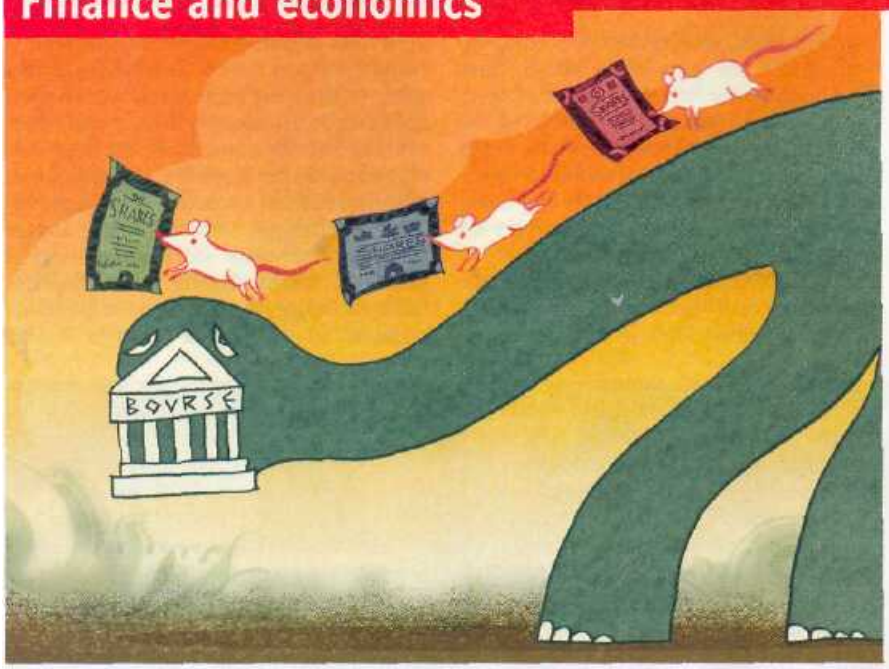

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Stock exchanges

The battle of the bourses

NEW YORK

Exchanges have gained from merger speculation and rising trading volumes. But competition from whizzy new markets is starting to spoil the party

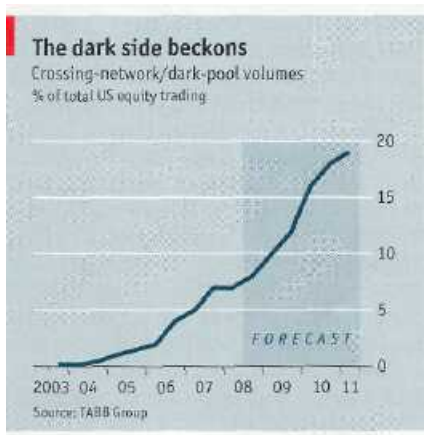
"ARGUABLY, (here's never been a better time to be an exchange business," enthused Clara Furse, chief executive of the London Stock Exchange (LSE), on May 22nd after unveiling record profits. The past few years have been a golden era for the world's bourses: their own share prices lifted on a wave of mergers; trading volumes, already rising smartly, sent into orbit as investors sought to profit from the volatility triggered by the credit crunch.

But Ms Furse's joy is not unconfined. The LSE'S share price has fallen by half since January. NYSE Euronext, which runs New York's exchange and several European markets, is down by 30%. Since March the volume of trading it handles has tumbled, even as the overall market has surged. NASDAQ, its cross-town rival, has seen turnover drop to its lowest level since 2004. Why is this happening?

The main culprit is competition. In America electronic upstarts have been nipping at the exchanges' heels for years. They got a fillip last year with the introduction of Reg NMS, a rule that forces trades to be sent to the venue offering "best execution". (The European Union's new MIFID directive does much the same.) The old exchanges' share of the market is rapidly eroding: in America it stood at 73% in April, down from 86% a year before.

The competition comes in two forms. The first is electronic markets that aspire to become full exchanges. In America BATS and DirectEdge are the trail-blazers, having grabbed a combined 13% of all matched trades at last count. The leader in Europe is Chi-X, launched in March 2007, and the closest thing to a pan-European electronic market. At times its share of British and German trades tops 13% and 6% respectively. Other platforms, such as the much-hyped Turquoise, are preparing for their launches.

These networks are typically backed by consortia of banks that were once in bed with the established exchanges as their member-owners. By stimulating competition, the banks hope to force the exchanges to cut their fees. These remain particularly expensive in Europe, where the cost of trading is, on average, three times higher than in America.



The new lot tout several advantages. With no legacy technology weighing them down, their platforms are ultra-fast. Chi-X, for instance, can complete trades at up to ten times the speed of older rivals, and more reliably. This appeals to high-frequency algorithmic traders at hedge funds and specialist brokers, an increasingly important constituency for whom a millisecond is an aeon.

They are cheaper, too, not least because they have been offering generous rebates to "liquidity providers" that post quotes. Chi-X has gone a step further, offering slivers of equity to its heaviest users. Such user-friendly tactics are hard for the exchanges to match without angering their shareholders. "They're still struggling to figure out how much liquidity is sticky and how much price-sensitive," says Larry Tabb of TABS Group, a consultancy.

Speed and price are not everything, however. In August and January the share of trades done electronically on NYSE fell from 90% to as low as 60-70%. At times of stress "people realise milliseconds don't matter", argued Duncan Niederauer, the exchange's boss, in a recent speech. "It's better to get it right."

The second type of competition conies from "crossing networks" and "dark pools", two forms of private market used to trade large blocks of shares away from the glare of the exchanges. Some investors like them because they conceal the buyer's identity and the price, reducing the risk of the market moving against them as others react. Dozens of these markets are up and running. In America they are expected to account for one-fifth of all share-trading in three years' time (see chart).

