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## **Muni Market Ambivalent About Rise in Inter-Dealer Trading.**

The steady rise of inter-dealer trading of municipal bonds since the financial crisis has spurred debate in the market.

The trades between bank broker-dealers have grown in 2013 through Wednesday, sometimes supporting as much as 30% of daily volume by par value, according to market figures.

Some industry watchers, such as BlackRock Muni Strategist Sean Carney, argue that inter-dealer traders provide needed liquidity and relieve pressure to put away paper in the primary and secondary markets.

"When the market goes through a correction and we see the dealer side holding less inventory, that puts pressure on the market, and pressure on more going-away trades," he said. "There will be inter-dealer trades that go back and forth as dealers swap inventory to meet specific inquiries."

Others say increased inter-dealer transactions could be a sign of illiquidity in the market, as dealers struggle to find customer counterparties and instead trade with other dealers, which shrinks their margins. This can produce price levels that are less-reliable because they're not coming from customer buying, said Matt Fabian, managing director, Municipal Market Advisors.

"When you have dealer-to-dealer trades driving price discovery," he said. "It can tend to exaggerate or misstate, or it can hide where real customer demand is."

Norman Schuerhoff, a Swiss Finance Institute professor at the University of Lausanne who studies the U.S. municipal marketplace, sees both sides. More inter-dealer activity could imply both greater price discovery and a decline in liquidity, he said.

As the financial crisis and subsequent tightening of regulations triggered a reduction in muni-bond inventories, inter-dealer trading increased, Schuerhoff added. The Federal Reserve flow of funds for the second quarter of 2013 showed that the muni holdings of brokers and dealers dropped to \$19 billion, or less than half of the \$40 billion they held in 2010.

"I believe we will see more inter-dealer trading in the future as a result of significantly lower inventory levels," Schuerhoff said. "Inter-dealer trading seems an efficient way to cope with margin pressure in a new regulatory environment."

And the market has seen an uptick. Municipal Securities Rulemaking Board numbers show inter-dealer daily activity rising by both par amount and number of trades.

Looking more closely at par-amount numbers, inter-dealer average daily trading has climbed to \$2.56 billion through three quarters in 2013 from \$2.28 billion in 2009. For average daily number of trades, inter-dealers have increased to 14,863 through three quarters this year from 11,703 in 2009.

By comparison, customer-bought numbers for average daily par amount have fallen each year from 2009 to 2013 through September. The average daily number of customer-bought trades has fallen to

18,106 through three quarters of 2013 from 21,775 in 2009.

Average daily customer-sold numbers by par amount have decreased since 2009, MSRB data show. But average daily customer-sold trade numbers have risen over the same period.

Inter-dealer trading numbers by par amount also show an increase in their overall percent of muni trading from 2006. Average daily trading by par amount shows inter-dealer activity accounted for 15.5% of all trading in 2006. Through three quarters of 2013, that number stands at 22.2%.

And the number increases during sessions when tax-exempt yields strengthen, Carney said. On September days where the market demonstrated a better tone, or rallied, dealer-to-dealer activity accounted for 26% of trade volume, compared to 19% when the tone was weaker, as in a sell-off.

"That's less pressure on the buy-side community to have to put away as many bonds," he added. "The bigger takeaways are when the market is feeling stronger and has a good undertone, you see more inter-dealer support; there's perceived more liquidity and better flow. When the market goes through periods of correction, or heavy supply is coming, and people focus more on the primary than the secondary, then inter-dealer support goes down."

In the past, the inter-dealer community acted as a conduit for all muni trading, said Robert F. Millikan, executive director at Sterling Capital responsible for managing the muni portfolios for the Sterling Capital Funds. Dealers would play a dominant role in placing negotiated deals in the marketplace, assuming the market risk in the process.

They would buy munis for their own trading accounts, holding much larger inventories than they do today, he said. Now they commit fewer dollars.

Interdealer trading itself has evolved, according to Schuerhoff and Dan Li, an economist who covers capital markets at the Federal Reserve Board. The two wrote "Dealer Networks: Market Quality in Over-The-Counter Markets," published in April. Their paper covered the relation between trading costs, liquidity, price efficiency and the centrality of dealers as financial intermediaries within the topology of the muni market.

According to Li and Schuerhoff, the dealership network in the muni market "exhibits a hierarchical core-periphery structure with about 20-to-30 highly interconnected dealers at its core and several hundred peripheral dealer firms," with firmly established trading relations between and among their ranks. Furthermore, dealers "intermediate" bonds through chains of up to six inter-dealer trades, flowing from the periphery to the center and back; the last dealer in the chain makes the lion's share of the markup.

Core dealers, which provide more liquidity for muni investors and assume the most risk, place bonds with them more efficiently than peripheral dealers. Generally, Li and Schuerhoff wrote, the more central the dealer involved in the trade is, the more efficient prices related to the transaction are.

But the shrinking of dealer inventories has altered interdealer trading, market watchers say. Rising rates from May to early September also affected dealers.

For one thing, dealer desks, forced to do more with less, had to bring in inventory to either put away or move, but not hold in inventory.

"A lot of dealers just lost their year when the market really fell out of bed in May and June," a trader in Texas said. "If you look back at that period, people lost 10-to-15 points on some bonds."

This discouraged dealers from taking on risk and positioning as many bonds as they normally did, he added, as they weren't getting paid for it. It proved easier and more economical instead for them to work on other people's inventory, raising their transactions numbers.

The backup in yields from May through early September drew retail investors and crossover buyers back into the market. It also daunted issuers from bringing refunding volume, the principal driver behind the market's increase in supply last year, to the primary market.

Dealers worried about the profitability of trading desks for the approaching bonus period: they don't want to mess up a year's worth of work on bringing deals, Millikan said.

"Even though there's more retail interest, perversely, the Street isn't carrying as many bonds as it used to because they got run over in [May and June]," the Texas trader added. "So, a lot of that stuff is getting done dealer-to-dealer, which might account for some of that increase."

By the end of the third quarter, dealer activity accelerated to promote or further the municipal bond rally. Again, Millikan said, dealers acted with an eye toward their year-end results.

"With new issuance falling, their job is obviously to trade and to make money," Millikan said. "So, in theory, they need to pick up their inter-dealer trading to make money, for a lack of new issuance."

But dealers have higher costs of keeping inventory and so hold fewer muni bonds, Schuerhoff said. The net result, he said, is that liquidity suffers because dealers need to look longer to find counterparties, making it take longer to trade.

This makes sense, MMA's Fabian said. If it's more difficult to find going-away customer demand, the bonds must go through more dealer platform trade chains.

"So, when you see heavy inter-dealer trading, it would appear that the dealers lack an easy outlet to customers, and that they're moving bonds between each other to find a customer," Fabian said. "So, heavier inter-dealer trading implies a less-certain market."

BY JAMES RAMAGE