THE AUSTRALIAN

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MARKET | -1.36% 5.82 | CSL -0.31% 92.46 | BXB -1.00% 9.95 | IAG -1.35% 5.12 | QBE -1.

S&P/ASX 200	AUD/USD	TOP GAINER MSB	TOP LOSER REG
+0.12%	+0.00%	+12.50%	-5.65%
5239.8000	$0.72	$3.69	$5.85

Rates riot behind the market correction

STIRLING LARKIN THE AUSTRALIAN AUGUST 29, 2015 12:00AM

The correction reminds us that in the end it is the US investor that dominates. Source: AFP

If markets volatility seen in 2013 was known as the "taper tantrum", then the events of this week would most definitely be considered a "rates riot".

Director of the IMF's monetary and capital markets department, Jose Vinals, warned this week that this "super taper tantrum … is going to take place in uncharted territory" and could see spikes in US Treasury yields.

Such statements support the argument that everything that has transpired this week has a direct linkage to the widely expected shift in US monetary policy above the current ZIRP — zero interest rate policy — level.

Up and until this week, this was presumed to come at the 17 September US Federal Reserve FOMC press announcement but as of Wednesday has a 76 per cent probability of being delayed until the 16 December meeting, according to US futures traders.

Just like the intentions of any other orchestrated riot, the agitators may win this rout and see the era of ZIRP in the US continue, at least for now.

What in particular has raised concerns throughout institutional participation — including those directly representing ultra high net worth wealth, sovereign wealth funds and superannuation/pension

allocators — is the sheer velocity amplified by the volume of "flow" seen during Monday's moves.

Viewed in isolation, the events of Monday were epic, compared to any historical comparisons. The US Dow Jones opened down more than 1000 points, before eventually closing 588 points lower.

This was the largest single session drop in total terms — price level multiplied by aggregated volume — in US stockmarket history.

But the institutional concern was not focused on the drop alone but the immediate "price action" that promptly and erratically followed.

The Dow and S&P 500 indices "ratcheted" up and down, in "arithmetically" identifiable parcels of about 3 to 5 per cent, more than four times, within two trading hours in New York.

Coupled with the single largest drop on the Hang Seng since 1987's "Black Monday" — remembering that Hong Kong's 1987 fall triggered the 1987 global stockmarket crash — these events have led institutional participants to deeply question how involved automated algorithmic computer systems have become. The presence of computers throughout markets is an obvious reality that will need to be accepted.

But the question stemming from events on Monday that affect all global market participants, including those focused on the ASX 200, is if automation was designed and introduced to aid the "price discovery" process throughout any given market, why did these systems, during live markets, ricochet so often and so far?

The answer may be multi-faceted but their implications matter greatly to Australian investors; especially as our Australian economy sits on the razor's edge of China's blade being wielded, it appears, by Janet Yellen and the US Federal Reserve.

Not since "Black Monday", October 28, 1929, has the Dow seen a momentary "air pocket" — market condition whereby constituent stocks have no buyers at any price — of this scale but unlike then, this week's market found liquid support levels within an acceptable time frame.

What became unacceptable was the subsequent ricocheting, which saw the CBOE "VVIX" index — a volatility of volatility measure used to gauge expected movement out to a 30-day forward horizon — peak at all-time highs.

The ramifications of this robotic and synthetic volatility on Monday have seen traditional market correlations — such as between equities prices and bond yields, between geographies and tiered currency pairs — break down.

Evidence of this has been continuously seen all week, whereby, markets across asset classes and geographies have been fluctuating between positive and negative territories, almost hourly and without any fundamental underlying rational causation.

Such oddities are then exacerbated by human behaviour, which will, not unsurprisingly, fear what appears to be unknown.

This week will be remembered as a watershed moment for two reasons.

• First, whether we like it or not, China's listed bourses are now well entrenched within our globalised "ecosystem" and the excuse of segregation, no longer applies.

• Second, this is the most significant "market moment" on the world stage, whereby, automated systems have so explicitly made themselves seen, known and felt.

But for those attempting to seek some “rhythm or rhyme” out of this week and comprehend why China became the obvious “whipping boy” who got caught in this “beartrap”, it is smart to rewind back to what happened in New York, not Beijing, last Friday.

Last Friday’s S&P 500 Exchange Traded Option expiry saw “put option gamma” exceed “call option gamma” by more than $US50bn ($70bn) before expiration — crucially, this was the highest S&P500 gamma imbalance of all time.

Put very simply, there was a significant institutional derivative imbalance established solely to hedge and possibly benefit from a stockmarket downturn.

Even despite these derivatives expiring Friday, an imbalance of $US38bn continued into this week and the unprecedented magnitude of the negative price impact could well explain the selling pressure which triggered Monday’s “air pocket” moment.

Although there are several schools of thought regarding these events, the strongest circling is referred to as the “bifurcation of liquidity” argument.

Due to higher US institutional regulations, such as Dodd Franks, many institutional trading strategies are becoming highly systematic and therefore these participants are leaving all of their hedging to what is referred to as the “closing reference price”.

What this meant last Friday in New York was that the swings seen during the trading day did not well reflect the eventual closing volumes.

Bundling these observations goes a long way towards comprehending the price actions, “air pockets” and record VVIX levels.

This week reminded us to not for one moment underestimate the immense primacy, hegemony and dominance of the US institutional investor.

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