Moonwalking bears and underwater bergs: hidden risks in markets

Alex Brazier

Executive Director for Financial Stability Strategy & Risk, Bank of England

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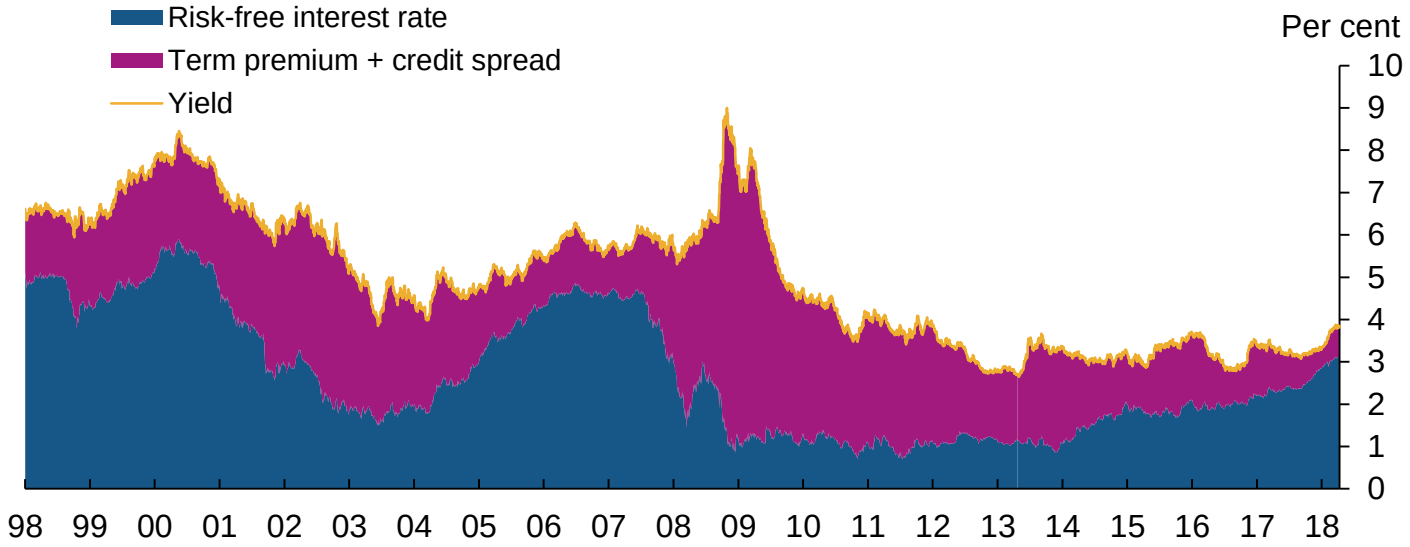
Two types of hidden risk in markets

