Segmented Arbitrage

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We use arbitrage activity in equity, fixed income, and foreign exchange markets to characterize the frictions and constraints facing intermediaries. The average pairwise correlation between the 29 arbitrage spreads that we study is 21%. These low correlations are inconsistent with canonical intermediary asset pricing models. We show that at least two types of segmentation drive arbitrage dynamics. First, funding is segmented—certain trades rely on specific funding sources, making their arbitrage spreads sensitive to localized funding shocks. Second, balance sheets are segmented—intermediaries specialize in certain trades, so arbitrage spreads are sensitive to idiosyncratic balance sheet shocks.

**Url:**<https://www.nber.org/papers/w30561>