CAPITAL STREET|FX

Intermediate Concepts in Bond Trading

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Welcome to the intermediate eBook for Bond Trading. This eBook will help you to learn more about Bond Trading and how trading is conducted, as it introduces Factors affecting Bond trading, Benefits, and relationship between bond and stock trading.

1. INTRODUCTION

As debt securities, bonds can provide excellent diversity to your investment portfolio. They represent money borrowed by a corporation (or government or municipality) to fund expansion, construction, and other growth-related projects. The bond market is by far the largest securities market in the world, providing investors with virtually limitless investment options.

BOND MARKET: The term “bond market” refers to the financial market in which people buy and sell debt securities, which usually are government-issued bonds and corporate debt instruments. Trading in the bond market typically is done in the primary market -- in which debt securities are purchased by investors from sellers, who are the borrowers -- and in the secondary market, where investors trade securities that were previously issued. Most bond trading is done over the counter, or OTC.

BOND: Bonds are loans made to large organizations. These include corporations, cities and national governments. A bond is a piece of a massive loan. That’s because the size of these entities requires them to borrow money from more than one source. The borrowing organization promises to pay the bond back at an agreed-upon date. Until then, the borrower makes agreed-upon interest payments to the bondholder.

The volatility of bonds (especially short and medium-dated bonds) is lower than that of equities (stocks). Thus bonds are generally viewed as safer investments than stocks.

Types of bonds:

Convertible bonds: A convertible bond is a type of bond that the holder can convert into shares of common stock in the issuing company or cash of equal value, at an agreed-upon price.

Zero coupon bonds: A zero-coupon bond (also called a discount bond or deep discount bond) is a bond bought at a price lower than its face value, with the face value repaid at the time of maturity.

Inflation-linked bonds: Inflation-indexed bonds (also known as inflation-linked bonds or colloquially as linkers) are bonds where the principal is indexed to inflation. They are thus designed to cut out the inflation risk of an investment.

2. WHAT IS A BOND TRADING

Bond trading is one way of making a profit from fluctuations in the value of corporate or government bonds. Many view it as an essential part of a diversified trading portfolio, alongside stocks and cash.

While a bond's end return is fixed, the market conditions surrounding its sale can cause fluctuations in its price to buy. High-interest rates, for example, tend to make bonds less attractive to investors by providing other means of attaining high returns with low risk. For this reason, interest rates and bond prices tend to have an inverse relationship.

3. BASIC TERMINOMOGY USED IN BOND TRADING

Coupon: The percentage interest to be paid on a bond in the course of a year. The interest is usually payable semi-annually, although it can also be payable monthly, quarterly, and annually.

Maturity: The date the bond will be redeemed or paid off.

Price: The quoted price is usually based on the bond maturity at a price of par, or 100.00.

Yield: The term "yield" usually means "yield to maturity." The yield to maturity takes into account the coupon payment, and considers whether the bond is maturing at a different price than its current price.

Bid: The price at which the trader will pay for a bond.

Offer (Ask): The price at which the trader will sell a bond.

Bid-offer spread: The price difference between what the trader will buy a bond at and the price at which the trader will sell a bond. The difference between highly liquid and tradable government bonds is usually only a few cents.

Basis points: A basis point is a hundredth of a percentage point. For instance, if a yield moves from 5.5% to 5%, it has moved 50 basis points.

4. RELATIONSHIP BETWEEN BOND TRADING AND STOCK TRADING

"Debt is a safer investment than equity"

INTEREST RATE

- Low interest rates are good for the stock market for two reasons. First, because low or falling interest rates stimulate economic activity, allowing companies to do more business. Second, because bonds are an alternative investment to stocks. So when bond prices rise (yields fall), stock prices should rise too, and when bond prices fall (yields rise), stock prices should also fall.