Bears: in plain sight

Bergs: in the system

Little compensation for risk in global corporate debt markets

Components of yield on US-dollar investment-grade corporate bond index

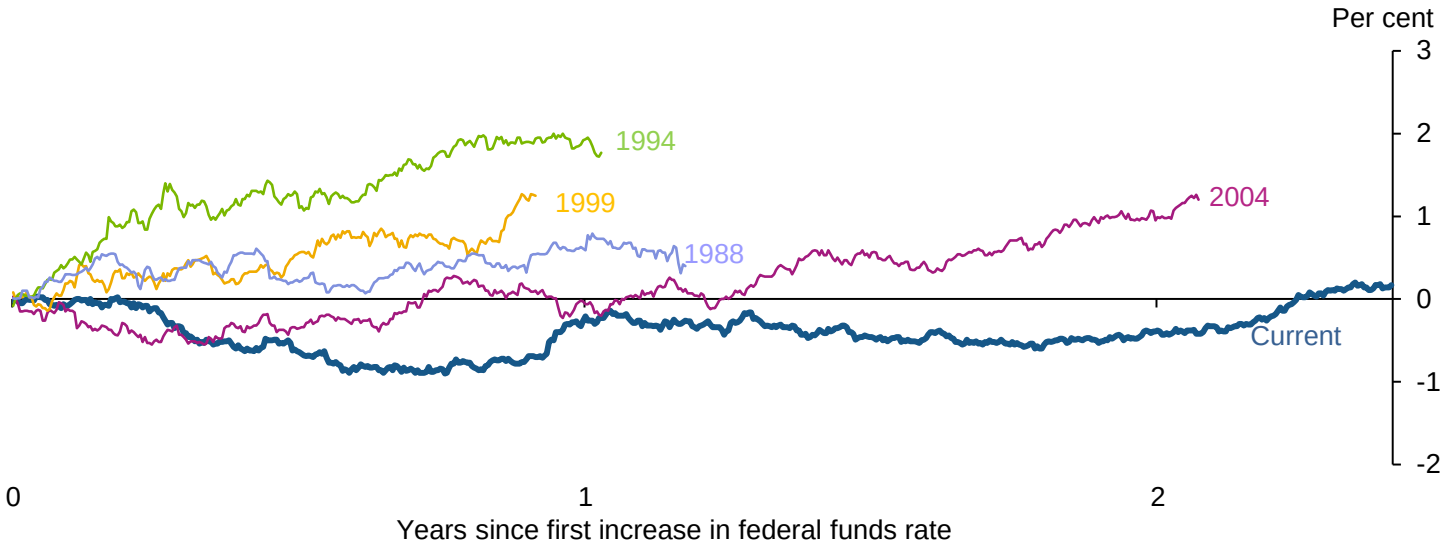


Sources: ICE Bank of America Merrill Lynch, Federal Reserve Bank of New York and Bank calculations.

Note: The chart shows how the yield on an index of US-dollar investment-grade corporate bonds (in orange) splits into two components. The first component (in blue) is the risk-free interest rate, which reflects expected Federal Funds rates over a period equal to the (7-year) duration of the index. The second component (in purple) is the difference between the yield and the first component, and reflects the term premium and credit spread.

…Very unusual in a US monetary policy tightening phase

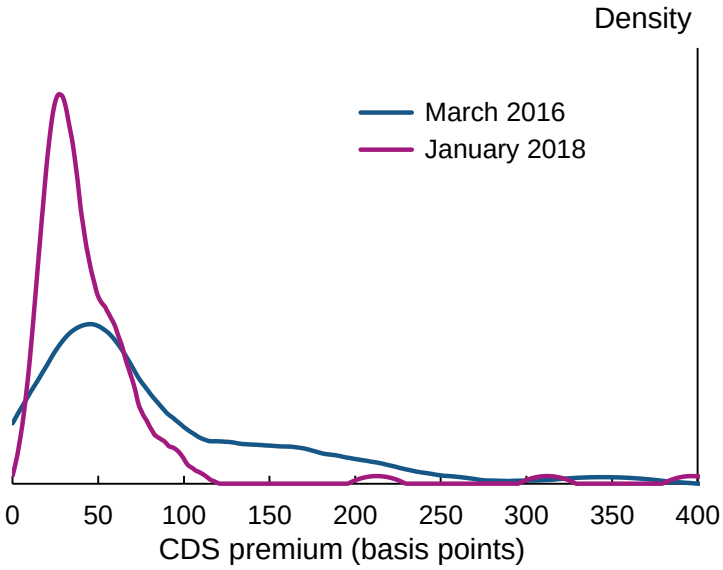
Cumulative changes in US-dollar investment-grade corporate bond yields



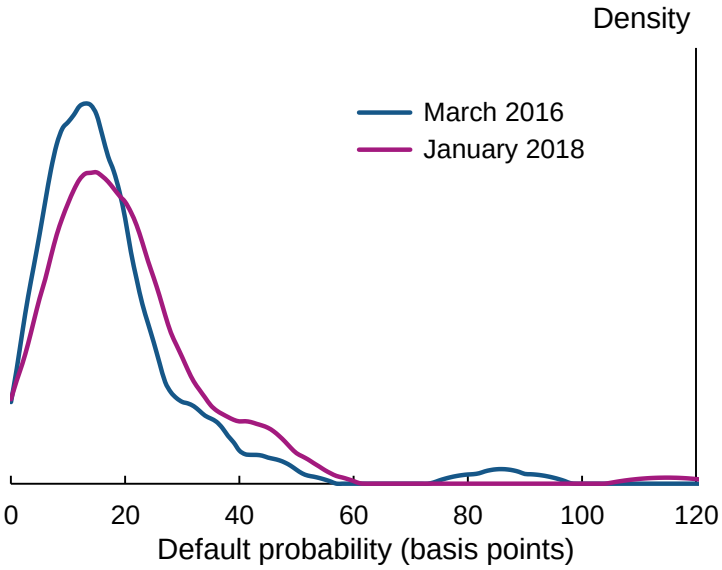
Sources: ICE Bank of America Merrill Lynch and Bank calculations.

