The Bond Market

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Outline

Introduction

- The bond market is the core of the capital markets
- Government dominates the bond market due to high liquidity and low risk
- Corporate bonds and LDC bonds offer higher return for a risk
- Recent developments suggest reduced government liquidity
- Quantitative easing

Bond price

The value of the bond is just the discounted value of the payments that will be made

$$P = \sum_{i=1}^{i=n} \frac{C_i}{(1+r)^i} + \frac{M}{(1+r)^n}$$

Where C is the coupon payment, r is the rate at which future payments are discounted (the redemption yield), M is the par value and n is the number of years to maturity.

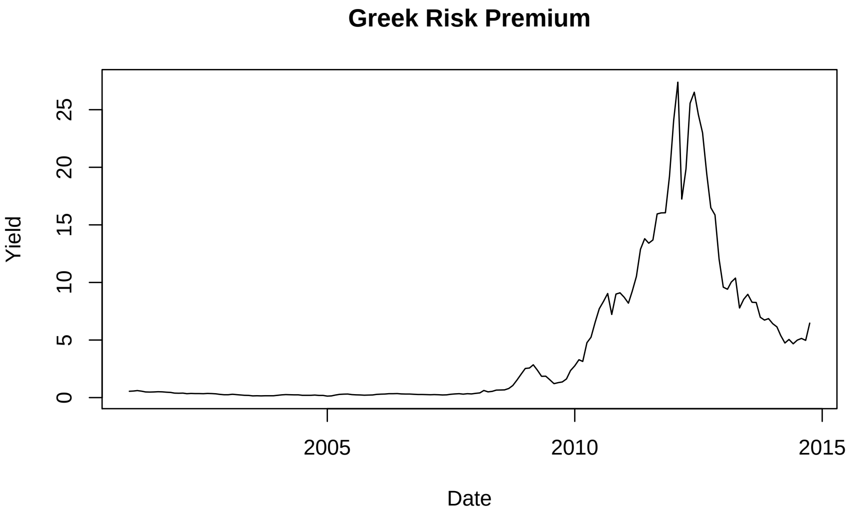
Relative Value

A strategy that will assess the relative value of two bonds

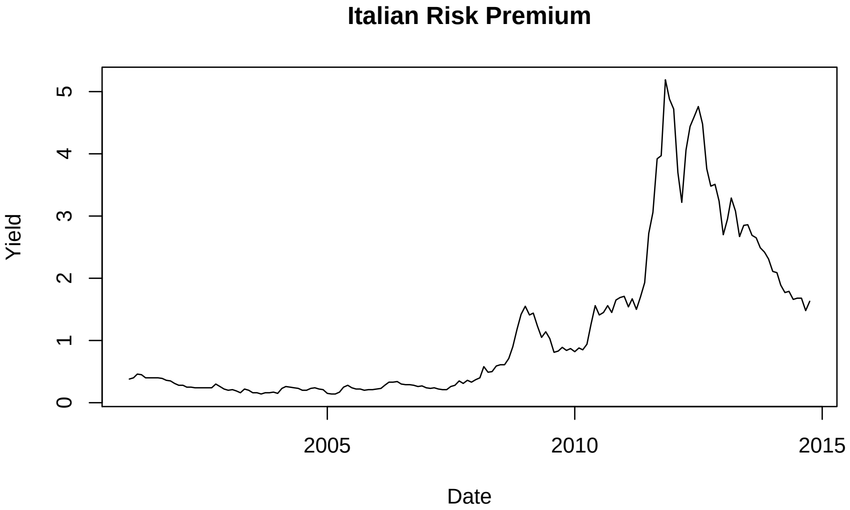
- There is a standard relationship between yields
- **Quantitative strategy** (return to normal)
- **Fundamental strategy** (new relationship)

German yield

Greek Risk Premium



Italian Risk Premium



Yield Curve Theory

There are three main theories about the shape of the yield curve

- Expectations theory
- Preferred habit or segmented market theory
- Liquidity premium theory

Expectations and Liquidity premium

Expectations theory

- Return is $i^* = (1 + i_i)(1 + \hat{i}_2) - 1$

if there is a *liquidity premium* $\theta_L = p(L)$

- Return is $i^* = (1 + i_i)(1 + \hat{i}_2) + \theta_L - 1$

The liquidity premium is the balance between *interest rate risk* and *reinvestment risk*.

Credit

- The government curve provides the benchmark
- Lower quality credit requires a *risk premium* (denominated in bp)
- Global and idiosyncratic factors will affect the risk premium