Meltdown…this was nearly 1987 all over gain

A casual glance at the UK market today might lead you to believe that the parliament, with which we have hung ourselves, is the main reason for the mark down. There is however the little matter of a 30 minute session last night just after 7:30pm when global markets went into free fall. The Dow was down close on 1000 points at one stage but within 10 minutes had made up a fair chunk of the fall. FTSE hit 4400 based on spread betting prices, so some room for "error", but a pretty terrifying moment for some. And this was hours before the exit polls.

The blame was initially attributed to an input error on a trade ie a "fat finger" hit "sell a billion" instead of a million. Proctor & Gamble is the stock that has been singled out, but there were hundreds of similar price "anomalies" at the same time. The bids kept going through the floor ie you couldn't sell stock at any price. On the flip side, US Treasuries and gold were going the other way.

There were similar runaway prices in currency markets too and they may have triggered the equity sell off as carry traders tried to close their positions. Carry traders borrow a cheap currency, sell it and invest the proceeds in stocks and other assets. Last night the yen was a major beneficiary as the traders, who were short yen, had to buy it back and close out their equity positions.

The real culprit appears to be "high frequency trading"; a computer based system that initiates buy and sell orders using "clever" algorithms at lightning speed. In 1987 a relatively crude form of trading known as portfolio insurance had a similar effect. Stocks fell a certain percentage triggering sell orders, which pushed prices down triggering further sales ad infinitum…well not quite literally!

HFT in addition can drain liquidity from the market which exacerbates the falls and this was the main reason for last night's plunge. It also works the other way around, which might just explain why the markets, over the past few months, have managed to tick ever upward on a diet of bad news and low volume.

The less than subtle implication from all this is that the markets are being "massaged". Not surprisingly the major investment banks are the leading exponents of HFT under the guise of providing market liquidity which all but dried up last night. Either the regulators get on top of this or we will have a proper re-run of 1987 and then a hung parliament will seem like a walk in the park.