.

It is one of the main ways central banks can help western governments erode their huge debt burdens.

"Financial repression is a very serious issue and it will slow the recovery," says Andrew Lo, an economics professor at the Massachusetts Institute of Technology.

"Traditional monetary policy suggests low rates spur investment, but consumers drive – or, in this case, don't drive – the economy."

For now, the prospect of QE3 remains cloudy, amid the uncertainty over the economy. In his latest testimony to Congress at the start of March, Ben Bernanke, chairman of the Fed, did not provide a definitive signal that the central bank would be willing to go ahead with QE3.

While that disappointed some investors, concerns that the economy will expand at a lacklustre pace in the first quarter mean QE3 cannot be ruled out. The spike in oil prices this year poses a big risk that the economy could soften and counter the recent improvement in job hiring.

Steven Ricchuitto, economist at Mizuho Securities, says that QE3 could arrive in the second quarter should the economy weaken. "We may see some giveback, and if the economy suffers, the Fed will start QE3."

Such a slide, after the US economy expanded by 3 per cent in the final three months of 2011, stands to arouse concerns that the US is stuck in a sluggish stop-start economic cycle, with the writing-down of debts incurred during the mortgage and credit bubble preventing a sustainable recovery.

> The threat of QE3 remains, should bad news come from Europe or the hard landing feared for China

Dan Greenhaus, chief global strategist at broker BTIG, says: "Without a meaningful and sustained improvement in the US economy, the likes of which we do not forecast, the Fed will launch another bond buying programme later this year."

As it stands, the Fed is engaged in Operation Twist, its policy of selling short-dated Treasuries and using the proceeds to purchase long-term debt.

The Twist has kept long-term Treasury yields at low levels, with the 2 per cent yield on 10-year notes below the current annual inflation rate of 2.9 per cent.

"The Fed is still doing the Twist and that's controlling rates," says Gerald Lucas, senior investment adviser at Deutsche Bank.

With earlier bouts of QE sparking a sharply weaker dollar and surging commodity prices amid fears of higher inflation in the future, the Twist may remain a key policy tool after its proposed end date of June.

Mr Lucas says a scaled-down version of the Twist is likely after June, so as to keep rates low and boost the recovery.

Richard Gilhooly, strategist at TD Securities, says: "Twist is the electric shock wire that keeps yields contained, while the option of doing QE3 is more efficient and powerful than actually doing it and expanding the Fed's balance sheet."

That said, the threat of QE3 remains, should the US economy be hit by bad news – whether from Europe or the hard landing feared for China.

"QE3 will loom on the horizon," says Professor Lo, "if there is a further deterioration in the eurozone with a spillover to the US."

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Funding infusions risk addiction

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worry about where markets might go from there.

Roman Schmidt, head of corporate finance at Commerzbank, says the LTRO has made a "big difference". But he expresses concerns about how dependent markets have become on fresh infusions of central bank liquidity.

"It is a soft addiction, a sugar addiction," he says.

"The big question now is what happens when the effects [of the LTRO] wear off in the next six to nine months. Will we need another one?"

Like many other market participants, he frets about what will happen in three years, when so many banks – 800 took part in the second LTRO – have so much debt maturing at the same time.

> 'You can't delever by borrowing money – even from the central bank. That's the dilemma'

Mr Fisher also points out that while it lessens the pressure on banks, it fails to remove the fact that they need to shrink the size of their balance sheets, through so-called deleveraging. "You don't want to delever too quickly, but delever you must," he says. "And you can't delever by borrowing money – even from the central bank. That's the dilemma."

Across the Atlantic, both corporate bonds and equities have made a barnstorming start to the year, in part due to the LTRO but also thanks to signs that job hiring in the US is gaining strength.

This embrace of risky assets has confounded many wary investors, who still worry that the string of better data may be nothing more than another false dawn, particularly as oil prices have risen sharply this year.

Oil's not well: prices present another risk to the economy
Dreamstime

Jerry Webman, chief economist at Oppenheimer Funds, says: "The parallels with 2010 and especially 2011 are striking so far, and the burning question is whether early optimism will once again give way to disappointment and heightened volatility as we near midyear."

He adds: "While the US economy is indeed showing signs of strength, growth is far from roaring.

"Add in the likelihood that most of the easy gains in the financial markets have already been made, and it stands to reason that some caution over the current cyclical rally is warranted."

