Hello and Happy Monday,

Late last Friday, The Federal Reserve Board published its fourth Financial Stability Report. These regular reports began in November 2018 and present the FED’s current assessment of the resilience of the U.S. financial system and views on near risks. The content is always organized under four categories; Asset Valuations; Borrowing by Businesses & Households; Leverage in the Financial Sector and Funding Risk; and the data used to identify near-term risks is based partially on industry surveys.

Items/statements which we believe are of interest to this group are below.

Please note that the FED at time uses broad characterizations like “direct liquidity provided by market makers” but then fails to distinguish nuanced differences among market makers of different asset classes.

Institutional Activities and Market Liquidity – Page 28
In March and April, even the deepest and most liquid financial markets experienced poor liquidity and extreme price volatility. Against this backdrop, we take a longer-range view and highlight a few trends in the activities of securities dealers, leveraged funds such as hedge funds and principal trading firms (PTFs), and mutual funds and ETFs that could have implications for market liquidity.

Principle Trading Firms/Electronic Trading/HFT – Page 30
Although this trend suggests that dealers may be less willing to engage in market making in the corporate bond market during times of stress, other changes in market structure, such as the increased prevalence of electronic trading, may also affect market liquidity. Against this backdrop, measures of corporate bond market liquidity deteriorated sharply in March 2020, although they have subsequently improved. Besides market making, dealers also contribute to market liquidity by providing credit to leveraged funds such as hedge funds and other firms that engage in significant trading activity, including those that engage in high-frequency trading (HFT). This funding liquidity is provided in several ways, including repos. Leveraged funds, in turn, depend on the credit provided by dealers to finance their trading activities in a number of markets, including bond and equity markets.

ETFs – Page 30
investors in passive mutual funds tend to be less responsive to performance than those in active funds, this shift to passive investing might help reduce large redemptions arising from poor
performance and, therefore, damp fire sale risks.
At the same time, some types of exchange-traded products (ETPs)—leveraged and inverse ETPs—have features that could cause strains in market liquidity. Those two types of ETPs must rebalance their portfolios near the end of the day in order to meet fund objectives. By construction, the rebalancing is in the same direction as market movements earlier in the day. Because this pattern is well known by other market participants, there is the potential for “front running,” or executing trades in anticipation of the rebalancing, leading to further liquidity strains.

Hedge Funds – Page 31
Concentration of borrowing - The top 25 hedge funds accounted for 50-percent of the industry’s borrowing as of 2019:Q2, although they accounted for less than 14 percent of its net assets.
Similar trading strategies - Many hedge funds have increasingly relied on model-driven trading strategies, which has increased the potential for “crowding” in trading strategies.

Near Term Risks with Working Remotely – Page 60
Many financial infrastructures have switched to operating completely remotely at a time when transaction volumes have often been extremely high. During periods when financial institutions operate remotely or with limited staff, the possibility of operational miscues or other mistakes may increase. For example, remote arrangements have slowed decision making or approval channels which can result in processing delays and create backlogs due to employees who experience difficulties with internet or other infrastructure issues at home. And financial firms are also more vulnerable to security risks, as more employees work from home.

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