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Trading?volumes retreat with investor trust

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It is summer time, but the livin' feels far from easy on Wall Street. In recent weeks, the main equity indices have been trending higher, helped by good US earnings and the European stress tests.

But while the S&P 500, say, rose about 7 per cent last month, the mood is anything but euphoric. As my colleagues Francesco Guerrerra and Michael Mackenzie reported this week, one striking feature of this summer is that trading volumes in many asset classes have tumbled

This is partly because many institutional investors have quietly gone on strike, choosing to sit on their cash rather than trade.

But something curious is happening in the retail world too. In recent months, US retail investors have continued to put money into government and investment grade bond funds. More recently, there have also been some flows into junk bond funds.

But in the equity world – which is perhaps the most visible cornerstone of American finance – retail investors are also on strike. Last week there were $1.5bn outflows from US equity mutual funds, after $3.2bn and $4.2bn of outflows in each of the previous two weeks. Indeed, in the past 12 weeks – or since May – there have been continuous outflows of more than $40bn.

So what on earth is going on? Optimists like to blame it on a summer lull, or temporary jitters about US unemployment or the eurozone. They may be right. But personally, I suspect that there is something more fundamental going on too.

The most pernicious issue hanging over the system right now is a loss of confidence – not merely in the idea that the future will be a brighter place, but also, most crucially, about whether anybody is able to predict that future at all.

Think back, for a moment, to the halcyon years before the summer of 2007. Back then, it seemed to be such a cosy and stable economic era that economists dubbed it "the Great Moderation" and most investors and businesses had absolutely no qualms about making 10-year plans. Indeed, that was expected in a world, where long-term planning – armed with complex computer forecasts – appeared to be not just rational, but a hallmark of modern society, something that separated us from earlier ages.

However, the financial crisis has shattered that sense of complacency. And while the immediate panic that erupted in the autumn of 2008 has now ebbed away, in its wake it has left a loss of trust – and innocence. These days, investors and businesses know that the world can sometimes be a profoundly unpredictable and uncontrollable

place. No longer does it seem wise for corporate boards (or investors) to make 10-year plans, instead, time horizons have shrunk and many businesses and financial players have developed a mentality more akin to third-world peasants, who create strategies – but do so with bated breath, constantly braced for fresh storms.

And in practical terms, there are a myriad of uncertainties – or potential storms – out there now. The political trajectory in the US, for example, seems pretty volatile, given the rise of populist rhetoric. The government is intervening in the economy in unpredictable ways and financial reform could potentially change capital flows significantly. New jitters are afoot about a double-dip recession and deflation too.

And just to make matters worse, the memory of the May 6 “flash crash” haunts the markets. In the past three months, US regulators and bankers have scurried around trying to work out what caused equity prices to gyrate so wildly that day. But, thus far, they have not offered any convincing explanation.

That is shocking and profoundly debilitating. After all, it is bad for investors to feel confused about the outlook for government regulation or deflation; but it seems that nobody really understands how the basic mechanics of the equity market work any more, it is hard to trust that the stock markets are a good destination for your money. Little wonder, then, that those US equity mutual fund outflows have accelerated.

Of course, as I said above, all this may yet turn out to be just a temporary phenomenon. If, say, the outlook for financial regulation becomes clearer or the economy rebounds, animal spirits may yet return. But the history of Japan shows that this does not always occur – a full two decades after its bubble-and-bust, most retail investors (and even some institutional investors) remain terrified of putting their money into stocks, due to a corrosive loss of trust.

The US is nowhere near that point yet. But policy makers and bankers alike had better keep watching those trading numbers. And cross their fingers that there will not be another “flash crash” any time soon.

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