# Liquidity Premia and Financial Oppression

The co opting of banks in debt monetization, the fear of investors, the shackles of Basel 3, place significant constraints on the banking industry.
Fractional reserve banking has always carried liquidity mismatches, but has managed to mitigate this by relying on some degree of inertia and asymmetrical information. Bank’s historically high ROEs were a function of leverage and the carry trade.

Today, government bond yields are low on a historical basis (even in Italy and Spain), and term structures are still flattening.

For the investor, the actions of central banks and regulators have created an acutely high liquidity risk premium. Normally, this would imply a steep term structure. Today it manifests in a flat term structure. How can this be? The liquidity in sovereign bond markets is responsible for their flat structures and low yields. Because the longer maturity bonds are tradable, they are liquid; and because they are liquid, they are sought after, hence their yield compression. Mark to market volatility remains a risk, however.

Investors seeking liquidity are now forced to take much higher risk than before since liquid assets either produce a low yield, or exhibit high volatility, or both.

Dogged demand for both liquidity and yield will drive some investors to seek equity dividends (discounting capital gains or losses), high yield bonds (discounting mark to market volatility and default), selling options (sometimes unknowingly in structured products), and whatever new products the financial industry will almost surely invent to meet this demand.
**Spread between 2 and 10 year US treasuries:**