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Are there Structural Issues in the U.S. Bond Markets?

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Facts rebut the manufactured liquidity hysteria

- There is zero actual evidence that financial regulation is causing liquidity problems
  - in fact, the evidence shows the opposite
- History shows that volatility increases when the Fed “normalizes” policy, i.e., changes rates, **especially** when rates are increased
- Everyone knows the Fed is preparing to “normalize”/increase rates
- After an historic financial crash & economic crisis, this comes on top of years of unprecedented rate actions plus bond buying, both of which add to uncertainty
- Also, Fed policy has dominated investment & trading decisions, thereby exaggerating the historical patterns, i.e., herding, etc.
- Fed not the only reason for changes in liquidity, i.e., massive shift to gigantic asset managers, historically high bond issuances, electronic/HFT activity, etc.

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(More) facts rebut the manufactured liquidity hysteria

- The decrease in Wall Street dealer bond inventory has been grossly exaggerated
- Wall Street dealer banks never had much inventory to begin with and much of what they did have pre-crisis was illusory or phantom "toxic" products
- There was no golden age of liquidity when everyone could trade at all times at the price and size they wanted, as so many of today's claims suggest
- Wall Street's dealers aren't beneficent market makers standing ready at all times to buy and sell to maintain an orderly market regardless of volatility
- Wall Street's dealers aren't shock absorbers: they are opportunistic and, at times, predatory buyers, but are mostly shock creators and/or amplifiers
- Thus, Wall Street's dealer banks and their allies have created a false crisis and then created a false culprit, financial regulation, but the facts show otherwise

Jamie Dimon is wrong: Wall Street dealer inventories of corporate bonds are NOT down 75%

- Never one to let the facts get in the way of talking his book, JP Morgan Chase CEO Jamie Dimon created this tempest in a teapot in his April 8, 2015 Letter to Shareholders, claiming:
  - "Dealer positions in corporate securities are down by about 75% from their 2007 peak …."
- Even apart from the irony of selecting the 2007 peak of the fraudulently inflated subprime bubble to start with, this is simply not true, as a Goldman Sachs analysis has demonstrated