Price of default insurance fallen… …but risk of default hasn't

Distribution of CDS premia



Distribution of default probabilities

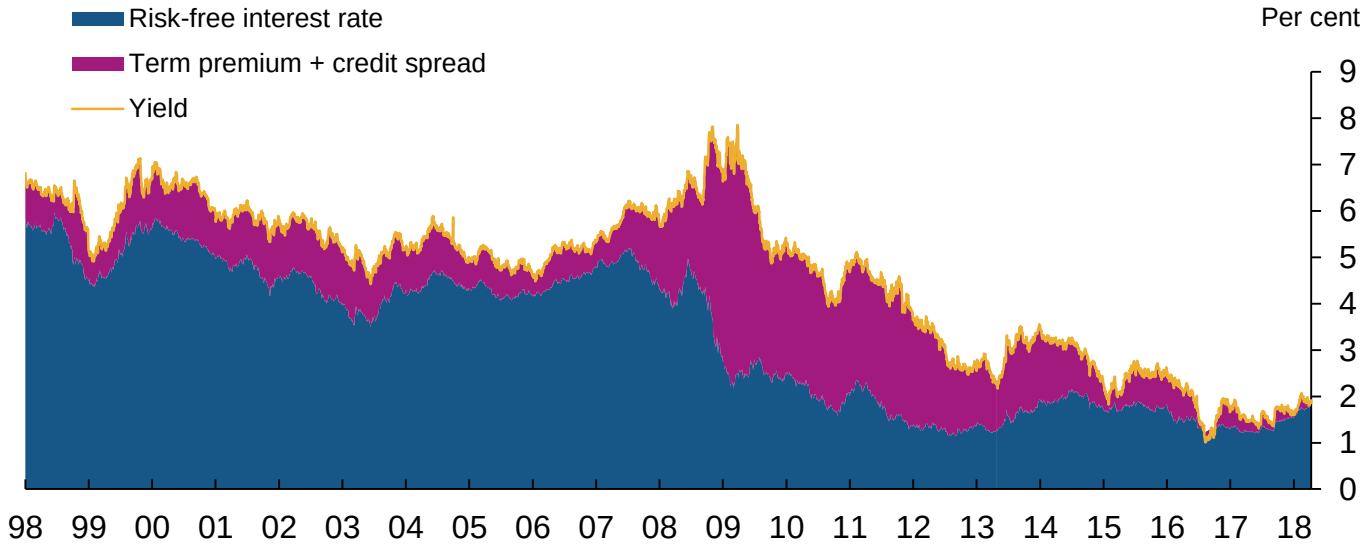


Sources: Bloomberg, Credit Benchmark and Bank calculations.

Note: The charts show fitted densities of CDS premia and default probability estimates for corporate debts referenced in the current CDX.NA.IG credit default swap index. The CDS premia are annual amounts on five-year senior CDS contracts and the default probabilities are aggregates of one-year ahead estimates constructed by financial institutions following an internal-ratings-based approach to regulation.

Little compensation for risk in £ corporate bonds

Components of yield on adjusted sterling investment-grade corporate bond index

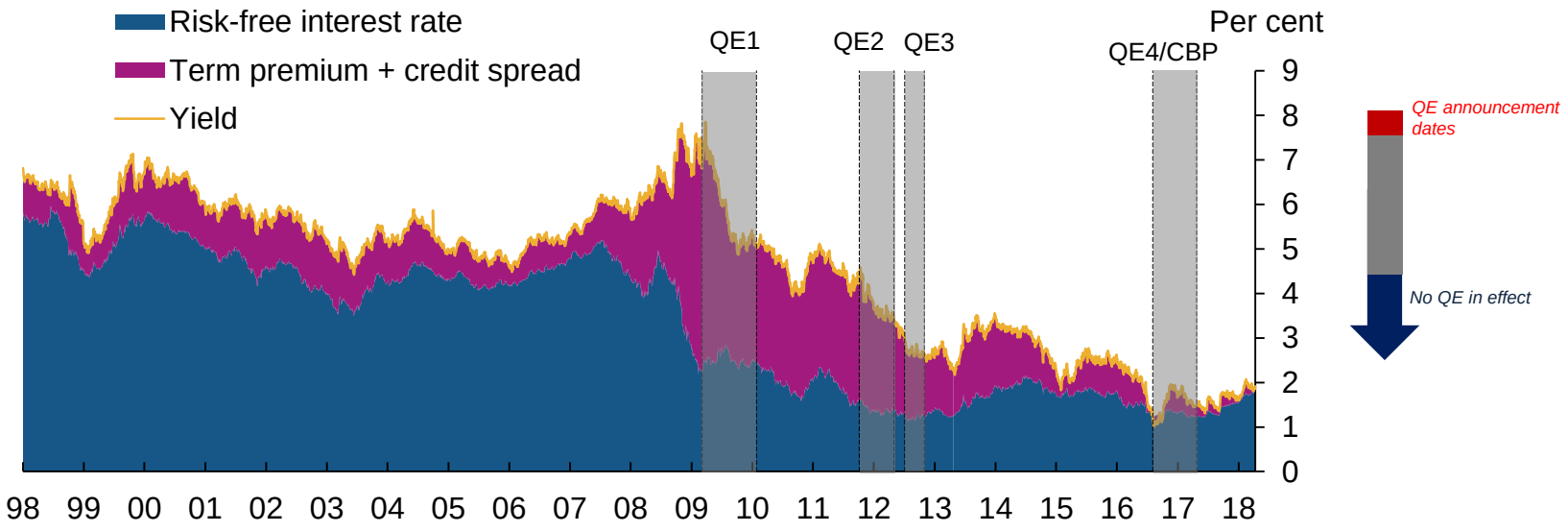


Sources: ICE BofAML, Bloomberg, HMT and Bank calculations.

