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The Future of Fixed Income Trading

In 2007 with the markets beginning to look over extended, I began speaking to clients about the future of cash management and fixed income sales/trading. At that time the commercial paper market was running at a record daily outstanding of 2.2 trillion dollars, funding a much wider range of investments that could have been even contemplated even 5 years before. Sure enough when the market turn sour, investors fled money market funds and other short term funds (used for collateral management in securities lending for example) after they discovered that they not as safe as once believed. Short term markets in commercial paper, repo, auction markets, and even overnight bank lending became frozen in the uncertainty. The Fed stepped in to provide guarantees to the money funds, at a price, to stem an even worse panic. While the Fed averted panic the additional costs combined with inevitable future regulation will no doubt diminish profitability even further and drive change to this once quiet yet profitable business. Recently it was reported that several money market funds were losing money given the increased costs.

While there were many reasons short term money markets grew, fundamentally it grew because Commercial Paper became a viable, cost-effective alternative to bank credit. In 1980, with short term interest rates at 18% and bank deposits paying 0% thanks to Fed Regulation Q that prohibited banks paying interest on deposits, money markets exploded. Once the market was primed, other instruments were created for this market. In 1980 the commercial paper market was about 125 billion outstanding and based on current data has grown at 10% compounded for the last 30 years.

All of that is now changed. We are now at an important juncture where bank lending is curtailed, short term corporate markets are still frosty, equity markets flat. So where is all this money going? Now, they are going to Money Market Funds and bank accounts that have fewer investment options and less size.

With Money Funds there is an ongoing paradox of choice. The paradox lies in the fact despite the number of funds to chose from, it is not too difficult for the average retail investor and corporate cash manager to realize when they look at their statement that they could always earn more, somewhere else, As a result of all the fund choices, no one is happy or fully satisfied about the returns. Most investors do no understand why there is such variation. With the personal-savings rate reaching a 14-year high, 5.7 percent of disposable income, in March 2009 with no break in the trend, its easy to predict that more investor attention will be

going to money fund investments and to participants making these markets more efficient and less costly. Clearly, cash will now be a cornerstone in every “well managed” portfolio for quite some time.

What does the future look like for fixed income trading? If the equity markets are any example, investors on both the corporate and retail will design their own money market product based on risk, yield, duration, etc. that will allow greater variation of returns. Through automation, executable investment alternatives would be presented and perhaps the money funds will disintermediated. In one possible scenario, a buyer’s investment requirements could be aggregated and presented to issuers or sell side who would then collectively bid. Today there is no single market or order routing network or off market exchange that covers the gamut of fixed income, a level of fragmentation that the market can no longer afford. Perhaps given the current market some consolidation or new entrant will create a solution. Who knows, it just might happen.

About the author:

Barry Weinstein has led the industry in fixed income trading and sales building the first on-line, electronic, corporate and retail fixed income sales and trading system Transaxis, at Citibank as well as operating and building the first Commercial Paper, Euro-Commercial Paper, and Preferred Auction issuance systems, third party trading platforms for equity, foreign exchange, and fixed income, and participated in the development of EJV. He received the Citibank Technology Award for his breakthrough efforts in electronic trading and information systems.

Later at State Street, where he was CIO and head of Strategy led the Cash Management Business, he launched the industry’s first web based fixed income system MOM and spearheaded development of cash management to enable cash management for the 100Billion dollar securities lending business.

He provides assistance in trading and product strategy in the fixed income, foreign exchange and securities lending.

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