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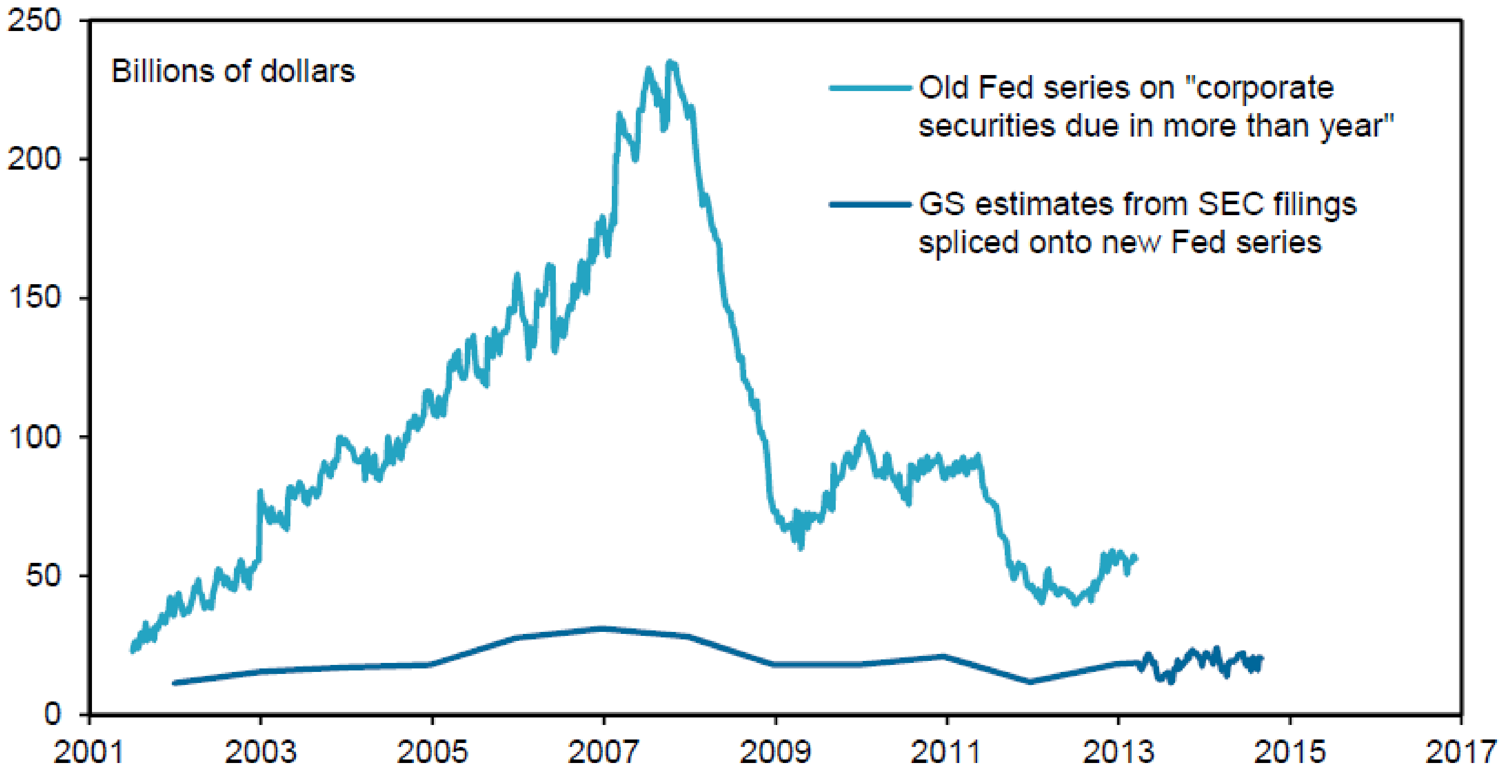
"We also think the decline in dealer corporate bond inventories has been **exaggerated**. Some frequently argue that the ability of dealers to intermediate outflows has been severely diminished since the financial crisis. This claim is typically supported by data from the Federal Reserve's survey of primary dealers' net positions in 'Corporate securities due in more than one year.' This series peaked at more than $230 billion in 2007 and fell more than 75% before the data series was discontinued last year (see Exhibit 6). But as we have pointed out on several occasions, the definition of 'corporate securities' used in the survey included private-label mortgage-backed securities in addition to plain vanilla corporate bonds, which **overstates** the magnitude of the decline in corporate bond inventories."

Source: Goldman Sachs, Global Investment Research, Oct. 9, 2014:
"The state of play in the leveraged finance market: Ok for now"

Exhibit 6: Old Fed data on primary dealer positions in "corporate securities" include private-label mortgage-backed securities and overstate the level of corporate bond holdings