A warning signal over the sustainability of the rally in risky assets resides in the Treasury bond market, where the 10-year note yield remains anchored at about 2 per cent.

With yields being kept in check by the Federal Reserve's hefty purchases of long-dated bonds under Operation Twist, some believe that weaker growth will compel the central bank to undertake QE3 – a third round of quantitative easing.

Hans Mikkelsen, credit strategist at Bank of America Merrill Lynch, says: "US interest rates have failed to increase because of a combination of QE3 expectations, a dovish Fed on hold for a long period of time, the diversion of foreign flows away from Europe, and huge inflows into the bond market."

This support from the central bank is making some economists doubt how long the risk rally can continue.

Dario Perkins, economist at Lombard Street Research, says: "The question is whether this latest reflation trade is founded on economic fundamentals and will continue, or whether this is simply another case of investors over-extrapolating recent data trends."

"There are good reasons to believe growth in the world's leading economies will remain sub-trend in 2012 and then weaken again in 2013."

Gerald Lucas, senior investment adviser at Deutsche Bank, warns of brinkmanship over Europe.

"There is a risk of financial contagion for the US from the eurozone," he says.

Bond market How true is the mantra 'governments bad, companies good'?

"Governments bad, companies good" has been the mantra of many bond investors in the past year, writes **Richard Milne**.

The introduction of credit risk into government bonds through the Greek debt crisis and the eurozone's woes led many investors to flee sovereign debt markets. Many see corporate bonds as the new haven.

But some investors question whether companies are as safe as assumed. Many have extremely strong balance sheets at present – of governments, banks and consumers they are the strongest. And profitability has held up well throughout the financial crisis.

But Jim Leaviss, head of retail fixed income at M&G, says: "The argument of safety is probably naive. Walmart doesn't know yet how to print money."

The money-printing argument is often used in support of sovereign bonds – the "true sovereigns" such as the UK, the US and Japan will never default in the sense of not paying, many say.

David Hoile, head of asset research at Towers Watson, a professional services firm, says it depends on whether an investor holds corporate bonds to maturity or needs to mark to market. Such bonds can suffer in turmoil such after the collapse of Lehman Brothers in 2008.

"If there is a systemic issue, global liquidity will dry up considerably and corporate credit will do very poorly," he says. "Regardless of whether these companies are good or bad."

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Cash injection is a 'caffeine boost'

Eurozone

Cheap loans have turned sentiment, says **David Oakley**

The €1tn-plus injection into the financial system by the European Central Bank has been likened to a caffeine boost to the system. It has worked like a powerful pick-me-up on the troubled eurozone government bond markets.

Bankers and strategists say the ECB's two three-year loan offers, under which eurozone banks borrowed about €489bn in the first tender and €529bn in the second, has turned market sentiment from one of gloom to one of optimism over the future of Europe.

Peter Schaffrik, head of European rates strategy at RBC Capital Markets, says: "The ECB injection has worked very well. It has certainly bought Europe more time to fix its problems."

Yet the liquidity injection cannot alone solve the problems of the stalling, uncompetitive economies on the eurozone's southern and western fringes – Greece, Ireland, Italy, Portugal and Spain, say strategists and bankers.

Spain has already warned that it is likely to miss economic targets, and Italy has a long way to go to revive growth and create a flexible economy that can compete with Germany, the eurozone's flagship.

There are also worries that problems in Greece, which sparked the crisis in the eurozone, could return.

John Stopford, head of fixed income at Investec Asset Management, says: "I still have little appetite for peripheral government bonds. The liquidity injection is not the solution. This is a crisis about solvency."

Mr Stopford and other investors warn it may take a long time before they consider buying bonds of Greece, Portugal and Ireland. It can be difficult to restore confidence in a government and its bonds once it has been lost, they say.

This explains why the rally in eurozone government bonds has been mainly driven by domestic banks, which have used the cheap loans from the ECB to buy sovereign debt. Many foreign investors, by contrast, have used the rally to sell, traders say.

A trader at a big US bank says: "There is still a lot of volatility in the Italian and Spanish bond markets that makes me reluctant to take a big position. There is a lot to lose if the market swings against you."