Note: The chart shows GBP investment-grade corporate bond yield and the expected risk free rate (based on a maturity (7 years) that is similar to the duration of the corporate bond index over the period shown). The difference between the corporate bond yield and the expected rate is the term premium plus the credit spread. The adjusted sterling investment-grade spread accounts for changes in credit quality and duration of the index over time.

Something more than QE at work...

Components of yield on adjusted sterling investment-grade corporate bond index



Sources: ICE BofAML, Bloomberg, HMT and Bank calculations.

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A search for yield? Past performance used as guide to future?

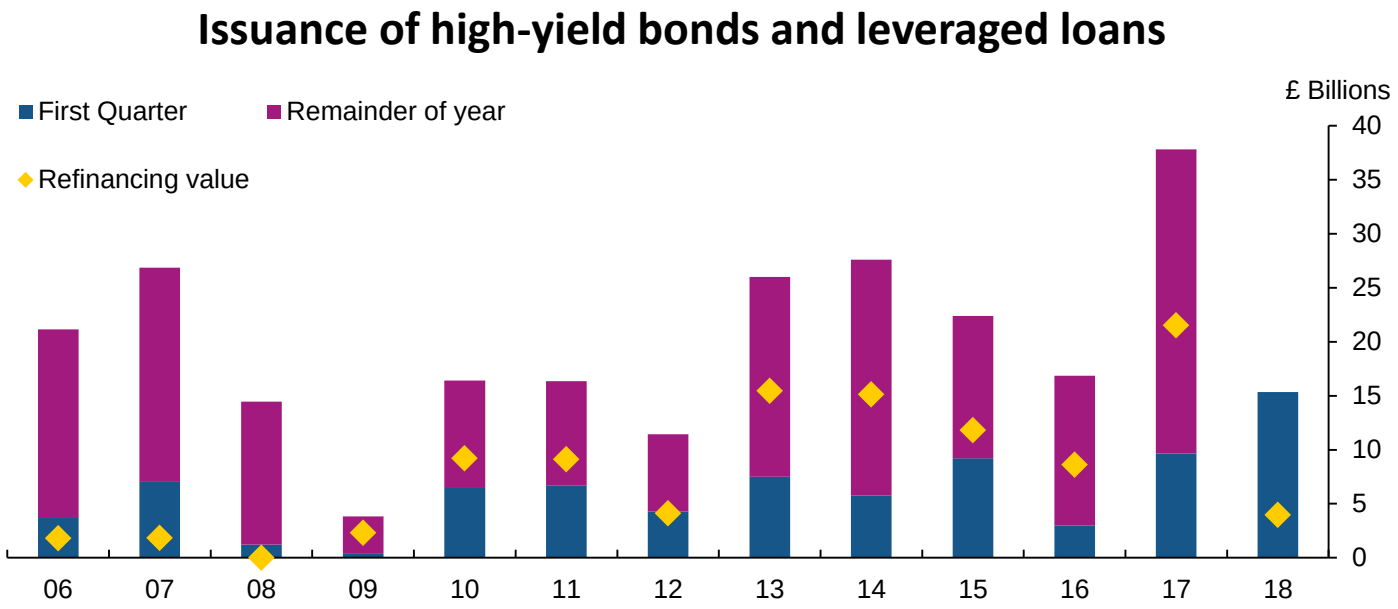
Total return since March 2009

Investment-grade corporate bonds	High-yield corporate bonds
106%	382%

Gilts	Cash
59%	4%

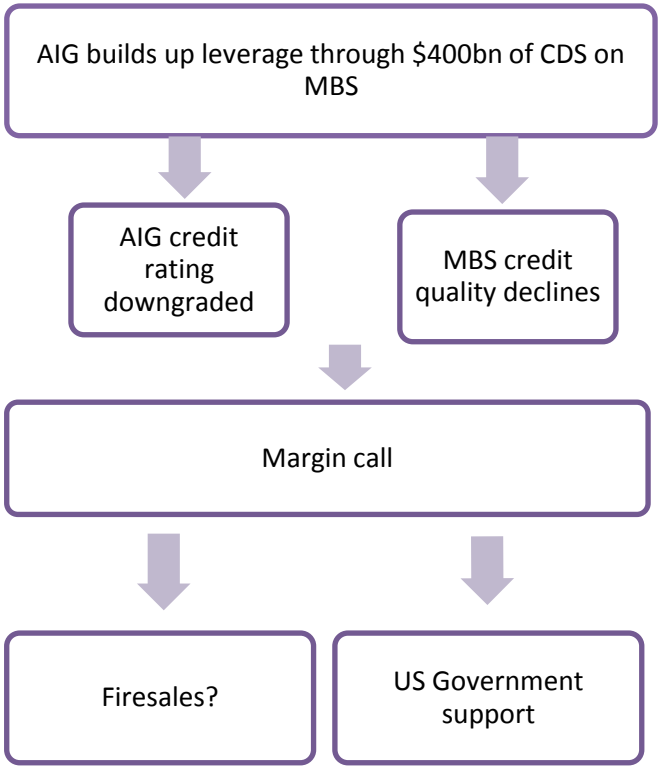
Sources: ICE Bank of America Merrill Lynch, Bank of England and Bank calculations.
Note: Change is calculated between 02/03/2009 and 31/03/2018.

Record issuance of riskier types of corporate debt recently

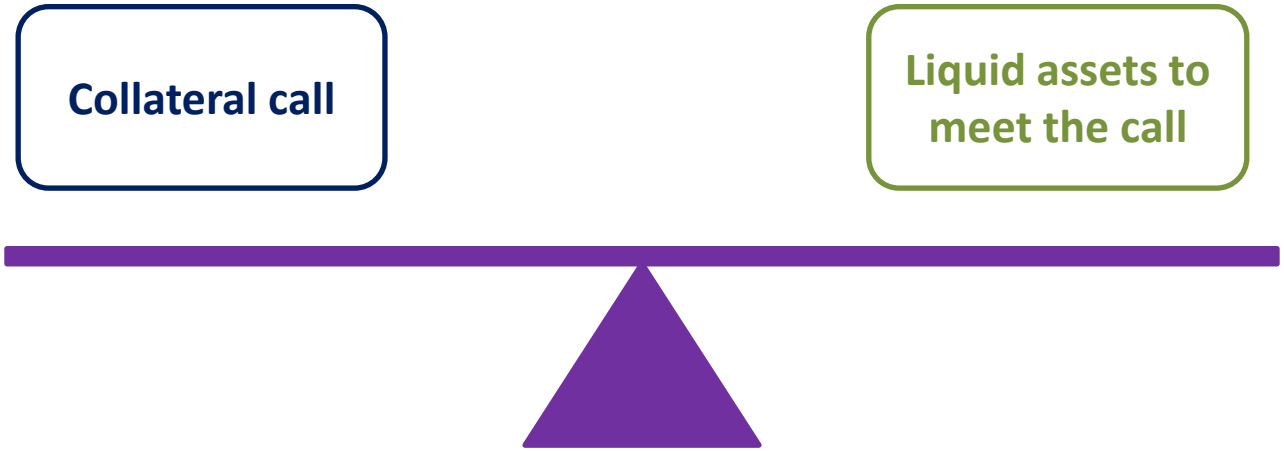


Sources: S&P Global Market Intelligence and Bank Calculations.
Note: Issuance is shown on a gross basis.

