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Corporate-Debt Market Slows to a Crawl

Banks' Reduction of Bond Inventories Is Fueling Lack of Liquidity

By Katy Burne
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Corporate-bond investors have struggled this week to find trading partners for some large orders, causing unusual price drops and raising concerns that trading could freeze in future market turmoil.

"Buyers just disappeared" early Thursday for many low-grade bonds and even some higher-grade ones, said **Jason Graybill**, senior managing director at Carret Asset Management LLC, which oversees $2 billion.

He said a large block of Deutsche Bank AG bonds, rated investment grade and bearing a 1.35% coupon, were offered for sale both Wednesday and Thursday, as worries about the health of the European economy spread and traders sought to sell European financial-sector debt.

Fueling the reduction in so-called liquidity, or the ability to buy or sell securities quickly at a given price: Many large banks have reduced bond inventories in recent years, in response to new capital rules and other measures.

Traditionally, large banks and brokerage firms have acted as middlemen in the bond market, matching buyers and sellers and sometimes buying and selling from their own holdings to keep trading going.

Their pullback now is playing out in the market, along with other factors such as diminishing Federal Reserve purchases of bonds, declines in stock and commodity prices and investor concern over economic data, the Ebola virus and geopolitical tumult.

Trading is far from frozen, but choppy conditions have spooked investors. A pullback by banks is leading to a "quest for liquidity," said Scott Colyer, chief executive of Advisors Asset Management Inc., which oversees $15 billion.

Trading profits picked up in the third quarter at firms including Goldman Sachs Group Inc., reflecting increased trading around larger price swings in some markets. But investors say the signs of reduced liquidity are unmistakable.

In a normal market, investors typically pay a dealer to drum up buyers when they need to sell. But in a market when investors are panicking, traders selling to meet client redemptions have less bargaining power, leading prices steadily lower.

Affinion Group Inc. bonds bearing a 7.875% coupon and due in December 2018 were hit hard this week. At one point Thursday, the bonds traded down 5 cents to 63.5 cents on the dollar for a yield of 21.621%. The previous day they traded at 66.5 cents, and on Oct. 10 at 72.5 cents, according to MarketAxess Holdings Inc.

The premium that investors were demanding to own U.S. junk-rated corporate bonds rose to 5.08 percentage points above comparable Treasurys Wednesday, according to a Bank of America Merrill Lynch index. That premium, or “spread,” was 4.66 points at the start of the week and 3.97 points in mid-September.

Now, instead of purchasing bonds from clients and holding on to them in the hopes of finding a higher price when they go to sell, dealers often are charging a fee to locate a third-party buyer.

In a September report, researcher Greenwich Associates said before the financial crisis, banks wouldn’t hesitate to buy $100 million in bonds from a client, but today they would be more apt to take $20 million.

Facing delays, many traders have headed to the derivatives markets, where transactions can be simpler and cheaper to complete. The volume of interest-rate futures and options trading reached a daily record Wednesday on exchanges operated by CME Group Inc., surpassing the previous record set in May 2013.

Many investors also blame structural changes in the bond market. A boom in issuance since the financial crisis has left fund manager portfolios overflowing with bonds, while dealer inventories used to trade with clients have shrunk.

Until now, however, the effects of the changes and regulations haven’t been fully felt because markets have been relatively placid.

Most investors were worried the liquidity problem would materialize when interest rates were poised to rise. Few may have expected it when rates were falling. The 10-year U.S. Treasury traded around 2.153% late Thursday, up from 2.092% as of Wednesday’s close but down from 3% to start the year.

Dealer risk appetites “have been on a clearly exhibited declining trend,” said Bill Awad, portfolio manager in multisector fixed income at Babson Capital Management, whose team oversees $75 billion.

Harvey Schwartz, finance chief at Goldman Sachs, said reduced trading may be part of the postcrisis norm.

The firm posted a 48% jump in net income for the third quarter Thursday, in part due to fixed-income trading gains that constituted its first rise in trading revenues in more than a year. Some desks at Goldman handled record volumes on Wednesday, people familiar with the matter said.

“All the banks are being much more conservative in creating liquidity,” said Mr. Graybill. “They are doing it in smaller positions sizes and they want to get paid for it.”

—Justin Baer contributed to this article.