"Computers can do an unmatched job dealing with the things that can be counted: things that are quantitative and objective. But many other things – qualitative, subjective things – count for a great deal, and I doubt computers can do what the very best investors do." **Howard Marks**

Market Price Gyrations, Liquidity and Algorithmic Trading

In December 2018, the U.S. equity markets experienced their worst December performance since 1931 with stocks plummeting in a waterfall pattern that unnerved investors for its speed and magnitude. While there were many worrisome issues on the domestic and international scene, it was obvious that some other force or combination of forces was at work to create the havoc. Following a market low on Christmas Eve, the markets began a sharp recovery that extended well into the New Year and recovered most of the losses sustained in the last quarter of 2018. While some of the concerns of December eased, there appeared to be other factors that contributed to the V-shaped recovery.

To add further evidence to the puzzling picture, earnings season has been characterized by benign comments from corporate executives that were followed by unusual market price gyrations. It begs the question…..***what's going on beneath the surface that is causing this phenomenon?***

While there are many market commentators who have opinions on this subject, it is my view that the reduced level of risk capital allocated to the trading operations of major investment banks is a contributing factors. Following the Great Recession of 2007-09, new rules were implemented that restricted the amount of risk capital that could be used in security trading and associated capital markets activities. This reduction in "risk capital" is diminishing liquidity available for the smooth functioning of the capital markets. Unfortunately, when the economic environment is stable, the reduced liquidity is not noticeable. However, when sentiment and economic fundamentals turn negative, there is insufficient liquidity to accommodate all sellers without causing larger than desired price fluctuations in individual securities. By itself, this lack of liquidity is detrimental to the efficient operation of the markets, but there is another factor that is beginning to attract attention……***algorithmic trading.***

As security firms increasingly battle for position in gathering assets from individual investors, costs are being constantly slashed. While investment management fees are under constant downward pressure, the emergence and subsequent growth of the ETF business has been impressive. The proliferation of ETFs is mind-boggling and has resulted in management fees in the single-digit basis-point range. Furthermore, the need to remove high-salaried professions from ETF management responsibilities has created a need for another method to manage the day-to-day functioning of these portfolios. In this regard, algorithmic trading has filled the void. While this transition has worked well is most instances, there is a sub-universe of ETFs that move into and out of the capital markets in a "risk on" and "risk-off" pattern. As more and more funds are designed to capture even the smallest market moves, both up and down, the day-to-day trading is being handled by algorithms, devoid of professional human intervention. Once again, in most cases this algorithmic trading is handled without much impact on the fluctuations of individual stocks. However, as the amount of capital devoted to this style of management increases, the need for market liquidity grows even greater than in normal times.

It is very likely that at some point in the future, the combination of growing negative sentiment along with reduced liquidity and algorithmic-induced indiscriminate selling in large ETF portfolios will create a toxic cocktail that may result in another market crisis not unlike earlier market meltdowns of years ago.

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