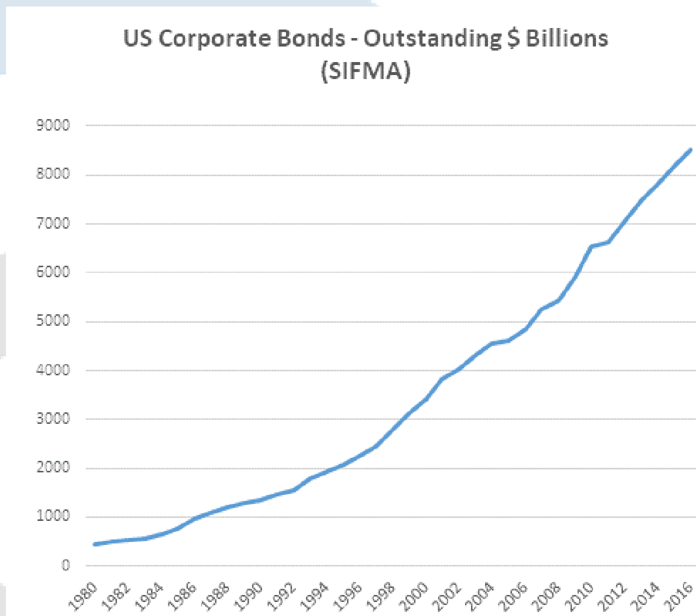
BondCliQ

The Inside Market May 2019

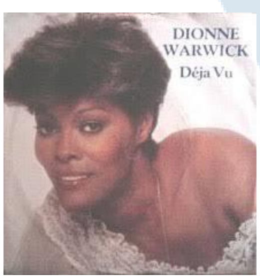
As a new solution provider, we intend to make your assessment process easier by clearly and consistently articulating our approach to improving the US corporate bond market through our monthly blog post (The Inside Market). This post will touch on just a few topics, but there will be many more to come. To be clear, **this forum WILL NOT be used to talk in detail about the BondCliQ product**. We have a nice website for that, thank you (www.bondcliq.com). Your feedback, criticisms, thoughts, and, of course, encouragement are welcome. Feel free to comment openly or directly to me (chris@bondcliq.com).

Size Matters

While the future state of the US corporate bond market is a topic of constant debate, there is universal agreement that the market has changed. Relative to 20 years ago, the most visible difference in structure is the sheer size of the outstanding market. Discussing the rapid growth of the corporate bond market is not new, but **the details of this expansion are profoundly and permanently altering the environment**. An in-depth examination of how the US corporate bond market has grown is essential for predicting which new ideas will help participants adapt.



Deja Vu



Revisionist history tells us that one of the key catalysts for the 2008 market meltdown was the lack of lending standards for individual borrowers. NINJA loans and no-asset mortgages are relics of a time when we were not as wise about the potential consequences of easy money...right? Well, it hasn't taken long for history to repeat itself. Just replace "individual borrowers" with "corporations," and similar conditions that precipitated the crisis are currently in motion. The recent outstanding performance of both the stock and bond markets are diverting our attention, but this sobering quote from Bill Gross in 2012 is highly relevant today: *"They would have you believe that stocks, bonds and real estate move higher because of their wisdom, when in fact, prices float on an ocean of credit, a sea in which all fish and mammals are now increasingly at risk because of high debt and its de-levering consequences."*

