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For many traders, the London and European trading hours are the most advantageous. But the so-called ideal trading time, which straddles the end of Asia trading and the beginning of the U.S. sessions, may be more dangerous than it appears.

Trading in the shadow of the liquidity mirage

BY ALEX BENJAMIN

Globalization has created four distinct blocks: Asia, Europe (dominated by London), the United States and the Middle East. With the Internet allowing effectively instantaneous communication between these blocks, the retail market has become relevant, a new and vibrant independent market force.

Everything from the European Central Bank's news conferences broadcast live via your computer's media player to the words of governors of the U.S. Federal Reserve Bank posted at the precise time of a speech means that the difference between retail and institutional is less informational and more logistical.

In other words, we all now have access to the same information at the same time. It's just the processing and execution of ideas based on that information that sets the professionals apart.

Beyond the number-crunching capabilities, institutional accounts are defined by their capability to link markets and products so that a single click can launch multiple orders across different exchanges and continents,

resulting in a deluge of orders followed by a lull. Many times, it's just prior to that lull when retail traders identify the right time to put on a trade — but only to watch the market suddenly become inactive.

This situation is one example of what is known as the liquidity mirage.

TESTS OF THE SYSTEM

Since October 2006, three distinct liquidity mirage situations have played out in the markets.

The first occurred on Globex in the E-mini S&P 500 December futures contract and spilled over into the big S&P 500 as well as the Nasdaq 100 and Russell 2000 contracts.

The trade occurred at 6:26 p.m. (EST) on the Sunday evening of Oct. 22, 2006. This was just as the new week began trading in the Asian hours. The bulk of the move began as the S&P 500 December futures went from 1375.70 to 1380.80, with a major buy order lifting all the offers.

Once the big S&P 500 contract traded 1380.80, it represented a trade 0.6 above the previous recent high of 1380.20. This triggered orders from

large buy-stops resting above this key level. This created a domino effect and a surge of nearly 25 handles from the original open, taking the contract to 1399 (see "To the moon," right).

Due to orders being queued on a first-come, first-served basis, the resting buy-stop orders would have been filled on the high of the move as the original large market order had precedence over the buy stops. This liquidity mirage scenario demonstrated how the stops failed to protect those trying to limit losses. Instead, they were likely filled with massive slippage on the high of the move after the initial buy order was satisfied.

By 6:31 p.m., the world had woken up to the trade, and the market was back at 1377.40. The market traded contracts with a nominal value of approximately \$350 million, with a possible transfer of actual equity of about \$25 million from losing accounts to the winners — in most cases those were also the accounts in tune to the earlier moves in the E-mini.

Relative to the E-mini, \$350 million represents a fraction of the un-

leveraged hedge fund community and does not affect the aggregate bottom line in a meaningful way. But consider the effects of the move on the individual retail level. The \$1,250 per contract multiplied by 5,000 contracts (the original order was a size equivalent to 5,000 E-mini contracts) equals \$6.25 million, or \$12.5 million when the entire move, up then down, is considered. This represents for many retail accounts a 225% ratio of the minimum margin required by many brokers, or 25% of many retail account balances.

This move could have potentially wiped out 50% of many accounts. The \$12.5 million, therefore, may have been small in the grand scheme of things, but the effect on undercapitalized or overleveraged accounts was significant.

The second liquidity mirage event occurred in the Chicago Board of Trade's (CBOT) e-CBOT market in the December 2006 gold contract. On Nov. 12, 2006, the contract traded from \$626 per ounce down to \$608.80, then straight back to \$626 within two minutes, just prior to the open of the U.S. session.

In the S&P 500 example, the cause was a market buy order for 5,000 E-mini equivalent lots. In the mini gold futures, it was a sell stop for 100 lots. Either way, both orders, when launched, took precedent over all other potential resting orders because they automatically became market orders. One difference is the gold order appeared confined to that contract while the S&P 500 order impacted the Nasdaq 100 and Russell 2000 futures.

The third incident occurred on Feb. 12, 2007, on Euronext Liffe in the Cac 40 March contract. It opened at 7 a.m. (GMT) or 2 a.m. (EST) and within one minute had plunged almost 100 points from the previous settlement, representing €1,000 (\$1,341) per contract with a little more than 200 contracts changing hands on a market order (see "French slip," right).

MADNESS BEHIND THE MOVES

These examples show how, even in today's supposedly liquid active marketplace, the domino effect and potential systemic risk trips one order into another forcing a major move. Although these appear to be aberrations, they can easily become a meltdown due to markets being linked via algorithmic auto-traded systems.

