Informed Trading and the Dynamics of Client-Dealer Connections in Corporate Bond Markets

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Using a unique non-anonymous dataset, covering virtually all secondary market trades in the UK corporate bond market, we show that clients outperform when they trade with more dealers. The effect is stronger for informationally sensitive clients (holding CDS positions on the issuer), assets (high-yield bonds), and during informationally intensive periods such as rating changes, macro-announcements and during the COVID-19 crisis. We also show that total (market-wide) connections can forecast future bond returns.

The results are consistent with clients varying the number of dealers they trade with to conceal private information. Various tests support our information-based interpretation, controlling for alternative explanations related to uninformed demand and supply.

Identifying clients who simultaneously trade in government and corporate bonds reveals that the informational role of connections is larger and more persistent in the corporate bond market. Motivated by this cross-market results, we use a Kyle (1989)-type model to show that both the degree of inter-dealer competition and the magnitude of private information could, in theory, explain the strength of the performance-connection relation. The empirical evidence supports the mechanism related to the magnitude of private information, while the inter-dealer competition channel is rejected by the data."