This highlights the eurozone's problems. Greece, Ireland and Portugal alone are unlikely to bring the whole edifice of monetary union crashing down because they are small. But Italy and Spain, the third and fourth biggest economies in the eurozone, matter because of their size. And, despite the rally since the ECB's first announcement of three-year liquidity injections in December, confidence in these markets is fragile.

Mr Stopford says: "There is still a danger that negative news or poor economic data could turn sentiment."

The US trader adds: "If the market does turn, then instead of a virtuous circle where yields fall, boosting confidence and depressing yields further, we will be back to the vicious circle or death spiral that we saw towards the end of last year."

The ECB action has definitely bought the eurozone time, possibly until the end of the year at least.

On a technical level, it has also steepened the bond yield curves of Italy and Spain.

This means that short-term yields are now much lower than long-term yields. This fall in short-term yields, which have an inverse relationship with prices, is because the near-term outlook has improved sharply.

This is good news for banks as it enables them to borrow short cheaply and lend long at higher yields, the traditional way of making profits through a so-called carry trade.

Therefore the eurozone crisis and contagion have been contained for now, as many bankers and investors are prepared to give eurozone policymakers the benefit of the doubt, as they attempt to bring in fiscal reforms aimed at curtailing the high debt levels that triggered the crisis.

The day of reckoning for the 17-member eurozone club, when it is feared markets might decide time has run out for policymakers to put right past mistakes, has certainly been delayed.

Some optimistic market participants think the eurozone may even have turned a corner.

The more than €1tn liquidity injections by the ECB might have saved not just the peripheral economies. but the entire monetary union club.

Waving the flag: European action has bought time to fix the problems of Greece and others Bloomberg

Eurozone 'Wretched crisis' blamed for denting investor appetite but now stars are 'aligned for high yield'

European corporate bond sales have revived again after the resurgent eurozone crisis dented investor appetite and caused even supposedly haven-status, high-grade company bonds to lose some of their lustre in late 2011.

European companies, excluding banks and other financial institutions, have sold almost €60bn of bonds so far this year, almost double the volume over the same period last year, and the second-best start to a year on record, according to Thomson Reuters data.

Although companies based in the more stolid northern European countries have dominated, those on the eurozone's struggling southern fringe have also enjoyed renewed market access. Moreover, many European companies have headed across the Atlantic, borrowing large amounts in dollars as well.

Investors and bankers are sceptical that the latest Greek rescue is the beginning of the end of the eurozone crisis, but the European Central Bank's offer of unlimited cheap loans to banks has transformed sentiment this year.

"It's been a complete game-changer," says Andy O'Brien, global co-head of debt capital markets at JPMorgan. "We've seen a big improvement in the tone and activity of the European credit markets since the year began."

Investment-grade corporate credit has also emerged as a haven trade for European investors paring their holdings of continental bank and sovereign debt. Allocations to corporate credit have been on the rise in recent years, while equity funds have suffered large outflows.

Despite the eurozone's myriad challenges, most bankers, investors and analysts expect bond sales by highly rated European companies to remain healthy.

European companies have historically relied mostly on pliant local and regional banks, many of which are under pressure to shrink their balance sheets. Although blue-chip companies will still be able to rely on banks keen for their custom, many are turning to the debt market with gusto.

"The constraints on bank lending will force more companies to turn to the bond markets, and there is almost unprecedented liquidity in the market right now," says Claus Skrumsager, head of European debt capital markets at Morgan Stanley.

John Ream, European head of investment grade credit sales at Citigroup, says investors eager to buy corporate bonds are often forced to do so at auctions rather than in the secondary market. This reflects poor liquidity and the low inventories of the trading desks of global banks.

Joseph Faith, a credit strategist at Citigroup, forecasts that the volume of European investment grade, non-financial corporate bond sales will rise by a third to €125bn this year. Given €95bn of estimated repayments, this will increase the size of the market by a net €30bn.

Mr Faith expects companies rated below investment grade, known as junk ratings, to sell €35bn of bonds this year, a 17 per cent increase from last year's total.

Trade in the US is also expected to continue, with large European multinationals likely to be particularly active in borrowing in US dollars. In addition to often attractive pricing, many European companies need dollars for their operations and can borrow more there than in the euro market.

Even Europe's high-yield bond market, which effectively shut in the second half of 2011, is livelier. Many lower-rated companies go to the US market for larger junk bonds, but European investors have still bought deals previously thought of as too speculative.