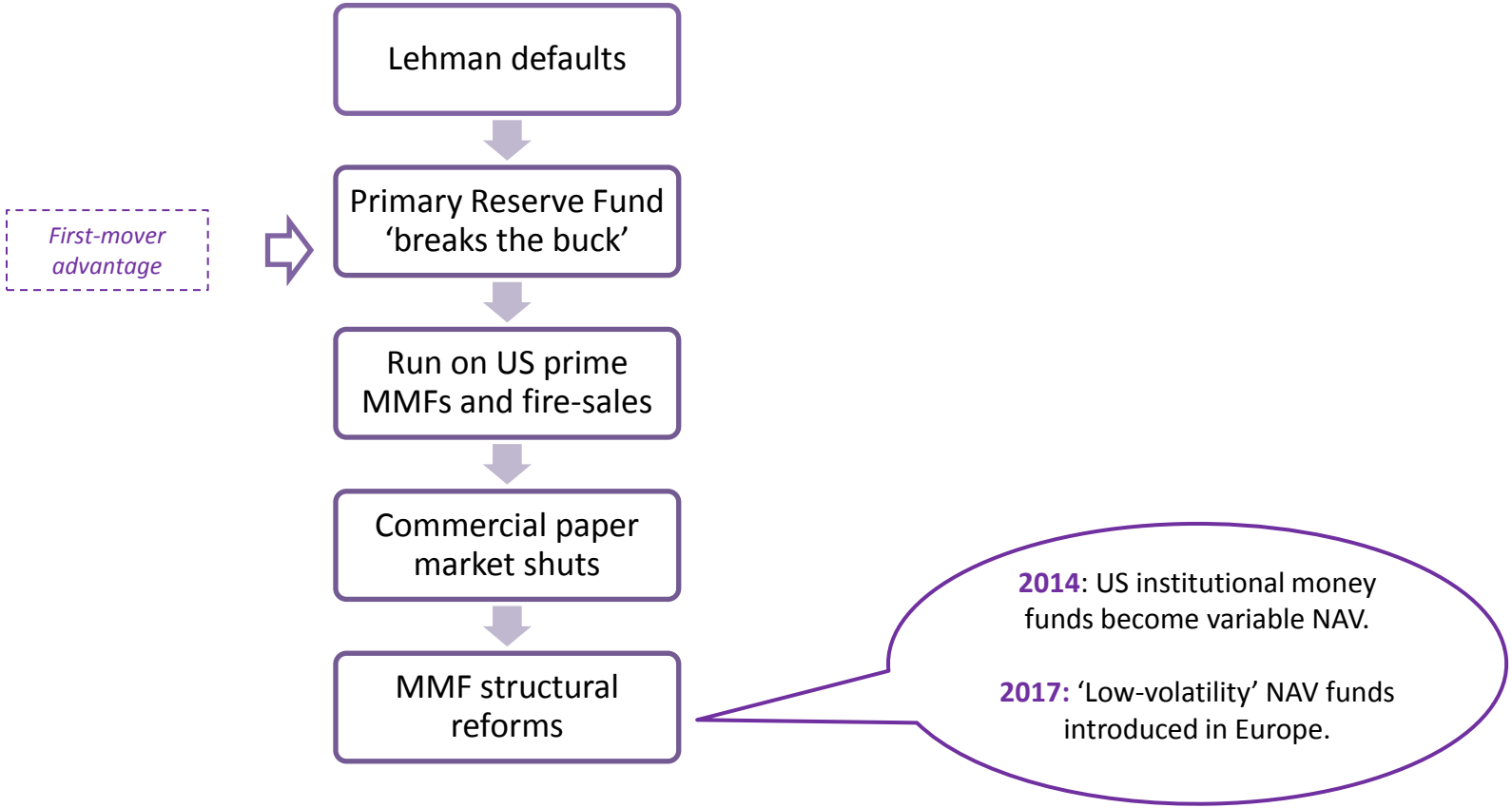
In 2008, built up of excessive leverage via derivatives = firesales



Need for diagnostic tools I: collateral calls

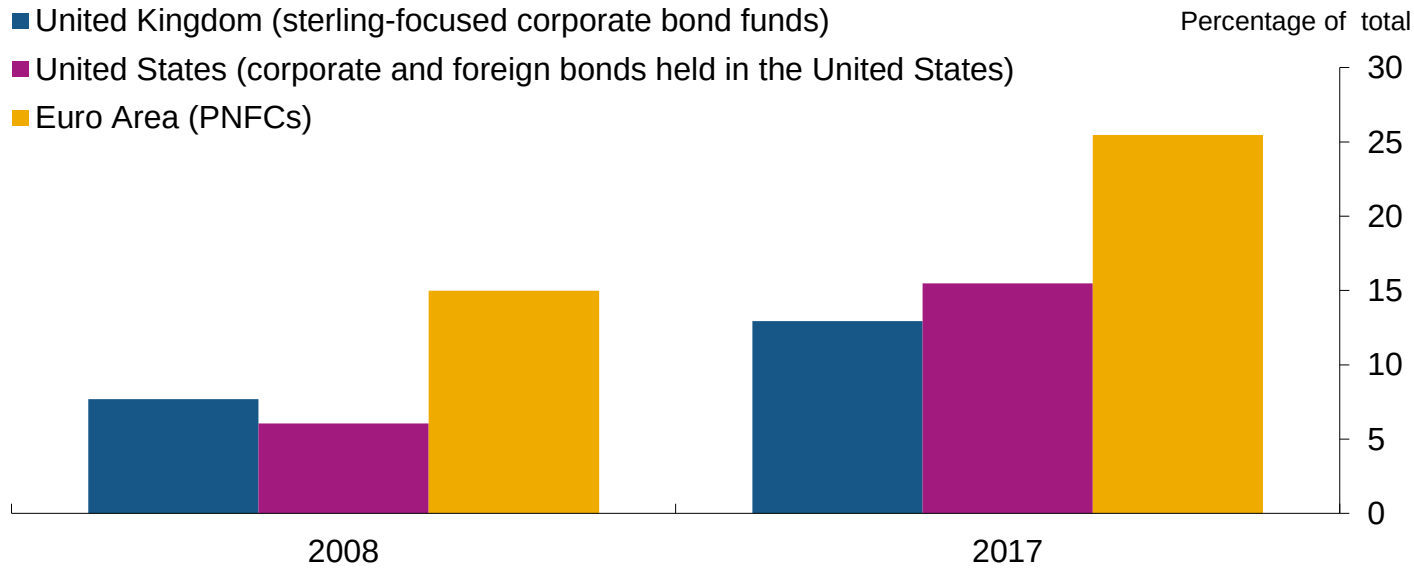


In 2008, a run on money market funds. Now reformed.



