Palmetto Wealth Management

"Seesaw, Margery Daw…"

John M. Gustafson – 8 April 2014

Seesaw, Margery Daw,
Johnny shall have a new master.
He shall earn but a penny a day,
Because he can't work any faster.

A debate that was rekindled last month, primarily by the recently released book from Michael Lewis titled, "Flash Boys" is one of the biggest news items that is not directly politically related, but certainly caused quite a stir in the markets and the media of late. After a fairly damning "60 Minutes" piece featuring Mr. Lewis and his market opinon, I received a few emails asking my thoughts on the topic. I was sure that comments were written to clients as well as published online previously, and a little investigation proved that to be correct… A note I wrote titled "Sentiment and Volatility," that is also still archived on the PWM website – dated August 18, 2011 – discussed the issue at length.

Once again, I'm happy that the scourge of HFT is receiving some much-needed cleansing sunlight, however I'm still amazed that jumping your orders to the front of the line simply because you've co-located your servers and have faster fiber-optic lines than anyone else can be in any way considered legal. Again, if I were to trade in such a fashion it's called "front-running," and I would likely receive a significant fine from regulators, lose most clients and probably be sued.

Of course the high-frequency traders all claim that they add much-needed liquidity to the markets and actually reduce volatility. However, study after study has shown that it's quite the opposite… At times of great volatility (both up and down) they fan the flames with incredible speed, but when things are slow and calm, where perhaps a little more liquidity would be welcomed, they sit on the sidelines and wait. If you look back at my 2011 note, the analogy I used is that high-frequency traders function somewhat like a snowmaking machine at a ski resort. You can truly almost "feel" when they are "making snow" and when they are not.

As ridiculous as the argument is that HFT actually *helps* the markets, the widely proposed solutions are just as silly – a transaction tax is the one I hear the most. I guess it goes back to the old saw, if all you have is a hammer every problem looks like a nail. The lack of creativity and understanding by regulators and legislators continues to be stunning, as the tax hammer does appear to be the only tool in their toolbox that they understand and embrace.

In reality, the public doesn't care if HFT fans the flames to the upside (but that may be even more dangerous in the long run, by blowing bubbles to unnatural heights very quickly) what they really worry about is pouring gas on the fire to the downside, as in the "flash crash" of a couple of years ago. That problem is very easy to solve simply by reinstituting the "uptick rule" for shorting stocks as well as ETF's, making it nearly impossible to pile-on to the downside with ever-increasing ferocity. (i.e. "making snow") This set of circumstances is worth paying attention to over the next several months, curious to see what solutions come about to restore some of the confidence lacking in our current markets.

As for the rest of the quarter and the actions in the market, not much has changed… Unsurprisingly after a bang-up year in 2013 we seem to be in a bit of a sideways grind to digest those outsized gains. All in all, as many will notice from their quarterly reports, lots of smoke, not much fire and an overall sideways ride.

On the political front, as discussed in my last note, Congress kicked the debt-ceiling can down the road as expected and seemingly laid their broad swords to the ground. Of course, they quickly grabbed their pea-shooters for minor, very district specific, sniping that is primarily geared towards winning a return to Washington in the fall. (*always* the true goal) Our current market environment of artificial capitalism is very politically driven, especially in an incredibly important midterm election year, (because of the full-on fight for the White House on both sides of the aisle in 2016) and it is very unlikely that we see any significant proposals for the rest of the year. Grand rhetorical flourishes and possibly over emotional reactions, but nothing truly of significance on the political front until very late in the year.

As for the ongoing theme of the *Bizarro 90's*, the Bear camp has fully populated the media and it is now almost impossible to hear any positive market or economic news, yet the public who still claim to be uncomfortable and nervous with the market at current levels doesn't seem to let things fall very far before they start piling in once again. I think the comparisons to early 2000 from a practical standpoint don't make much sense, however I was around then and I do recognize the patterns and echoes. (For example, the quarter-end "window dressing" we just witnessed last week was so blatant it made me chuckle as I watched the flickering ticks.)

The critical difference is, the Bears were just as frustrated back then, however they weren't even given a legitimate platform at the time. Generally, the same three Bears were brought in as punching bags so that the financial media would appear to be "fair and balanced," all the while poking holes in any negative story that came out. Currently, we appear to be in a position where any time someone with a positive spin (on anything) is interviewed in print or shown on television, there are multiple negative statements attempting to pooh-pooh their theory with the same level of ridicule and disdain. To me that is healthy skepticism keeping irrational exuberance in check.

I'm not saying that I think we continue to go to the moon nonstop – we're certainly due for a pause that even I've been outlining the past few quarters – and I thought we might have one beginning after Q1 window dressing - I just don't think the comparisons to the internet or property bubbles at this point are valid. Once again, nobody had ever heard of the term "Black Swan" until a couple of years ago and now it is used as part of the vernacular on a regular basis, which is simply antithetical.

After the grand move upward we've had in this past cycle I don't have any great expectations for 2014, but I do think that Fed actions will neither be as swift or crushing as appears to be the crowd's expectation. I just don't believe the Fed fears inflation as much as they fear slow growth turning back into recession. They have a monetary fire extinguisher that works quite well against inflation (see "Volker, Paul"); however slow growth, especially with the buffoons in D.C. continuing to work against us all "in thought, word & deed" requires a much more gentle and ongoing touch.

Thank you as always for your continued support, welcome to the new folks on board and please email or call with any questions or concerns. Enjoy your well deserved and long-awaited spring.

Cheers!