lets reflect for a moment on the subprime mortgage meltdown. Why did all those banks give loans to anyone with a pulse and why did institutions buy those loans ? Because the spreadsheets told them it was ok. Their models included “no way it will get this bad” default rates. Which was great, until it got that bad and then some.

Now lets look at the stock market. Today’s models include variables based on liquidity. Every high volume trader only has a single exit strategy: Sell the stock (or some synthetic version of selling the stock). Every one of their models is based on the fact that the liquidity will be there.

What happens if its not ? What happens if the volume introduced by High Frequency traders disappears, or as some suggested about yesterday, they just decide to stop trading ?

Where will the buyers come from ?

The stock market ecosystem has changed considerably in the last 5 years. The interdependencies have changed and expanded. Not only do we live in a global economy, we transact on a global network. But these interdependencies have a significant problem, you don’t know when a node/trader disconnects until its too late.

If a fund/institution/High Frequency Trader generates 100mm shares or contracts a day/week/month, market observers will tell you thats a great thing because it creates a liquidity premium. In other words, because there is always someone on the other side of a trade, it is easier to match buyers and sellers and that ease creates smaller spreads and often lower pricing. On the surface thats a great thing.

It is a great thing until the market becomes completely dependent on that liquidity. If every model expects X volume, what happens when that volume falls ?

Now some may say that the risk of light volume is just the risk of playing the game, and they are right. But it also opens the door for market manipulation. You have heard of “too big to fail”.   What do you call it when a significant percentage of volume of an exchange is concentrated in just a few hands ? **Too big to pull the chair** ?

You pull the chair when someone expects to sit comfortably on a chair, the chair is yanked away and that person lands on their ass. You pull your trading volume when the market expects it to be there and what happens ? There can be a lack of buyers, which in turn pushes stock prices lower, perhaps quickly and significantly. Which could lead to triggering selling programs, pushing the market down to circuit breaker levels.

What is to prevent growth of a few high volume traders or consolidation of those players to put themselves in the position (if they are not already), to do a planned “pull the chair ” on the market ?

Why wouldn’t they build dependencies on their volumes and then on a low volume day, or on a day where there is news that could be seen as a catalyst to the down side, just stop trading? Knowing that in minutes, prices would fall. A decline they would be expecting. A decline they would take advantage of, buying or trading on the reduced prices. Or it could happen in reverse. They could pull the chair and short stocks that rose because there were natural sellers and walked away.

Of course there would still be huge risk to this practice. But that just exasperates the systemic risk to the market. If the high volume trader thought this practice could make them huge money, it could wipe them out if it didn’t work.

Tell me why it couldn’t or hasn’t happened ?

Now as far as my portfolio is concerned, thats not a bad thing. I tend to be an investor that is a shareholder, with much of my portfolio paying me cash. If the market craters like it did yesterday, it is always a buying opportunity. I’m don’t freak out about where my portfolio is marked to on a daily basis. I look for opportunities to increase my ownership or increase my cash returns. Which i did yesterday. But I dont think its good for the overall market. I don’t think its good for our economy. I don’t think its good for the general well being of the country and the world.

So what can be done ?

To me its pretty straightforward. Regulating agencies should set a trading volume threshold relative to exchange/issue/security volume that when exceeded, the trading entity must “notify” the appropriate agency . In the event they plan to vary their trading below or above that threshold, they must immediately report the change to the regulating agency. The agency won’t report to the public the change is coming, that would not be fair. However, they will be able to notify the exchanges to expect trading volume changes . This will allow them to coordinate actions among the exchanges . Something that did not happen yesterday , but needs to happen in the future.

The illusion of liquidity and the de-levaraging that occurs when markets lose significant amounts of liquidity is a real risk that we need to acknowledge before something really bad happens

One last thing. I’m not suggesting I have all the answers. I certainly do not. But I do think it is valuable to throw ideas out for discussion. These posts on the market are food for thought.

If I think I have the definitive answer, I’m not shy. I will say so ■