INFLATION RATE

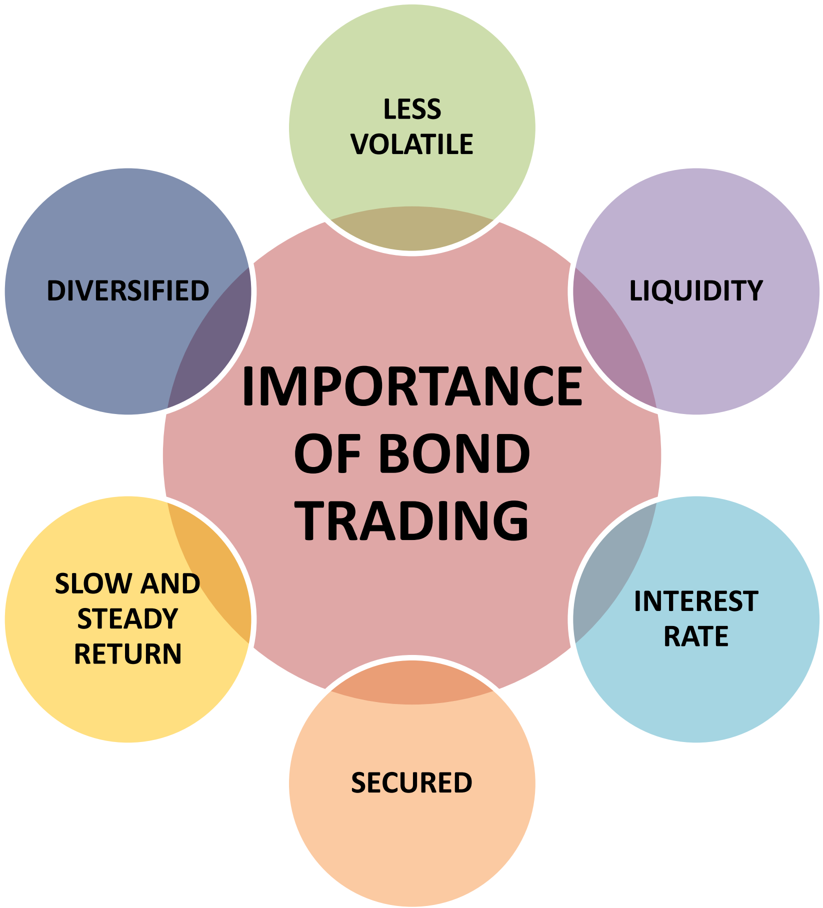
- Rising stock prices can lead to higher inflation and falling stock prices can lead to lower inflation. So when stock prices rise, bond prices should fall (yields rise), and when stock prices fall, bond prices should rise (yields fall).

MINIMISE RISK

- When stock prices are falling quickly and hard, investors may "park" money in the bond market, causing bond prices to rise.The predictability of returns from bonds makes prices much less volatile than stock prices.

5. IMPORTANCE OF BOND TRADING

Bond trading happens many thousands times a day and is an important part of global economic markets. The bond market is far bigger than the stock market and central banks conduct monetary policy in the bond markets. When buyers and sellers are trading their bonds, they dictate the yields of the various types of bonds they are trading. This, in turn, sets the price of credit in the economy.



1. Less volatile: The volatility of bonds (especially short and medium dated bonds) is lower than that of equities (stocks). Thus bonds are generally viewed as safer investments than stocks. In addition, bonds do suffer from less day-to-day volatility than stocks.

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2. Liquidity: Bonds are often liquid. It is often fairly easy for an institution to sell a large quantity of bonds without affecting the price much, which may be more difficult for equities.

3. Interest Rate: Bonds are attractive because of the comparative certainty of a fixed interest payment twice a year and a fixed lump sum at maturity.

4. Secured: Bondholders also enjoy a measure of legal protection under the law of most countries, if a company goes bankrupt, its bondholders will often receive some money back (the recovery amount), whereas the company's equity stock often ends up valueless. Furthermore, bonds come with indentures (an indenture is a formal debt agreement that establishes the terms of a bond issue) and covenants (the clauses of such an agreement).

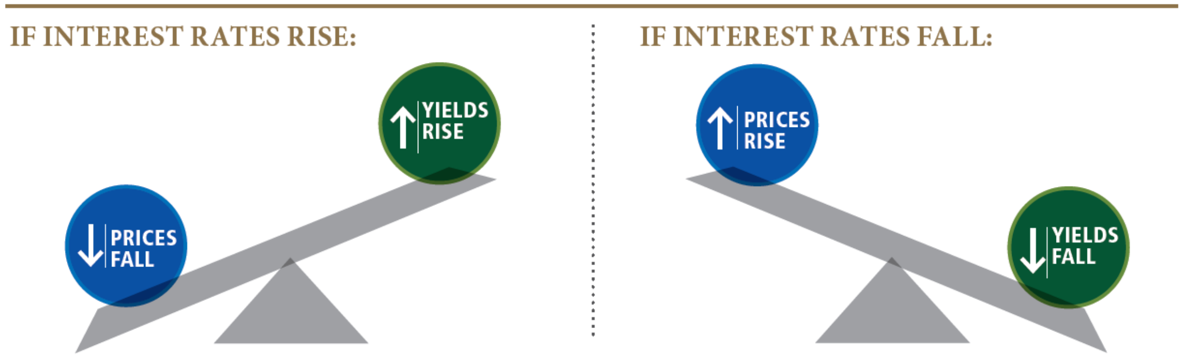
5. Slow and steady Returns: A slow but steady growth rate is virtually assured over time with bonds. Although not quite as safe as savings accounts or certificates of deposit — which are federally insured up to $250,000 per account — bonds offer an alternative at a higher interest rate. Bonds also serve as a hedge against volatile markets, with guaranteed returns in both bull and bear markets and higher secondary-market selling prices in down times.

6. Diversified: Just like stocks, bond investing can be -- and should be -- diversified. Different types of bonds and varying maturity terms can minimize volatility and ensure a steady cash flow. Just like stocks, try avoiding putting all your bond-investment eggs in one basket. Bond funds are another strategy for diversifying.

