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Market conditions, fragility, and the economics of market making

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ACCEPTED MANUSCRIPT

Market conditions, fragility, and the economics of market making *

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Abstract

Using audit-trail data from the Toronto Stock Exchange, we find that market makers scale back in unison when market conditions are unfavorable, which contributes to covariation in liquidity supply, both within and across stocks. Market conditions lower aggregate participation via their impact on trading profits and risk. Contrary to regulatory view, higher stock volatility is associated with more participation and higher profits, even after controlling for other market conditions, including stock volume. Fragility concerns extend to larger stocks and to active participants. The designated market maker mitigates periodic illiquidity created by synchronous withdrawal of market makers in large and small stocks.

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