

## [Private Information and Client Connections in Government Bond Markets](#)

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The smooth operation of government bond trading is the backbone of developed financial markets. The rates of the yield curve serve as benchmarks in many financial transactions, they affect government financing costs and play an important role for the implementation of monetary policy. Hence, understanding how this market operates is of critical importance.

The classic view of government bond market activity is that variation in interest rates is mainly due to public information flow. According to this view, public news lead to instantaneous adjustments of the yield curve, and trading activity is the outcome of subsequent rebalancing. Since (Fleming and Remolona, 1997, 1999) there has been accumulating evidence that part of the price discovery in government bond markets occurs through trading activity. This suggests that clients and dealers have heterogeneous private information (or heterogeneous interpretation of public information) which is aggregated through trading, leading to changes in the yield curve.

In this paper, we contribute to this evidence by presenting three new empirical results, using use proprietary data, covering close to all dealer-client transactions in the UK government bond market.

First, we show that the average client has systematically higher trading performance when being more connected, i.e. when trading with more dealers. The economic significance of the effect is substantial: the majority of positive trading performance is concentrated in those months when clients have more dealer connections than usual. We also show that most of the effect comes from clients' increased ability to predict future yield changes (anticipation component) rather than these clients facing tighter bid-ask spreads (transaction component). These results imply that time-variation in clients' connectedness can be used as a proxy for the variation in clients' private information in government bond markets.

Second, using this insight, we characterise the nature of private information the client is relying on. We find that informed clients forecast and trade against the composition of their own dealers' order

flow. For example, these clients rebalance their trades towards short maturity assets a few days before their dealers receive orders predominantly for short maturity assets.

Third, we find that these informed clients forecast the order flow of dealers that they have a regular relationship with, and not the order flow of newly connected dealers, suggesting that information flows from regular connections and not from new connections. These results are consistent with our proposed theoretical framework where connectedness serves as an instrument of concealing information (rather than playing an active role in the information acquisition process).