"The stigma of junk bonds has disappeared in Europe," says Dominic Ashcroft, managing director of leveraged finance at Goldman Sachs. "A lot of chief finance officers and treasurers are now looking to the high-yield market to replace existing loans. Many companies which would previously have gone straight to the banks are now increasingly raising capital in the bond market."

Garland Hansmann, high-yield portfolio manager at ICG, says it

> 'Constraints on bank lending will force more companies to turn to the bond markets'

was only "this wretched eurozone crisis" that held the market back last year. "Now those risks have receded somewhat, we've seen a resurgence ... Almost all the stars are aligned for high yield," he says.

How long can this corporate credit gold rush continue? The ECB's unprecedented lending operations aside, investors and bankers continue to fret over the eurozone's weaker members.

Although corporate bonds have rallied strongly this year, yields still indicate some lingering investor nervousness. A resurgence of the eurozone crisis could again lead to debt sale volumes shrivelling as they did towards the end of last year. Deals that looked attractive at the start of the year may look foolish at Christmas.

In the longer run, some think European banks will reassert themselves as the dominant fund providers for regional companies once they have returned to health.

"We'll continue to see heavy capital markets activity until the banks fix themselves and lending resumes," says Melanie Czarra, head of European debt markets at Mizuho. "The question is when that will happen. I don't think it will until next year, at the earliest."

Other bankers and investors say that an increasing preponderance of bond funding over bank funding is part of a natural, much needed, evolution of Europe's financial markets.

"European companies are likely to stick with the capital markets even when banks return," says Ashish Shah, co-head of global credit at AllianceBernstein. "Once a company has issued a bond, it tends to be a repeat issuer."

Robin Wigglesworth

Rules shrink banks' fundraising options

Covered bonds

Investors are being directed towards asset-backed bonds, says **Mary Watkins**

Tighter regulation is encouraging lenders to shrink balance sheets and divest assets.

Issuers and buyers are being channelled towards a smaller group of public market fundraising options, with many championing covered bonds in particular.

The bonds, seen as ultra-safe by investors, are backed by a pool of assets such as mortgages and they have become increasingly appealing in recent years because of the extra protection they offer and because of the favourable way they are likely to be treated versus unsecured debt under new "bail-in" regulations.

Heiko Langer, senior credit analyst at BNP Paribas, says regulation has become a big factor in driving investors to covered bonds. The Solvency II and Basel III regulations encourage insurers and banks to favour covered bonds, in some cases over senior unsecured debt. "Basel III is the first set of regulations that also allows investors outside Europe to get special treatment for covered bonds," Mr Langer says.

As a result more Asian investors have started looking at the bonds.

The growing importance of the market became apparent late last year. As the eurozone crisis rumbled on, European banks faced serious liquidity problems and issuance of senior unsecured debt, traditionally the bedrock of bank funding, appeared to be faltering.

A few months on and the European Central Bank's €1tn liquidity injections into the banking system in December and February have transformed market sentiment. Hundreds of European banks have taken advantage of the cheap, unlimited three-year funds under the ECB's longer-term refinancing operation (LTRO). The flood of liquidity has allowed banks to refinance maturing debt, buy sovereign bonds and slow down the disposals of assets.

With markets rallying and cash-rich investors seeking a return, northern European banks were first to return to the public markets, issuing covered bonds

The LTROs gave banks 30%-70% of their funding needs – Armin Peter

and then, significantly, senior unsecured debt.

By February that positive market sentiment had spilled over into southern Europe, with a number of Italian and Spanish lenders, effectively locked out of the public markets for months, issuing debt – even though it should have been more cost-effective to use the 1 per cent loans they had from the ECB.

According to Dealogic, about $105bn was raised by banks globally in the covered bond market for the year to March 9, compared with $136bn for the equivalent period last year. The amount raised using senior unsecured debt stood at just over $203bn, slightly below last year.

While improved investor sentiment has paved the way for European banks to issue covered and senior unsecured debt, issuance in Europe this year is likely to fall as banks continue to deleverage their balance sheets, says Philippe Bodereau, head of European credit research at Pimco.

Armin Peter, head of covered bonds at UBS in London, agrees. He says that despite the initial rush at the start of the year, the level of issuance in the European covered bond market in 2012 is likely to drop off.