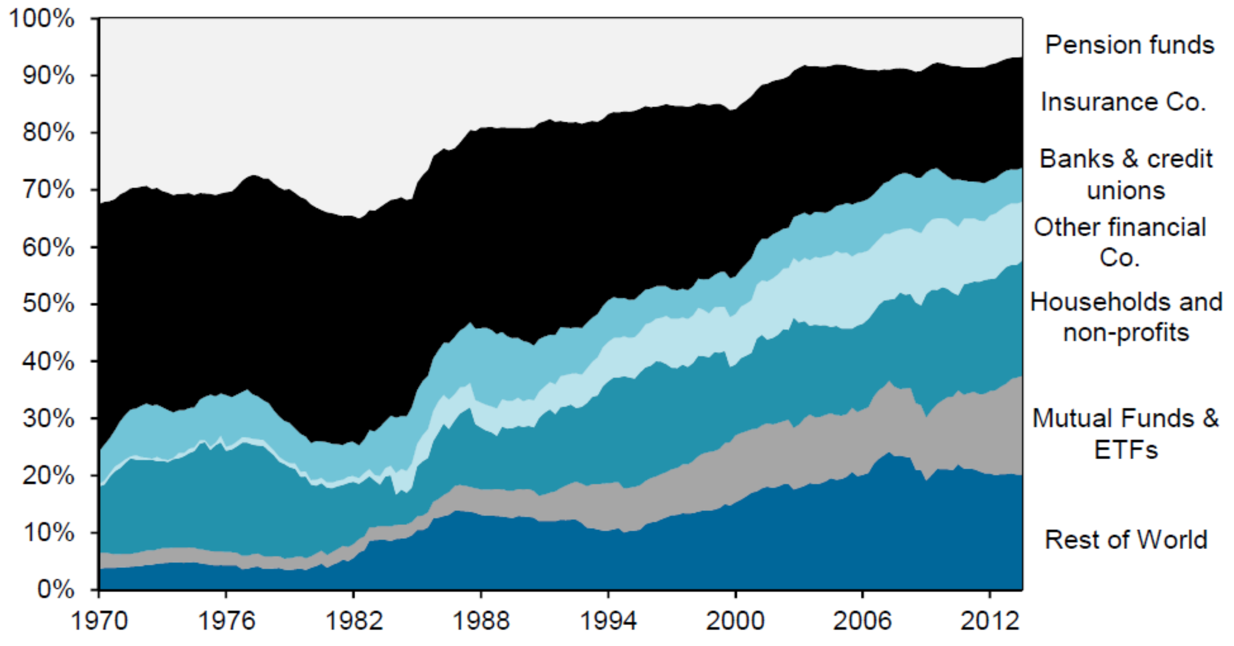


Source: Federal Reserve Board, SEC, Goldman Sachs Global Investment Research

- Down, sure, but no 75% drop
- But, also note that the data shows that current inventories of corporate bonds are not far off the range of inventories from 2002 through 2005
- Thus, if dealer inventories look much like they did in the period before the financial crisis, then the claim that post-crisis regulations have impacted -- never mind dried up -- liquidity is false

“To overcome this issue, we constructed our own estimate of dealer net positions in true corporate bonds based on a little-known SEC filing required of all broker-dealers (see “Revised survey of primary dealers sheds new light on inventories”, The Credit Line, April 18, 2013). These data, also shown in Exhibit 7, suggest that inventories of true corporates were never nearly as high as suggested by the original Fed data—that is, the majority of the “corporate securities” in the Fed data during the pre-crisis peak were actually private mortgage-backed securities. At just $21 billion, inventories of long-term corporate bonds are roughly 44% below their peak of $38 billion in 2006.”

Exhibit 7: Corporate bond markets have a diversified ownership structure



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Source: Goldman Sachs, Global Investment Research, Id.

Plus, Wall Street's dealers never had that much inventory

What Wall Street's dealers did have was only a tiny fraction of the outstanding corporate bond market

- Therefore, they couldn't and didn't act as so-called "shock absorbers"