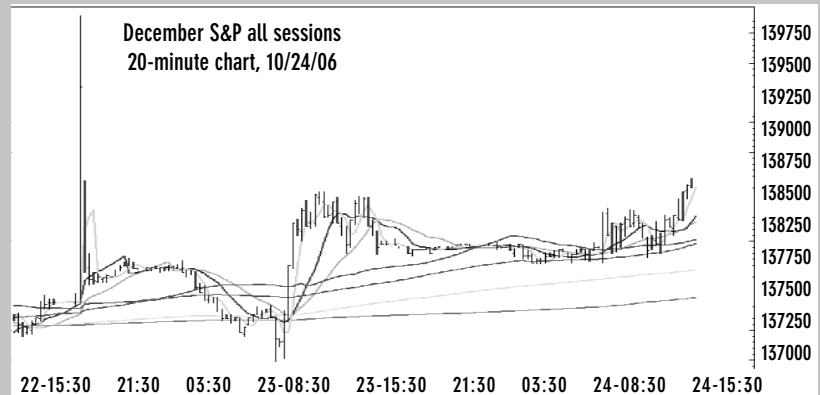
In the 1980s and early 1990s artificial intelligence (AI) became a fashionable following, as personal computers made even more significant inroads into market analysis. Multiple millions of dollars were spent on super computers to inves-

tigate whether markets were random walk or chaos or even fractal-like in their repetition. However as the markets ultimately showed, this rendition of AI was no better at predicting price moves than centuries-old statistics, at best akin to trading using a simple linear best-fit regression line and at worst akin to trading highly optimized and curve-fit models.

Modern markets are, in effect, data warehouses. Programmers input known reference points (opens, highs, lows, closes) and automatic black-box systems generate buy and sell orders based on current market activity complying

TO THE MOON

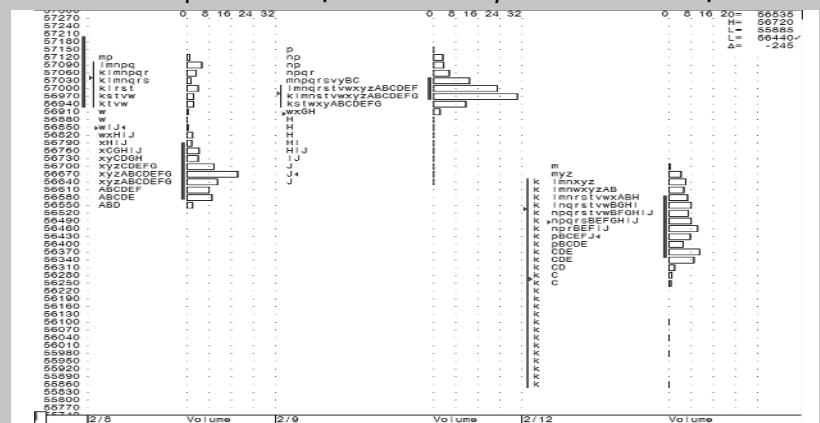
When a large order lifted all the offers in the S&P market on Oct. 22, the market surged to 1399. The powerful price spike could have created margin calls and liquidation of client accounts.



Source:

FRENCH SLIP

This Market Profile chart shows how the Cac 40 dropped nearly 100 points on the morning of Feb. 12 from the previous close (as demonstrated by the succession of "k"s).



Source:

(or not) with past moves.

What has changed in the past 30-odd years is that now, instead of weekly charts, this analysis occurs in milliseconds and it does so automatically. Introduce the various types of momentum indicators, Fibonacci extensions, moving averages, the six or so standard candlestick formations, seasonality, Commitments of Traders report analysis and Elliott wave counts and there are a multitude of strategies waiting to be executed.

Of course, there is the argument that that these schools of thought are all different, and therefore affect the mar-

ket in different ways at different times, and that is true most of the time. In the context of the liquidity mirage, however, they are all slaves to one occurrence: the big move.

What has become noticeable as technology has advanced in recent years is that markets are less likely to let you overstay your welcome. They tend to whoosh through several key price levels as algorithms roll through their various orders. Many charts show series of 10- to 14-day advances or declines, or even weeks for that matter, without the normal ebb and flow of two-way short-term (floor traders) vs.

long-term speculators or hedgers.

In other words, the algorithms are taking over; and while — as in the S&P market condition in last October — they might not have a significant impact in the big picture, they are easily capable of disrupting retail accounts in terms of both risk and opportunity. Today, if you are not on board a move just before it starts, it is difficult to get involved afterward. And on the other side of the trade, afterward is too late to protect the bottom line.

HOW TO PREPARE

Risk management is as key to trading success as market analysis and position sizing. It is as critical to your long-term viability as which vehicles you chose to position your trades in and when you take profits.

The first hard-and-fast rule of trading amid the risk of the liquidity mirage is simple, and was a hard lesson learned by those caught on the wrong side of the E-mini trade illustrated in “To the moon.” Do not over-leverage your positions. What may have been tolerable leverage, on a percentage basis, five years ago is no longer prudent given the ability of the market to surge quickly and persistently in one direction.