Increasing share of corporate bonds held in open-ended funds

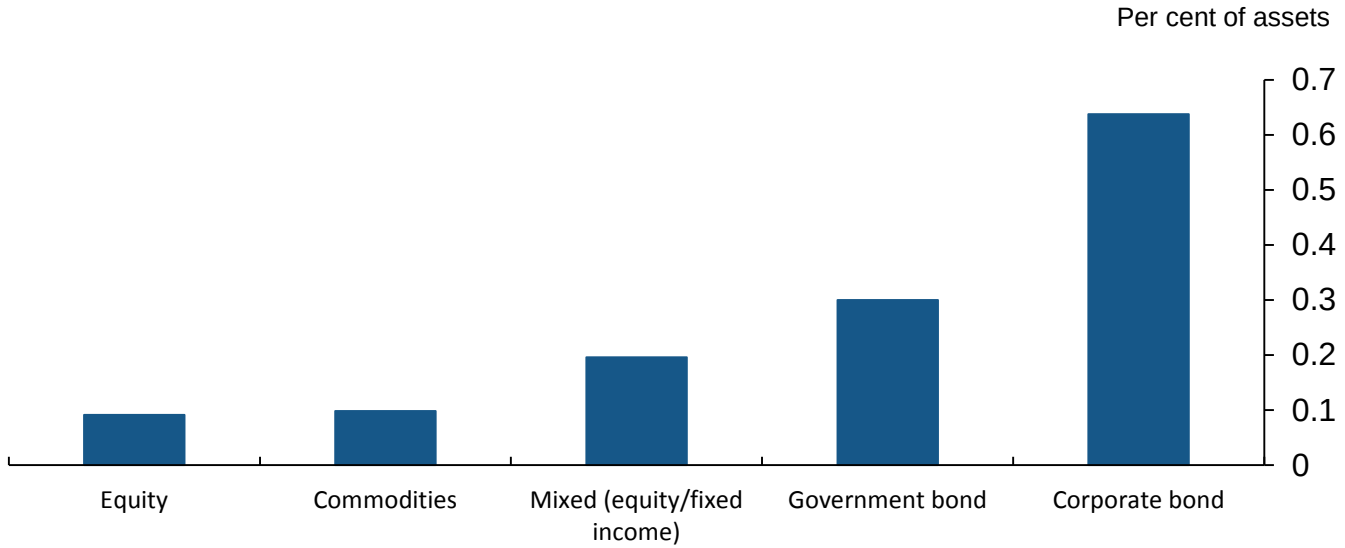
Funds' holdings of corporate bonds



Sources: Bank of England, Thomson One, ECB, Federal Reserve, Morningstar and Bank calculations.
Note: United Kingdom: sterling corporate bond funds (open-ended and ETFs) total net assets as a share of all outstanding sterling corporate bonds. United States: mutual funds' holdings of corporate and foreign bonds as a share of all outstanding corporate and foreign bonds. Euro Area: euro-area open-ended holdings of bonds issued by euro-area non-financial corporations as a share of total. United Kingdom data until July 2017. United States data until Q1 2017. Euro Area data until Q2 2017.

Open-ended funds are much safer. But could there be a more subtle first-redeemer advantage?