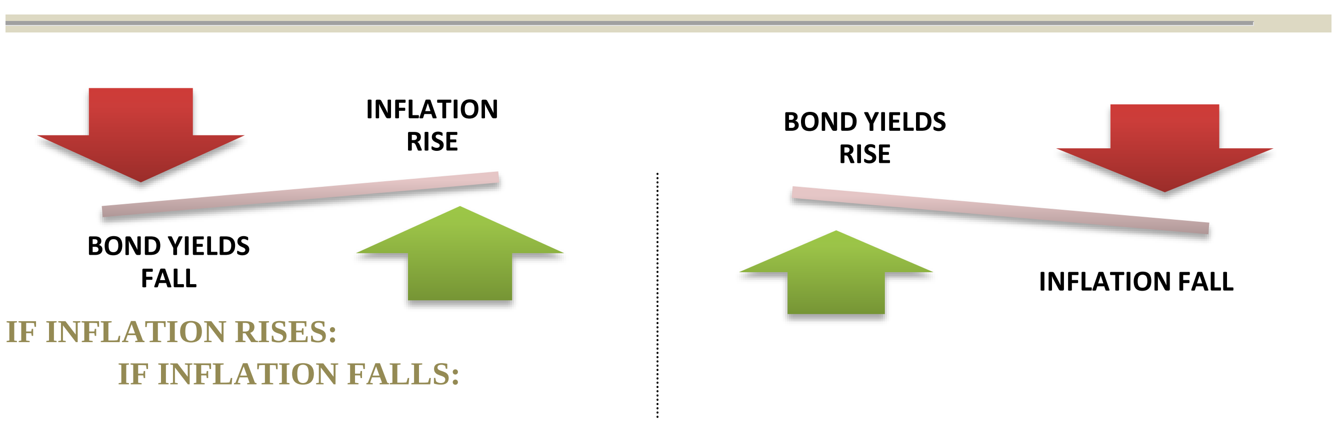
6. FACTORS AFFECTING BOND TRADING

1. Interest rate: In general, when interest rates rise, bond prices fall. When interest rates fall, bond prices rise.

Example – You own a bond paying 3% interest. When interest rates are low – say 1% – your interest rate is higher than the going rate. This makes your bond attractive to other investors. But if interest rates rise to 5%, your bond is less attractive.



2. Inflation: In general, when inflation is on the rise, bond prices fall. When inflation is decreasing, bond prices rise. That's because rising inflation erodes the purchasing power of what you'll earn on your investment. In other words, when your bond matures, the return you've earned on your investment will be worth less in today's dollars.



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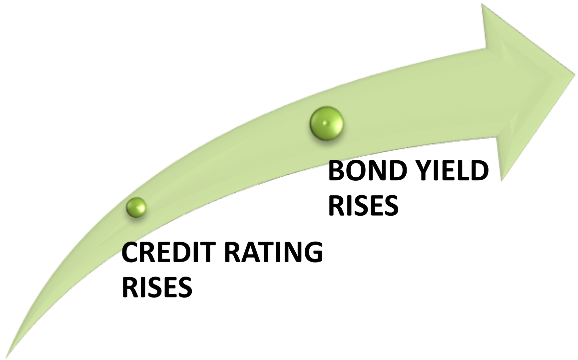
3. Credit rating: Credit agencies assign credit ratings to bond issuers and to specific bonds. A credit rating can provide information about an issuer's ability to make interest payments and repay the principal on a bond. If the issuer's credit rating goes up, the price of its bonds will rise. If the rating goes down, it will drive their bond prices lower.



IF CREDIT RATING RISES:

4. Time to Maturity: During periods of normal economic conditions, the yields on a longer term will be higher than for a shorter term bond. Investors expect to be paid a higher rate in exchange for locking money up for a longer period of time. The relationship between term and rate is called the yield curve. A normal yield curve slopes upward to show longer term rates higher as the term increases. In periods of economic disruption, the yield curve can flatten or even go inverted with short rates higher than long-term rates.

LONGER TERM BOND

10 Year

SHORT TERM BOND

5 Year

7. BOND RATING

INVESTABLE GRADES		
Moody's	Standarad & Poor	Fitch
Aaa	AAA	AAA
Aa1	AA+	AA+
Aa2	AA	AA
Aa3	AA-	AA-
A1	A+	A+
A2	A	A
A3	A-	A-
Baa1	BBB+	BBB+
Baa2	BBB	BBB
Baa3	BBB-	BBB-

NON-INVESTABLE GRADES		
Moody's	Standard & Poor's	Fitch
Ba1	BB+	BB+
Ba2	BB	BB
Ba3	BB-	BB-
B1	B+	B+
B2	B	B
B3	B-	B-
Caa1	CCC+	CCC+
Caa2	CCC	CCC
Caa3	CCC-	CCC-
Ca	CC	CC

WEAKEST		
Moody's	Standard & Poor's	Fitch
C	C	C
	D	D

8. CONCLUSION

Bond trading offers a relatively safe alternative, or adjunct, to stock investment. Despite some risks with corporate bonds, bondholders enjoy advantages over stockholders. Bond prices, either at auction or through the U.S. Treasury, are much less volatile than stock prices. Bond defaults are rare and bonds, overall, represent an attractive compromise between risk and reward for many people.