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ETFs as part of the credit liquidity story

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Liquidity in the corporate bond market is tough. We've written about it time and time again. At a high level we see two solutions. One, inject new electronic trading tools and liquidity providers into the existing corporate bond market to better match buyers and sellers (a theme discussed in our 2014 European Fixed Income Study). Two, look for alternative ways to gain the credit exposure sought by the investor. In a research paper released in the fourth quarter of 2013 we began to delve into this concept - providing investors with tools that help them not just find the bond they need, but instead helping them to find the best way to gain the credit exposure they need.

The most thought of instrument to fill this need is the credit default swap (CDS). It is a derivative (obviously), so by definition the supply is unlimited which should then makes its utility as a tool to gain credit exposure a perfect match. Unfortunately it is anything but perfect. The CDX index is now more correlated to the S&P 500 than it is to the underlying credits, and due to regulatory issues and the dismantling of bank correlation desks single name CDS liquidity isn't much better than liquidity in the underlying bonds.

That brings us to ETFs. In a Greenwich Associates study in 2013, 30% of institutional ETF users were using fixed income ETFs. In our most recently published ETF study, that number jumped to 55% signaling clear growth of fixed income ETFs as a proxy for direct credit market exposure. ETFs of course have their own liquidity issues, but for certain funds trading volume continues to rise. As a case in point, on June 3 2013 when talk of a Fed taper was the hot topic, HYG (the high yield bond ETF) traded over ten million shares. Not a bad showing.

I can't help but comment on a great story from Bloomberg News citing our ETF research: "Grandma Gets to Play Hedge Fund With New Credit Swap ETFs". While the story wins the title of the month award, it quickly explains that while ETFs are certainly available to anyone with an online brokerage account, the target audience for synthetic credit and other similar ETFs is not Grandma (or Grandpa for that matter), but institutions.

That all said, neither CDS nor ETFs can "fix" the corporate bond liquidity problem. Corporations need the bond market to raise capital that fuels business growth and innovation, and derivatives don't fill that need. However, if credit liquidity providers and investors alike feel they have liquid choices to hedge risk or supplement single name credit exposures, everyone's ability to buy and sell the bonds themselves could greatly expand despite bank's unwillingness to commit capital as they one did.

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