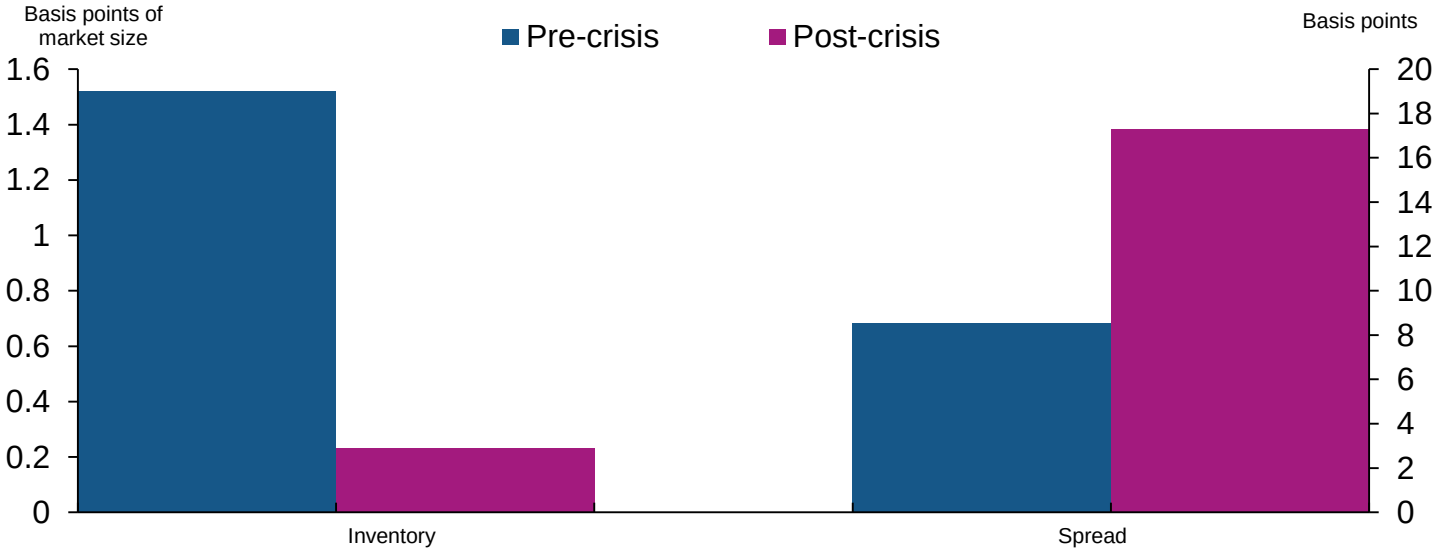
Fund redemptions following 1% fall in asset value



Sources: Morningstar and Bank calculations.
Note: These estimates are for European-domiciled open-ended funds, excluding ETFs, MMFs and funds of funds.

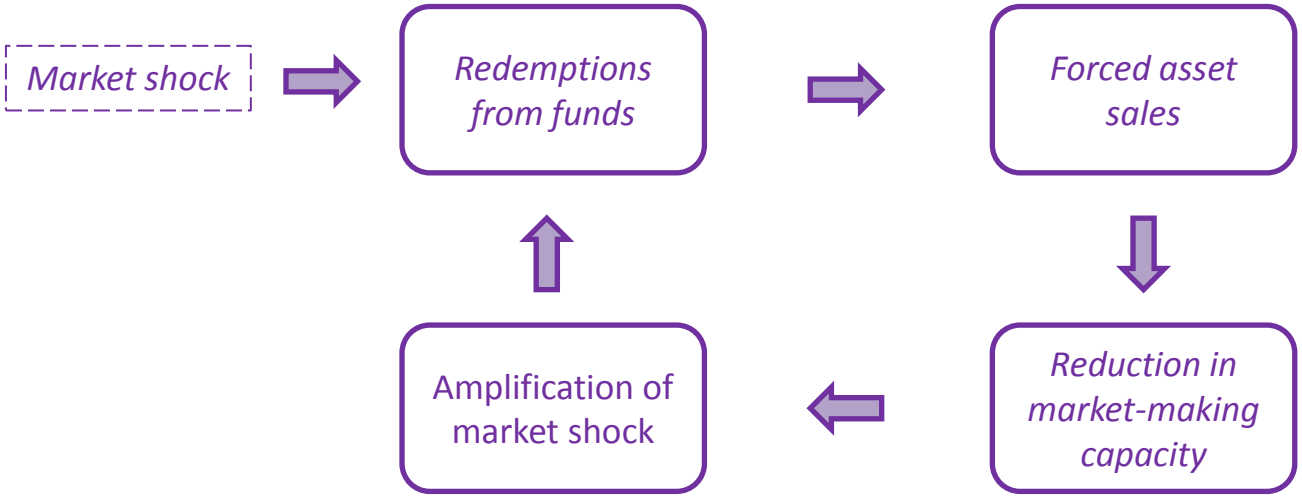
At same time, dealers have become less active in market making

Dealers' response to high-yield bond sales



Sources: BofA Merrill Lynch Global Research, Dealogic, EPFR Global, Federal Reserve Bank of New York, SIFMA and Bank calculations.
Note: Response (at 1 week) of US dollar-denominated high-yield corporate bond spreads and US primary dealers' inventory in these securities to a one standard deviation decline in asset manager demand (of the pre-crisis period). Based on the SVAR model. Pre-crisis refers to 2004-2006, post-crisis refers to 2012 - February 2015.

Need for diagnostic tools II: System simulations



Baranova, Y., et al. (2017), 'Simulating stress across the financial system: the resilience of corporate bond markets and the role of investment funds', Bank of England Financial Stability Paper, no. 42, (July)