**The new bond market: Bigger, riskier and more fragile than ever**

By

[Colin Barr, The Wall Street Journal](http://www.efinancialnews.com/search?q=Colin%20Barr,%20The%20Wall%20Street%20Journal) 

21 September 2015

**Stocks rise and fall, but bonds are starting to make people anxious no matter what they do.**

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The US bond market is among the biggest financial markets in the world, with $39.5 trillion outstanding at mid-2015, the Securities Industry and Financial Markets Association says. That is equivalent to 1½ US stock markets and nearly twice the aggregate size of the five largest foreign stock exchanges (in Japan, China and Europe), says the [World Federation of Exchanges](http://www.efinancialnews.com/search?mod=articlehyperlink&q=World+Federation+of+Exchanges). Foreign bond markets have boomed as well.

Surveying the global bond market of 2015 can be an intimidating exercise. Long associated with safety and predictability, bonds appear vulnerable as never before to price reversals and trading disruptions that could spill over and threaten financing for businesses and individuals.

This is the first in a series of articles exploring the new bond market that has taken shape since the financial crisis. It is a world of low interest rates that fuelled massive debt issuance and investor risk taking, tighter regulations that are constraining banks, and the rise of asset managers and fast-trading firms that are changing how bonds are bought and sold.

The market is under scrutiny because the [Federal Reserve](http://www.efinancialnews.com/search?mod=articlehyperlink&q=Federal+Reserve) is preparing to raise interest rates for the first time in nine years, at a time when the global economy is limping and debt ratios of countries around the world are higher than they were heading into the financial crisis.

In the US, household, corporate and government debt amounted to 239% of [gross domestic product](http://www.efinancialnews.com/search?mod=articlehyperlink&q=gross+domestic+product) in 2014, the [Bank for International Settlements](http://www.efinancialnews.com/search?mod=articlehyperlink&q=Bank+for+International+Settlements) estimates, compared with 218% in 2007.

The US is not alone. Dollar credit to non-bank borrowers outside the US hit $9.6 trillion this spring, the [BIS](http://www.efinancialnews.com/search?mod=articlehyperlink&q=BIS) said, up 50% from 2009. Repaying those loans and bonds will become costlier in local-currency terms should the dollar rise, as it often does, when the Fed goes ahead with tightening, potentially stressing large borrowers such as emerging market companies.

Domestically, the rise of large bond funds has created new risks. As the funds have grown, so has cross-ownership of the same bonds, increasing the likelihood of contagion if one manager starts selling, the [International Monetary Fund](http://www.efinancialnews.com/search?mod=articlehyperlink&q=International+Monetary+Fund) says. Regulators worry that many investors may not know what is in their funds. A market downswing could lead to rising redemptions of fund shares, prompting funds to sell assets to raise cash and amplifying selling pressure across the market.

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Since 2007, $1.5 trillion has gone into US bond mutual and exchange-traded funds holding assets from government bonds to corporates and municipal debt, according to the[Investment Company Institute](http://www.efinancialnews.com/search?mod=articlehyperlink&q=Investment+Company+Institute). That compares with $829 billion into comparable stock funds.

Bond mutual and exchange-traded funds now own 17% of all corporate bonds, up from 9% in 2008, according to the [ICI](http://www.efinancialnews.com/search?mod=articlehyperlink&q=ICI). In periods of market stress, more-concentrated mutual-fund ownership tends to mean larger price drops, the [IMF](http://www.efinancialnews.com/search?mod=articlehyperlink&q=IMF) said last year.

Annual US corporate high-yield bond issuance never exceeded $147 billion until 2010, according to [Sifma](http://www.efinancialnews.com/search?mod=articlehyperlink&q=Sifma) data going back to 1996, but has more than doubled that figure in each of the past three years. Defaults remain low, but portfolio managers say judging when they might rise is difficult with interest rates still near zero six years into the economic recovery.

The issue is not that the bond market is in a “bubble” that is about to be popped. The Fed’s decision last week to hold interest rates steady was another reminder that yields will stay low in the years ahead.

At the same time, events like the 2013 “taper tantrum” and the “flash crash” in the US treasury market last October 15 underscore the sense among many analysts and traders that the bond market is alarmingly fragile and increasingly subject to volatility more commonly associated with stocks and commodities.

Consider the trading this spring in the 10-year German bund – along with US treasuries, one of the world’s most trusted securities. On April 17, the yield on the bund plunged to an all-time low of 0.05%. Three weeks later, it spiked to 0.786%, without a major news event or apparent broad shift in investor sentiment. The bund, for this brief period, was a momentum trade, like the Internet stocks of a generation ago.

Asset managers say they have for decades successfully managed periods of outflows and rising rates.

At the same time, many bond funds were hit hard in 2008, raising questions about how they will perform in future upsets. According to [Morningstar](http://www.efinancialnews.com/search?mod=articlehyperlink&q=Morningstar), the average actively managed bond fund lost 8% that year, thanks to declines in corporate and municipal bonds, especially junk.

Maybe greater volatility is just the price investors pay for progress. By all indications, the market may soon get a chance to find out just how comfortable it is with that trade-off.