Bond Market Liquidity, Regulation, and The Public Interest

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Americans for Financial Reform
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Bond Issuance Looks Healthy....

Net Non-Financial Corporate Bond Issuance As Percent of GDP

25 Year Average -- 1.25%
Bond Spreads Look Healthy...

US Corporate BBB Option Adjusted Spread
Treasury Rates Lowest In History, On Very High Issuance

5 Year Treasury Constant Maturity Rate

Source: Board of Governors of the Federal Reserve System (US)
Shaded areas indicate US recessions - 2015 research.stlouisfed.org
So What’s The Problem?

- Internal market ‘plumbing’ in some markets
- Some markets show declines in average trade size – more trades to move the same dollar volume.
- No decline in overall secondary market trading – but some decline in the ratio of trades to outstanding.
  - But why should we expect trading volumes to grow with outstanding securities?
- Decline in balance sheet capacity for bank dealers.
- Several anomalous trading days in bond markets.
Questions

• Transactional liquidity: Do internal market issues interfere with the flow of credit to the real economy – so far they have not seemed to.

• Systemic liquidity: effects during market stress?
  – Could a lack of ‘shock absorption’ capacity lead to more rapid price declines during a sell-off?
  – Anomalous trading days -- are these blips driven by electronic trading? How worried should we be given that they did not have a systemic impact?

• What are the implications for regulation?
Regulation: Allow a Return to the ‘Good Old Days’?

Bank And Dealer Non-Government Bond Inventories

Includes non-GSE MBS, CDOs, Corporate Bonds, Foreign Bonds. Millions of $

Private depository institutions
Total Including Broker Dealers
Total As Percent of Assets (Right Axis)
Regulation: Or Address Emerging Risks?

• Predatory electronic trading.

• Liquidity management and stress testing by asset managers and funds.

• These are on the regulatory agenda, but we have yet to see results.