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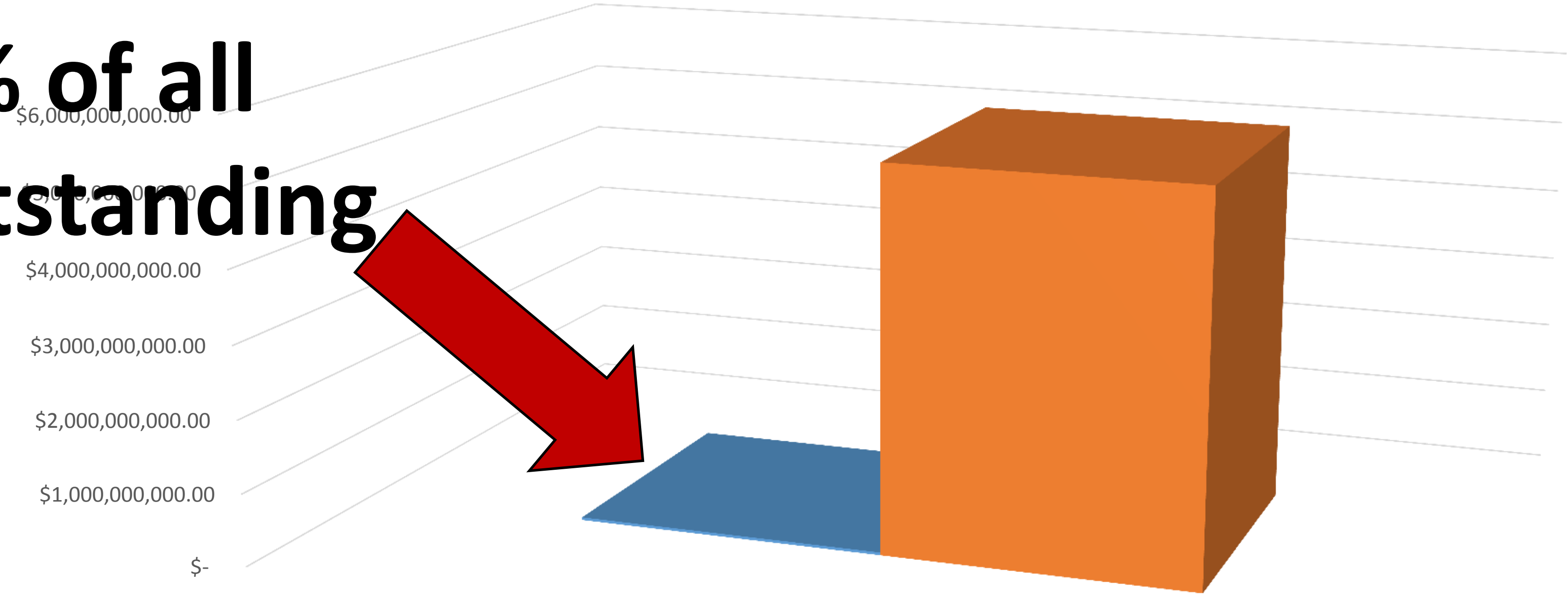
2006 Dealer Inventory of Corporate Bonds and Total Outstanding

.7% of all outstanding



Source: Goldman Sachs and SIFMA

Much of pre-crisis dealer inventories were illusory

- Much of the inventories Wall Street's dealer banks appeared to have pre-crisis were illusory
- Inventories bloated with toxic, often worthless, securities that had to be written off or marked down to reflect their market prices
- Thus, it is not bad to have less liquidity of and for bad/toxic/illusory trading and investments, which fueled the last crisis and crash

Drop in Wall Street dealer inventories merely getting rid of illusory or phantom liquidity

"IOSCO has concluded that the lower liquidity in corporate bond markets these days was caused by a reduction of bonds used for 'toxic structured products' up to 2007. So, we have got rid of phantom liquidity causing systemic risk. This was achieved partly by regulation and partly by the lack of appetite of investor to buy 'toxic' products."

Werner Bijkerk, IOSCO, Chief Economist, Director of Research

(See April 2014, Corporate Bond Markets: A Global Perspective: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD458.pdf)

“When the music stops, in terms of **liquidity**, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”

Citigroup’s CEO Chuck Prince in 2007

Source: http://www.ft.com/intl/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html?siteedition=intl#axzz3hTajrPnn

In 2008, Citigroup was one of the biggest, most reckless failures of the financial crash and received the biggest bailout of any single institution: $476.2 billion from a series of rescue programs.

- It is also the only Wall Street bank that didn’t repay the money it received from the TARP program.

“The result is a periodic tidal wave of credit during the boom followed by protracted credit drought during the crunch. Chuck Prince’s disco inferno causes murder on the dance floor.”