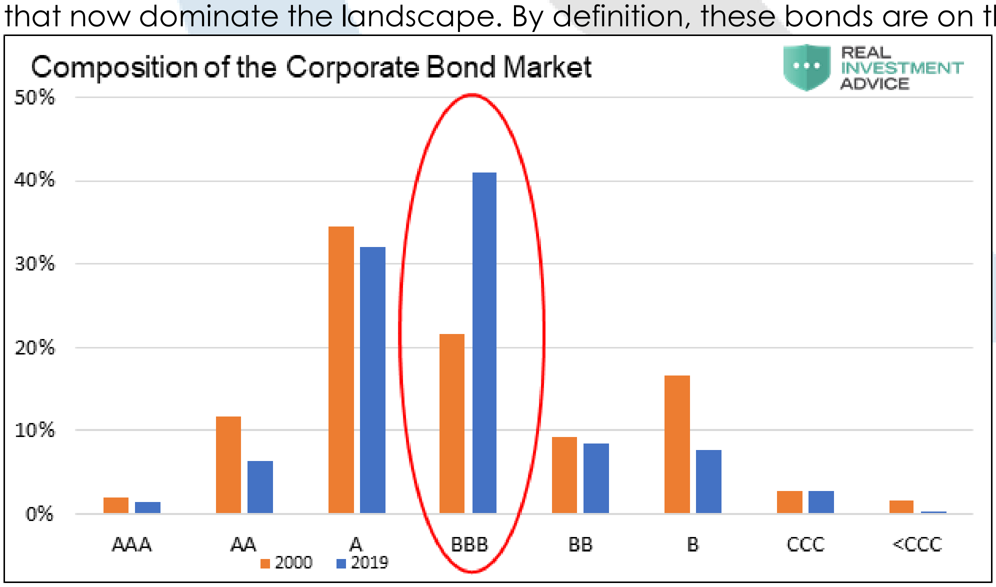
Low End Theory

As a result of central banks continued quantitative easing policies, it has never been easier for public companies to issue bonds with extremely low yields. Of course, just like the sub-prime crisis, the least qualified borrowers have been taking full advantage of this situation and yield-starved investors have no choice. Last year's WeWork deal provides the perfect illustration of this conundrum: *"This week high-yield bond investors faced a puzzle: **how to value a bond sold by an unprofitable company that does not own hard assets or offer a clear outlook for its free cash flow?** The company in question was WeWork, the office-sharing company that last year attracted a $4.4bn equity investment from Japan's Softbank. WeWork, which hired JPMorgan to lead the sale but had more than a dozen other banks working as well, attracted enough demand to increase the sale to $702m from $500m."*

The current "ocean of credit" has created a corporate bond market that has never been more dangerous. While the true risks have yet to fully manifest into losses, **investors are not being compensated properly for lending to hazardous companies**. This is the equivalent to picking up quarters in front of a steam roller. It only takes one misstep (a default)to flatten your entire portfolio (buy-side) or your balance sheet (sell-side).

Attack of the Killer B's

Any new idea in the US corporate bond market must address the growing population of BBB bonds that now dominate the landscape. By definition, these bonds are on the border of the investment grade universe. A bad quarter (or two) and a BBB issuer can find themselves reclassified as high-yield. Given these mechanics, many BBB bonds trade very differently than higher-rated issues. Transactions are less frequent, electronic trading is more difficult and market data (pricing and transaction information) is at a premium.



Corporate Bond Darwinism

Sophisticated buy-side institutions have been consistent in their demand for new solutions that allow them to adapt to the corporate bond market. While the initial requests were for more electronic trading tools, interests have shifted to data-focused tools like Algomi ALFA or the augmentation of their traditional OMS platform. In the short term, early adoption of market data solutions have provided buy-side institutions with a material edge over market markers: *"By aggregating formerly separate pockets of market data into one single interface ALFA enables the trader to instantly see the price of a security before engaging in a trade allowing us to be price makers rather than price takers. We are also mining data from this and sending it to quants who can look at a huge range of findings on cost and spread analyses, such as future new issue concessions and liquidity cost scores."*

This imbalance in information has led many to believe that well informed buy-side institutions will be the new liquidity providers in the market. I think this view is misplaced, but my thoughts are covered pretty well in an earlier blog. A more probable scenario is that instead of being replaced by buy-side institutions, the surviving dealers catch up and begin to leverage improved data as well.

Dealer Adaptation

The traditional approach to building a corporate bond dealing franchise could be loosely described as "building market share." This process involves printing enough trades to be viewed as "the market" in a sector, complex or individual issuer. In theory, successful implementation of this strategy will allow a dealer to profit over time by getting exclusive access to client order flow. **A riskier market combined with constrained balance sheets and less time to hold inventory may have rendered the market share approach obsolete**. Not all corporate bond dealers have remained committed to this strategy, so many are trying new ideas like algorithmic trading, direct electronic trading feeds with clients, increasing agency trading activity or ETF market making. **No matter the path, for a corporate bond dealer to successfully adapt to today's market, they need access to better market data.** Unfortunately, despite originating the invaluable pricing data that has become essential to any market, dealers are forced to buy their own data back from vendors that aggregate their pricing information. As a result, yet another line item is added to the operating costs of a corporate bond dealer. **BondCliQ breaks this structure by allowing dealers to access the institutional pricing information that they collectively create and proactively improve it over time.** Now dealers can adapt to the BBB-dominant market like buy-side institutions and "see the price of a security before engaging in a trade."

Looking before you step may be the most important thing to do in a market full of potential land mines.

-Chris White (CEO – BondCliQ)