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The fixed income capital markets jam

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Fixed income capital market revenues have transitioned from disappointing to under significant pressure in recent quarters. Unlike the cash equities business, fixed income is not a thin margin business. Citigroup Inc.'s weaker than expected fourth-quarter results were partially attributable to fixed income capital markets, which saw revenues decline 15% from the fourth quarter of 2012 to $2.3 billion. For the full year, Citigroup's fixed income revenues declined 7% to $13.1 billion with 61% of the revenues recorded in the first half of 2013. The same trends were true for all other major dealers.

In recent weeks Citigroup, JPMorgan Chase & Co., Goldman Sachs Group Inc. and Deutsche Bank AG also have indicated first-quarter fixed income results will be disappointing. On March 19, Bloomberg reported in separate stories that Bank of America Corp. and Deutsche Bank were planning across the board reductions in capital markets and investment banking units.

For capital market professionals, the news is not new, though fixed income rather than equity capital markets and investment banking is bearing more of the latest downsizing moves by Wall Street. One implication for investors in large banks is that the fixed income represents another headwind to overcome absent much better loan growth and margins before a revenue inflection point occurs.

So why the disappointment in fixed income capital markets when the bond market is not in a bear market? I think there are several thematic reasons. The obvious one is that most market participants believe rates are at unsustainably low levels and that over time the price direction of bonds will be down and yields higher. Since late 2007 virtually any non-credit related bonds purchased rose in price through 2012, and most credit-related bonds have rallied since mid-2009. Momentum is a powerful market force. It is easier to sell an appreciating asset than a depreciating asset even though lower prices improve value.

Fear of the Fed tapering bond purchases last summer caused the ten-year yield to increase 120bps from around 1.8% in April 2013 to 3.0% in September and then again in early January. Since then, there has been a modest rally that has pushed the yield lower to around 2.8% in spite of the Fed's pronouncement last week that it could begin to raise short rates in 2015. The jump in yields last year before tapering began caused big unrealized gains that investors had in their bond portfolios as of April to evaporate by September. Many investors are now frozen, anticipating what another upward move in intermediate- and long-term rates would do to portfolio values. A secondary concern is the fear of rising short rates that would then narrow the spread between financing the portfolio with excess deposits, repos and other forms of short-term funding. Absent that the carry spread is wide today.

Retail investors exhibited a familiar behavior: dump bonds on lower prices. The Investment Company Institute reports that inflows into taxable and municipal bond funds totaled $93 billion during January through May 2013; however, investors pulled $177 billion from bond funds during June through year-end 2013 as taper-talk began to push rates higher. Actually, the data implies that much of the selling occurred in municipal funds, which probably reflected fears related to Detroit's bankruptcy filing.

Another reason is the reemergence of a counter cyclical force that impacts the demand for bonds by banks—loan demand. While most banks are exhibiting only limited loan growth, loan portfolios are no longer contracting, and deposit growth has slowed dramatically. There is less liquidity at the margin to deploy into bonds. The slowdown, if not a virtual buyers' strike, has negatively impacted the "rates" units within the large investment banks and more depository focused fixed income dealers such as First Horizon National Corp.'s FTN Financial that sell Treasuries, Agencies and MBS to banks.

The "spread" side of the fixed income business is under pressure from Dodd-Frank generally, and the Volcker Rule in particular. Corporate bond inventories at the large banks, which now include Goldman Sachs and Morgan Stanley, are down by over two-thirds since 2007 according to the Federal Reserve. Gone (or nearly gone) are large proprietary trading operations that could dramatically add to fixed income earnings in addition to whatever revenue customer flow business produced. While the London Whale fiasco is fresh in investor minds, what has been forgotten is the massive gains that fixed income units at JPMorgan and Goldman Sachs produced in 2009 as the two banks and others profited from fire sales by levered investors in 2008 and early 2009.

From a market structure standpoint, *The Wall Street Journal* noted that reduced market liquidity has been channeled into new issues, leaving secondary issues to languish in an illiquid market. And the *Financial Times* reported on March 20 that the Fed is beginning to take market share from the primary dealer community in the all-important repo market through lending bonds directly into the market, including to 90 money market funds.

I think the *Journal* piece also touches on a thematic reason both the "rates" and "spread" units in fixed income are languishing. It took a while once the Fed reduced the target Fed Funds rate to 0% to 0.25% in late 2008, but the long-end of the yield curve gradually flattened (rallied) before tapering entered our lexicon last May. The result has been a massive refinancing wave that padded fixed income results and salesmen's incomes the past several years; however, refinancing is nearly spent.

In the "rates" business, the fixed income units rode a money-making machine in which broker-dealers would sell MBS and callable agency debt to banks and other investors. As rates trended lower, homeowners would refinance their mortgages, while the agencies would call the higher cost debt after an initial lock-out period. The brokers would then sell new issues with lower coupons to the same investors. No more.

Refinancing also has been a huge boon to the "spread" units within fixed income capital markets and the bankers that arrange financings. Corporate bond issuances have surged the past several years; however, most of the issuance for both investment-grade and high-yield borrowers has been to refinance higher cost debt and to term-out bank debt. That too looks as though it is running its course even though there has been a flurry of new corporate issues this month. Citigroup's debt underwriting revenues, which are a component of investment banking, declined 23% from the fourth quarter of 2012 to $488 million; full-year debt underwriting revenues eased 6% to $2.2 billion.

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