Andrew Haldane, Bureau of International Settlements

Source: “Curbing the Credit Cycle,” Nov. 20, 2010 (http://www.bis.org/review/r101214e.pdf

The myth of Wall Street’s dealer banks as market makers do not withstand scrutiny

- There never was a golden age of liquidity when everyone could trade at all times at the price and size they wanted
- That’s because Wall Street’s dealers aren’t beneficent market markers standing ready at all times to buy and sell to maintain an orderly market regardless of volatility
  - That’s why they aren’t shock absorbers; they are shock amplifiers and magnifiers
- Wall Street’s dealers trading shows that it is not regulation that is inhibiting trading

CFTC Market Risk Advisory Committee Meeting

- Chair Commissioner Sharon Bowen
- Committee meeting on June 2, 2015
- “Liquidity in the Derivatives Markets”

“Liquidity does not sit alongside life, liberty and the pursuit of [happiness] in the Declaration of Independence. Liquidity [provision] is, at the end of the day, … a service which needs to earn an economic rate of return.”

Isaac Chang, Global Head of Fixed Income, KCG

CFTC, Market Risk Advisory Committee Meeting, June 2, 2015

Why are those myths increasingly prevalent & strident?

"Historically, [Wall Street's biggest] banks have enjoyed a privileged position as intermediaries between buyers and sellers in the fixed-income markets. Unsurprisingly, these banks argue that their position must be maintained to facilitate liquidity during volatile periods. This is a myth intended to preserve their competitive moat around what has been a very lucrative business."

Ken Griffen, CEO, Citadel

Source: Ken Griffen, "Overlooking the Other Sources of Liquidity," *Wall Street Journal* (July 26, 2015), *available at* http://www.wsj.com/articles/overlooking-the-other-sources-of-liquidity-1437950015.

“I feel like sometimes I hear some of the comments and it feels like liquidity is this magical thing that’s going to keep everyone from losing money. I’ve never traded in a market where that’s the case.”

Isaac Chang, Global Head of Fixed Income, KCG

CFTC, Market Risk Advisory Committee Meeting, June 2, 2015

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That’s why trading drying up during high volatility is the norm, as was observed in 1994, 1998 and 2008,

- when there were none of the so-called restrictions on Wall Street’s dealer banks like today

“No … liquidity provider who’s economically rational is going to stand there and provide continuous liquidity in the face of new information which changes the fair value of an asset and I think that needs to be recognized…. I would have gotten fired so fast if as the market was selling off all I did was sit there and buy from customers because we wanted to watch the position ride against me as the market sold off.”

Isaac Chang, Global Head of Fixed Income, KCG

CFTC, Market Risk Advisory Committee Meeting, June 2, 2015

“In the face of newer information [i.e., the Fed moving on interest rates] markets reprice. You can’t avoid that. That’s trading. **Losing money in that situation is not ‘no liquidity.’ It’s you have a bad trade-on…. The role of a market maker is not to stand in the way of a one-way freight train where you know where it’s going.”**

Isaac Chang, Global Head of Fixed Income, KCG

CFTC, Market Risk Advisory Committee Meeting, June 2, 2015

“[**A]ny problem we may have in the bond market won’t be solved by higher dealer inventories or lower capital requirements.** No dealer is going to take the other side of a trade if they don’t foresee another investor with a different viewpoint becoming a buyer down the road. It would be just too much risk for them to warehouse. . . . All the talk of dealer inventory and liquidity mumbo jumbo is just a distraction.”

Krishna Memani

Source: Krishna Memani, “Don’t Confuse Bond Market Liquidity with Volatility,” *CIO Insights-Oppenheimer Funds* (May 14, 2015), *available at* https://www.oppenheimerfunds.com/investors/article/dont-confuse-bond-market-liquidity-with-volatility.

“**Even without new regulation**, it’s unclear whether dealer-banks would want to step in during heavy one-way selling because, despite what many people think of the big banks, these people generally aren’t idiots.”

Tracy Alloway

Source: Tracy Alloway, “Bonfire of the bond funds,” *FTAlphaville* (June 26, 2014), *available at* http://ftalphaville.ft.com/2014/06/26/1885912/bonfire-of-the-bond-funds/.