Although this free-for-all provides sought-after anonymity, the market as a whole may suffer from the fragmentation of liquidity. Banks are starting to address the problem. This month Goldman Sachs, Morgan Stanley and UBS agreed to offer each other access to their pools, using computer programs that roam, from network to network looking for matching buy and sell orders. "Technology is solving the problem of splintered liquidity as it arises," says one participant.

Full mergers among dark pools may be next. Some see parallels with the late 19908, when the first generation of electronic-trading networks consolidated, or were bought by exchanges looking to get ahead in the technological arms race. Both NASDAQ and the NYSE are cutting deals with dark pools. Mr Niederauer sees an opportunity to "reaggregate" markets.

Some exchanges are even quietly creating dark pools of their own, buried within their main market. Their reluctance to publicise this is understandable: although it helps them to hold on to business, it irks some of their big customers, whose own bids may be trumped by the service. Other counter-attacking measures are less surreptitious. Some bourses, such as Deutsche Borse and NASDAQ, have bought options exchanges, which enjoy bigger margins than pure stockmarkets. NYSE Euronext, which already has Liffe, a futures exchange, is looking to expand its business in derivatives (though it also ▸▸

Buttonwood | Not so vigilant

The puzzle of low Treasury-bond yields

THE yield of Treasury bonds is arguably the single most important indicator in financial markets. Since the American government is unlikely to default, the bond yield sets the risk-free rate against which other assets are measured. It also serves as a barometer of investors' feelings about economic variables like inflation and recession.

But precisely because it does so many things, the Treasury bond can send out conflicting signals. Consumers have been grumbling about the inflationary impact of higher oil and food prices for a while. But bond investors have only recently taken fright, pushing the yield on the 10-year Treasury bond above 4% on May 28, for the first time since the start of the year. Even now, however, the breakeven inflation rate (the difference between yields on conventional and inflation-linked bonds) on five-year Treasury issues is just 2.4%, within the range it has occupied for the past four years; compare that with the 7.7% inflation rate that American consumers expect over the next 12 months.

One possibility is that the "bond-market vigilantes" have been asleep. "We sometimes wonder if Treasury-bond investors enjoy losing money," muses Tim Bond, a strategist at Barclays Capital, as he ponders the logic of owning ten-year Treasuries yielding close to 4% when headline inflation is heading (on his view) for more than 5% by August.

Bill Gross of Pimco, a bond-market investor, argues that inflation is understated in the official American figures because of statistical adjustments made over the past 25 years. The result may be that investors have been fooled into buying Treasury bonds on unrealistic expectations of real (after-inflation) yields.

Another possibility is that breakeven rates are not an effective measure of investors' inflation expectations. That is the view of Jack Malvey, a strategist at Lehman Brothers. He argues that yields on inflation-linked bonds have been distorted over the past decade by demand from pension funds, which see the bonds as an ideal way to match their liabilities.

A third option is that bond investors think today's inflation rates are a blip. "Inflation may be an issue now but it likely won't be over the next ten years," says Pavan Wadhwa, head of European rates strategy at JPMorgan Chase. Optimists argue the anti-inflation credibility of central banks is stronger than in the 1970s. And they note that high oil prices, although they push up inflation in the short term, ultimately tend to act as a tax on growth.

The credit crunch may also be having lingering effects. Bond yields reached their low in mid-March when the Bear Stearns crisis was in full swing. At that point, the ten-year Treasury bond yielded just 3.31%, the lowest level in five years. Investors were fleeing the riskier debt of bank and other corporate borrowers for the safety of government paper.

Yields have moved up by more than half a percentage point since then, as investors have started to move money out of government bonds and back into the equity market. But recessionary fears still linger, especially when investors are bombarded with statistics such as the continued fall in American house prices and the decline in consumer confidence. It may still be worth holding Treasury bonds yielding around 4% as a hedge against a sharp economic downturn.

In short, the bond market is caught in an awkward compromise, with worries about the financial and economic outlook balancing concern about inflation.

In the medium term, however, it is hard to argue with Lehman's Mr Malvey when he says that he expects yields in some government-bond markets to rise by two-to-three percentage points over the next two or three years. Although the world may not be about to return to the excesses of the 1970s, the Goldilocks era is tapering off: the trade-off between growth and inflation has deteriorated.

Nor have Treasury-bond investors exactly been coining it in recent years. According to Barclays Capital, the annualised real return since the start of 2003 has been a meagre 1%. Will the Chinese, with a domestic inflation rate of 8.5%, really want to hold bonds yielding 4% in a currency they expect to depreciate against the yuan? Is the anti-inflationary credibility of the Federal Reserve really that convincing when it is clear that its rate decisions can be driven by concern for the health of the banking sector? Indeed does it make sense for German ten-year bonds to yield more than Treasuries when the inflationary rhetoric of the European Central Bank looks much more hawkish?

Veteran investors may recall 1962, when the Treasury-bond yield was less than 4%. Those who bought bonds then earned negative real returns over the succeeding five-, ten- and 20-year periods. They should be very careful about making the same mistake again.

needs to realise the transatlantic market it promised when it formed in 2006, and to plug gaps in its global network).

The exchanges have two more cards up their sleeves. One is to launch markets that the upstarts cannot. NASDAQ, for instance, has PORTAL, a marketplace for "144a" securities, which only sophisticated investors may trade. The other is to develop listings—the business in which brand counts most-by, for instance, offering in-house research for smaller stocks.

In America the battle between newcomers and old guard is already firmly joined. Across the Atlantic horns are only just starting to lock. As the head of trading at one Wall Street bank puts it: "Some incumbents, particularly in Europe, have had it their own way for so long that they still don't understand what's coming." ■

Fonte: The Economist, n. 8582, p. 77-79, 31 May. 2008.