"The introduction of the December LTRO was a game changer," he says, but adding in February's LTRO means issuers will have already met the majority of their funding requirements for 2012.

He says investors are in a weak position: "They are sitting on too much cash but there are too few issuers." Mr Peter says the LTRO has reduced banks' need to tap public bond markets. "The two LTROs will have provided banks with 30-70 per cent of their funding requirements, providing them with the opportunity to reduce their funding volume through public markets."

Yet growth in other regions and currencies should aid global full-year figures.

Gareth Davies, head of European ABS (asset-backed securities) and covered bond research at JPMorgan, says regulators have championed covered bonds.

But, while investors are drawn to them because of the treatment they receive under regimes such as Solvency II, it is "not healthy" for banks to rely on one type of funding product.

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Issuers develop a taste for dim sum market

China

Robert Cookson looks at a small but growing market

Dealmakers are ready for a busy year in the small but fast-growing "dim sum" bond market, as Chinese and international companies flock to Hong Kong to issue debt denominated in the currency of mainland China.

Yields on dim sum bonds, named after the bite-size delicacies served in Chinese restaurants, are still on average several hundred basis points lower than on the mainland.

As a result, these Hong Kong issued bonds are an attractive funding source for companies, if they can obtain permission to move funds from the offshore market to the mainland.

The year has got off to a brisk start. Baosteel, the Chinese state-owned steelmaker, America Movil, the pan-American telecoms provider, and Lotte Shopping, the South Korean retailer, are among 10 issuers that have raised the equivalent of $1.7bn so far in 2012, according to Dealogic.

Since the market began five years ago, dim sum bond issuance has grown following a series of regulatory reforms.

In 2011, there were 84 such deals worth a $14bn in total, up from $5.4bn in 2010 and $2.3bn in 2009. Herman van den Wall Bake, head of debt capital markets syndicate for Asia at Deutsche Bank, thinks a broader range of issuers means 2012 will be another strong year for the market.

He says: "Multinationals have woken up to the availability of this market. They realise that it's a viable alternative [to other debt markets and funding currencies] and that it's no longer quite as cumbersome to get approvals to remit the proceeds."

Having borrowed renminbi in Hong Kong, companies must obtain regulatory approval to invest the funds on the mainland. The approval process has been streamlined over the past year, but it still takes three or four weeks and is subject to restrictions.

> 'Multinationals have woken up to the availability of this market'
> **Herman van den Wall Bake**
> **Deutsche Bank**

Even so, the incentive for issuing renminbi bonds in Hong Kong will remain strong, so long as yields are lower than on the mainland. As an indication of the yield disparity, five-year Chinese government bonds yield 2 per cent in Hong Kong versus 3.3 per cent in Shanghai.

Companies are not only issuing renminbi-denominated bonds to invest on the mainland. Some groups are issuing dim sum bonds, then swapping the proceeds into dollars. The cost of swapping renminbi into dollars has fallen substantially, which has meant issuing a dim sum bond then swapping the proceeds can sometimes be cheaper than borrowing in dollars in the first place.

According to dealmakers, Lloyds, the UK bank, and BMW, the German manufacturer of cars and motorcycles, are two companies that have swapped the proceeds of dim sum bonds into their home currencies and kept the funds offshore.

Deals like these have been made possible by the growth of an offshore renminbi cross-currency swap market, where daily trading volumes now average about $150m, up from only $10m a year ago. Yet, as the swap market is relatively small and illiquid, the maximum amount of renminbi that can be swapped in one deal is about $75m.

Most dim sum bonds issued to date have been small, generally less than $100m. The biggest deal so far this year was the $475m bond by Agricultural Development Bank of China, a state-owned lender.

In general, deal sizes are capped by the amount each issuer can remit onshore under its foreign debt quota.

With most deals so small, trading volumes in the secondary market are low. In a sign of the dearth of liquidity, the bid/ask spreads on most dim sum bonds are about 100 basis points.

More than bite-sized Alamy

Most investors hold them to maturity, as trading them is so expensive.

Another reason for thin liquidity is that the supply of renminbi in the offshore market is limited. Renminbi deposits in the Hong Kong system totalled Rmb576bn ($91bn) in January, some 0.7 per cent of the total deposits of Rmb80tn in mainland China.

