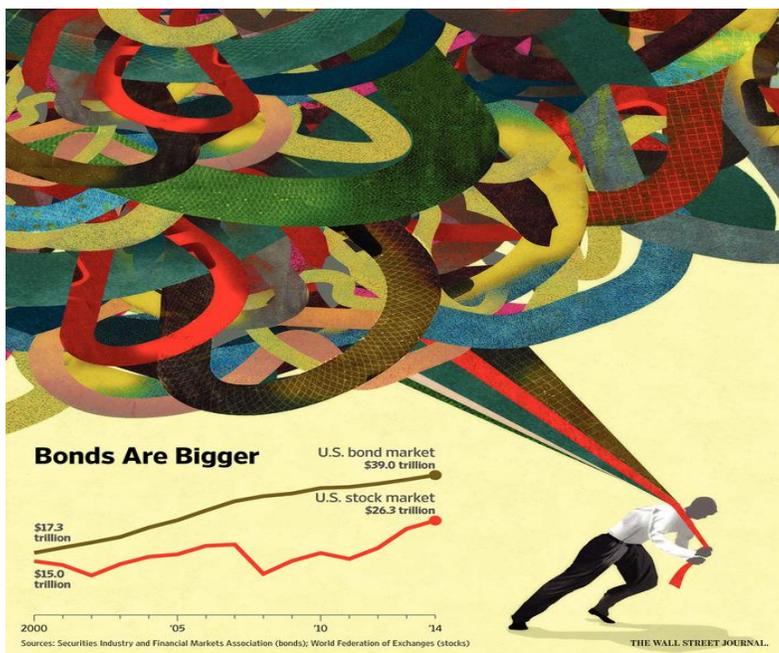


## The New Bond Market: Bigger, Riskier and More Fragile Than Ever

Gigantic debt-trading arena is subject as never before to price reversals and disruptions

By COLIN BARR

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

The U.S. 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 U.S. 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. 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.

### THE NEW BOND MARKET

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 fueled 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.

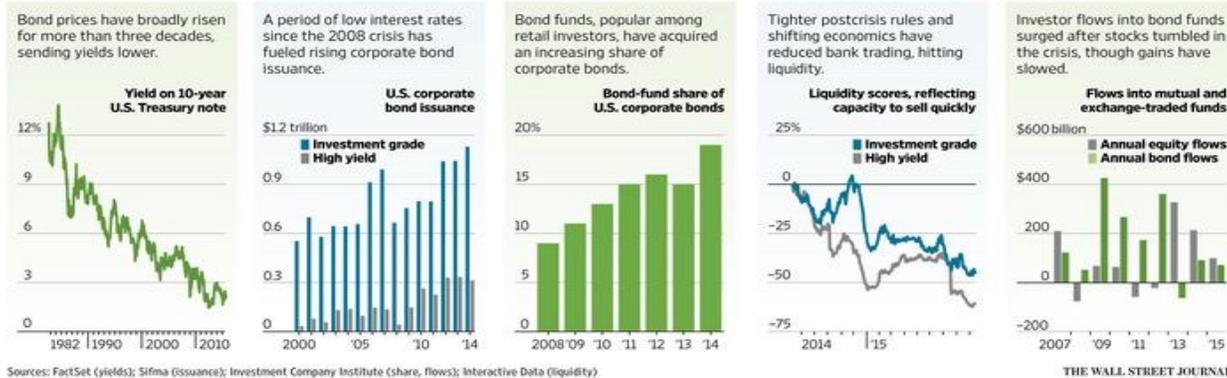
The market is under scrutiny because the Federal Reserve is preparing to raise interest rates for the first time in nine years, at a time when the global economy is limping and debt ratios of countries around the world are higher than they were heading into the financial crisis.

In the U.S., household, corporate and government debt amounted to 239% of gross domestic product in 2014, the Bank for International Settlements estimates, compared with 218% in 2007.

The U.S. isn't alone. Dollar credit to nonbank borrowers outside the U.S. hit \$9.6 trillion this spring, the 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.

## Breaking Out

The U.S. bond market has vastly expanded in recent years, creating fresh risks at a time when U.S. rates appear poised to rise for the first time since before the financial crisis.



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 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.

Since 2007, \$1.5 trillion has gone into U.S. bond mutual and exchange-traded funds holding assets from government bonds to corporates and municipal debt, according to the 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. In periods of market stress, more-concentrated mutual-fund ownership tends to mean larger price drops, the IMF said last year.

Annual U.S. corporate high-yield bond issuance never exceeded \$147 billion until 2010, according to 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 isn't 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.



Events like the 2013 "taper tantrum" and the "flash crash" in the U.S. Treasury market last Oct. 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. PHOTO: ANDREW HARRER/BLOOMBERG NEWS

At the same time, events like the 2013 "taper tantrum" and the "flash crash" in the U.S. Treasury market last Oct. 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 U.S. 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, 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 tradeoff.

Write to Colin Barr at [colin.barr@wsj.com](mailto:colin.barr@wsj.com)