“During a selloff, perhaps triggered by a change in sentiment or bad news, **dealers did not simply buy bonds to buffer the markets**. They would buy attractive bonds opportunistically, but also quite likely would contribute to the selloff by trying to lighten their inventory. Hence the buffer [claim] implies that dealers were fulfilling some form of public service. **Dealers may not always do smart things or have the right view about the market but they tend not to mix business with charity.”**

John Tierney and Kunal Thakkar

Source: John Tierney and Kunal Thakkar, quoted in Dan McCrum, “Will I be pretty, will I be rich,” *FTAlphaville* (Feb. 5, 2015), *available at* http://ftalphaville.ft.com/2015/02/05/2110182/will-i-be-pretty-will-i-be-rich/.

And, of course, no surprise that is exactly what was observed in the trading of Wall Street's dealer banks during the so-called "taper tantrum"

“[D]ealers may have been **able but *unwilling*** to provide market liquidity. . . . **[D]ealers with greater ability to take on risk prior to the [taper tantrum] selloff actually sold off more.** This suggests that dealer behavior during the selloff appears to have been driven more by differences in risk appetite than by regulatory constraints.”

Federal Reserve

Source: FEDS Notes, “Dealer Balance Sheet Capacity and Market Liquidity during the 2013 Selloff in Fixed Income Markets” (Oct. 16, 2013), *available at* http://www.federalreserve.gov/econresdata/notes/feds-notes/2013/dealer-balance-sheet-capacity-and-market-liquidity-during-the-2013-selloff-in-fixed-income-markets-20131016.html

“[B]roker-dealer subsidiaries of BHCs with <u>higher</u> capital levels actually sold off more. This relationship suggests that broker-dealer behavior during the selloff was driven more by differences in risk appetite than by enhanced regulatory requirements.”

Financial Stability Oversight Council

Source: Financial Stability Oversight Council, *2014 Annual Report* 42 (May 7, 2014), *available at* http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf.

Where does that leave us?

- First, make no mistake about it
- When the Fed raises rates, people are going to lose money
  - Some, lots of money
    - Remember 1994: the year of the bond market debacle
- But investors losing money – or even blowing themselves up – is not a liquidity problem
- And it is no basis to change financial regulation targeted at reducing illusory liquidity while making the financial system stronger and more resilient
- The real issues are risk and risk management not regulation

- The other issue is who pays for liquidity and the associated risk
  - It's investors or taxpayers
- Financial reform has shifted those risks and costs back to investors and away from taxpayers who ended up on the hook for Wall Street's dealer banks' reckless actions last time
- The new rules are designed to ensure that liquidity will be priced at its true cost, not underpriced to reflect government and taxpayer subsidies in the form of under-regulation, Fed emergency liquidity facilities and taxpayer bailouts

“Financial industry lobbyists are using concerns about market liquidity to try and scare policymakers away from necessary reforms to bank structure and capital…. If policymakers react in the wrong way to ‘liquidity lobbying’, they risk leaving us with more short term investing and a financial system that is more fragile and pro-cyclical than it needs to be.”

Greg Ford, Finance Watch

www.finance-watch.org

“[M]ore expensive liquidity is a price well worth paying for making the core of the system more robust. Removing public subsidies is absolutely necessary for real markets to exist.”

Mark Carney

Source: Mark Carney, “Building real markets for the good of the people,” Mansion House Speech (June 10, 2015), *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech821.pdf.

"Put simply, you could argue I think, correctly, that the liquidity that was observed pre-crisis was subsidized by the taxpayer. In our view, it would be a mistake to roll back those reforms for the sake of recreating the same set of issues."

Isaac Chang, Global Head of Fixed Income, KCG

CFTC, Market Risk Advisory Committee Meeting, June 2, 2015

What’s at stake in trying to roll back financial reform?

Another financial crash and economic catastrophe

- 2008 was the worst financial crash since the Great Crash of 1929
- It caused the worst economy since the Great Depression of the 1930s
- As detailed in a recent report by Better Markets, all of that is going to cost this country more than $20 trillion
- The American people have suffered too much already
- No one, especially Wall Street CEOs, should be advocating for returning to the 2007 peaks of anything

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