The currency flows between the onshore and offshore markets only through controlled channels, mainly trade.

In recent months, as the offshore renminbi deposit base has declined, dim sum bond yields have risen.

The average yield of dim sum bonds tracked by a Deutsche Bank index was 3.7 per cent at the beginning of March, up from 1.5 per cent a year ago.

Yields could rise further, given the heavy supply of bonds due to hit the market. Some Rmb80bn of a total Rmb244bn debt, including certificates of deposit as well as bonds, will come due by end 2012, HSBC says.

Some 85 per cent of all offshore renminbi debt products have a tenor below three years.

That means there will be a steady supply of debt that needs to be refinanced until 2014, particularly in the coming months.

Inventory reductions 'the death of trading'

Wall Street

Lower holdings by banks may increase the risk of bond market volatility, says **Nicole Bullock**

Before the global financial crisis, large Wall Street dealers used to hold big inventories of corporate bonds to facilitate trading for their clients.

When a bond manager such as Jesse Fogarty, of Cutwater Asset Management, wanted to sell a large number of bonds, the dealer would sell some of them to other clients for him and buy some itself to sell down over time, hopefully for a profit.

Since the financial crisis, however, large Wall Street dealers have sharply cut the number of corporate bonds they hold to facilitate this kind of trading for clients or for proprietary positions.

Mr Fogarty calls this move "the death of trading".

Known in the financial markets as "dealer inventories", these bond holdings reached highs of more than $200bn in 2007, but dropped to less than half that by the end of 2008, as dealers reduced their risk because of the banking crisis.

In the second half of last year, dealers cut their bond holdings again, as they dropped from about $90bn at the start of June to $40bn by the end of February 2012, the lowest level in a decade.

These lower inventories, analysts and investors say, reflect an environment of lower risk-taking by Wall Street banks in the aftermath of the financial crisis and ahead of tighter regulations.

The result is likely to be higher volatility in bond prices, as the buffer is far smaller now.

In addition, the so-called Volcker Rule, a part of the 2010 Dodd Frank Act, could make it impossible for dealers to take these kinds of positions, because it prohibits proprietary trading by banks. At the same time, higher capital costs under Basel III also loom as an impediment to holding bonds on a bank's balance sheet. Many in the market believe the rules, which still need to be finalised, are a big driver of the reduction in inventory that was seen last year.

Others, however, also see an independent move to reduce risk on the part of the banks as being behind last year's declines.

Mr Fogarty says the "risk on, risk off" trading that has characterised the past few years makes it increasingly difficult for all market participants, including the dealers, to take positions. Whole areas of the market have moved in parallel in response to what is perceived as good or bad news,

He says: "If everyone is a buyer or everyone is a seller, it is like stepping in front of a train."

Electronic trading platforms, such as MarketAxess, which have grown in prominence in the past few years, are taking up some of the trading.

As dealer inventories have fallen, MarketAxcess's share of investment-grade bond trading, for example, has increased, in part because of smaller banks becoming more active.

Nonetheless, market participants generally expect lower inventories will increase volatility, as they say happened during last year's sell-off.

As Europe's debt crisis escalated, risk premiums on investment grade and high-yield bonds widened sharply.

"The takeaway is that market liquidity has been reduced," says Chris Taggert, analyst at CreditSights, a research group. "You end up with higher volatility for the simple fact that, without the dealers taking positions, trading volumes will move prices faster."

Investors say the lower inventories are really being felt on large trades – those for more than $5m.

Hiding from risk: Wall Street banks have opted to play safe in the wake of the financial crisis and ahead of tighter regulation Panos

Liquidity has also shifted to new issues and bonds of companies that are frequent issuers of debt.

The heightened volatility is being seen in both bull and bear markets.

Corporate debt snapped back quickly this year, when the outlook for Europe brightened and signs of recovery in the US mounted.

Risk premiums, or spreads, on investment-grade corporate bonds have narrowed to about 180 basis points over US Treasuries from about 230 bps at the start of the year, according to an index from Barclays Capital.

Junk bond spreads have tightened to less than 600bp, from nearly 700 bps at the end of 2011.

"It is probably accelerating the current rally and will do the same on the downside," says Matt Toms, head of US public fixed income investments at ING Investment Management.

Samurai bonds maintain their strength

Japan

A low interest rate policy is a winning formula for all, says **Ben McLannahan**

Not all news out of Greece is grim for bondholders.

At the end of last month Athens said that the 20-year bonds it had sold to investors in Japan in the mid-1990s would not be subject to haircuts – for now, at least.

In Tokyo, holders of Y109bn of "samurai" bonds breathed a sigh of relief.

Not that the market for samurai – yen-denominated debt issued in Japan by foreign companies and governments – needed much of a fillip.

During the global market turmoil last summer, while dollar and euro markets saw primary issuance from even top-rated borrowers slow to a trickle, samurai deals kept appearing.

Last year saw a total of $25.3bn raised from 39 issues, with the lead taken by Australia – one of a diminishing number of triple-A-rated countries – and South Korea.

That was the biggest haul since 1996, according to Dealogic, the data tracker, 2011 has begun even more strongly – $7bn from eight deals.

Strong demand is being matched by supply. Overseas companies and governments remain keen to tap Japan's abundant liquidity for dependable, relatively cheap funding.

Yields on samurai bonds for investment-grade companies, for example, are about half the global average outside Japan, according to Bank of America Merrill Lynch indices.

Even after the cost to the borrower of swapping some or all of the funds into another currency, those prices can look attractive.

Last August, for example, Australian lender Westpac gave up a few dozen basis points to swap yen into US dollars in five years, but still paid about 30 bps less than a new dollar deal.

Meanwhile, for a Japanese buyer used to receiving measly spreads from even subinvestment grade domestic companies, those yields can look good too.

"The majority of buyers of samurai are financial investors such as life insurance companies and pension funds," says Ken Koizumi, managing director of debt capital markets at Goldman Sachs in Tokyo.

"The yield from Japanese government bonds and domestic corporate bonds is very low, but they need to make profits," he adds.

Since 2009, an occasional boost has come courtesy of guarantees on the repayment of principal, supplied by the state-backed Japan Bank for International Cooperation (JBIC). That has enabled the sale of samurai by a wide range of lower-rated developing countries.

JBIC says it wants to boost use of the yen as an international currency, while providing domestic institutions with a wider choice of investment opportunities.

"From the perspective of a Japanese investor, it is like taking Japanese government bond risk, with a hefty spread on top," says Kazuhide Tanaka, head of long-term funding for Japan at Rabobank, a frequent samurai issuer.

As risk assets have rallied this year, some lower-rated issuers have sensed an opportunity. The government of Turkey, for example, hired banks last month for a $1bn, JBIC-guaranteed offering of 10-year samurai bonds, seeking a yield of just a few dozen basis points above the benchmark yen swap rate.

At current rates, the yield could be about a quarter cheaper than when Turkey tapped Japanese investors for $2.4bn last March, in the biggest deal by a sovereign issuer in a decade, according to Bloomberg.

This is not a market for everybody at all times, of course. Investors still look askance at European names – especially after Norway's Eksportfinans, a once rock-solid samurai issuer, was cut seven notches to junk by Moody's last November.

US issuers, responsible for about a third of the outstanding samurai paper, may be shut out of the market altogether, if tax authorities in Japan and the US cannot resolve their differences.

Under a change in US law that takes effect this month, US samurai issuers will no longer be able to deduct their interest costs for newly issued bonds, while investors will be subject to a 30 per cent withholding tax on their coupon payments.

JPMorgan and Goldman Sachs have rushed to get samurai deals away before the deadline, says Kyoko Kaji, credit analyst at Nomura.

Hidechika Fukushima, managing director of debt capital markets at Mitsubishi UFJ Morgan Stanley Securities, says: "Some kind of solution should be found in order for us to bring US issuers to the samurai market again."

> 'Some kind of solution should be found to bring US issuers to the market again'
> **Hidechika Fukushima**

In spite of the US problem, the pipeline looks strong, say bankers. The government of Mexico may even look to issue samurai without a JBIC guarantee – testament both to strong demand and to better informed buyers, says Mr Tanaka at Rabobank.

He contrasts the sturdiness of the market last year with the turmoil a decade earlier, when the troubles of US car companies shut the market for everybody else. "Now, investors are more selective," he says. "They don't take such a simplistic view."

The basic driver remains simple enough. As long as domestic interest rates stay rooted near zero, yield-hungry institutions are likely to continue to hunt for opportunities outside their own borders.

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