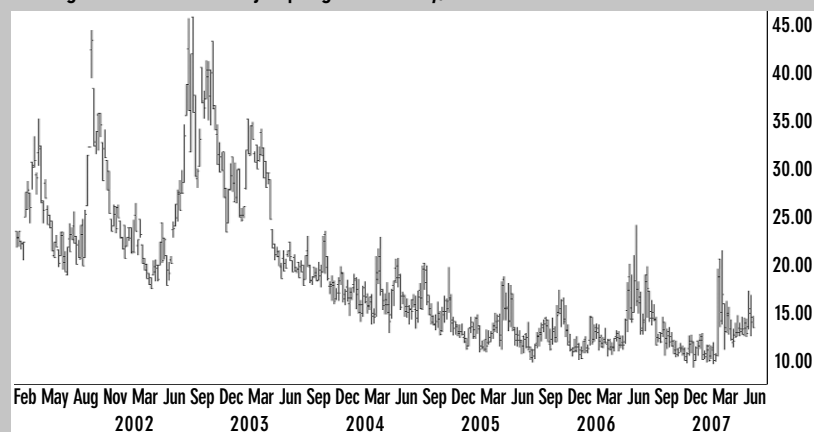
Risk appetite is based on an ability to withstand loss balanced by the perceived opportunity for market reward. Often, fear takes over once liquidity is deemed a premium. For example, Amaranth, which got caught on the wrong side of a liquidity crunch in energies, lost \$6 billion in two weeks last year.

Problems like these — often pushed to the headlines when large investors make an exodus from major funds — represents another version of the liquidity mirage.

One way to keep tabs on this risk appetite is to monitor volatility pricing in options. In the equity markets, the Chicago Board Options Exchange Volatility Index (VIX) is one measure of this. It's based on the standard deviation of daily percentage change in the S&P 500. When it begins to

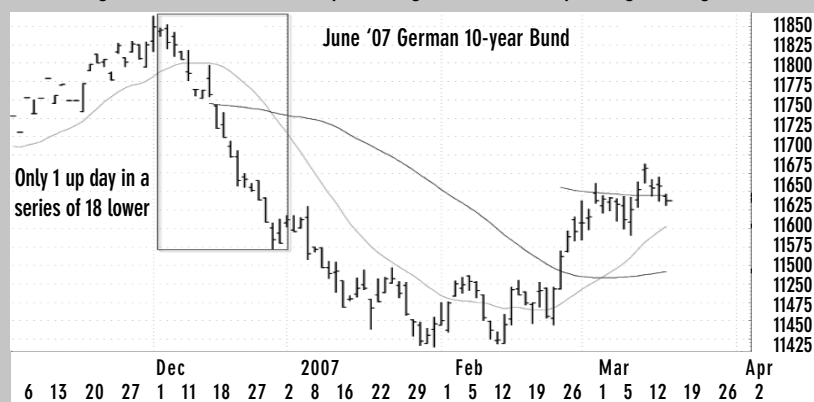
TRAPPED BY THE VIX

Although the Vix had had a jump higher recently, it is still off its historical norm.



CAUGHT IN A SURGE

This 18-day bear run in the bund consisted of all but one down day, making it difficult for traders to get in on the move without pressuring it even lower, squeezing the longs even more.



reverse what has been an ongoing four-year decline (from 35% or 40% to around 10%), pay attention to a possible market reversal (see “Trapped by the Vix,” left).

Another sign of a potential liquidity crunch is highlighted by the lessening diversification effect from spreading equity across asset classes. As investment products become more interdependent and correlated, risk can increase with additional positions, not decrease as modern portfolio theory suggests.

Consider that 50 years ago, equity mutual funds turned over their portfolios at an average rate of 17% per year. Today, the level of turnover has increased to 91%. Herein partially lies the explanation for the tendency of some moves to extend directionally for days on end. Not only does the lack of a pullback in the moves squeeze those on the wrong side of the market, but it's exacerbated by those getting in,

nervous that they'll miss out entirely if they don't pull the trigger immediately (see “Caught in a surge,” left).

Investors are clamoring for 9% to 10% returns. In today's markets, that means fund managers have to step outside indexing and passive investment and return to active trading. This creates a need for fund managers to adopt more risk to deliver what investors demand. This in turn encourages additional risk as the rewards are amplified by the need for a loyal investor base.

Finally, one last element of modern markets makes the liquidity mirage a greater risk — if not in terms of its potential but the lack of consequences if it comes to bear. While it can be said that today's electronic infrastructure creates a more complete audit trail in the physical sense, it also has bred an enormity of volume that allows individual transactions to become insignificant — and almost

invisible — by comparison. If or when a crack appears in the system, the trees of deception may well be fully obscured by the forest of anonymity.

This leaves the trader to watch his own back. Today, that means being able to get out on your own terms, or as close to them as a well-designed risk management approach can manage. Such measures of protection are even more critical for traders playing overseas markets, where trading times and regulatory overlap create a situation of even greater risk where perhaps the opposite appears the case on the surface. **FM**

Alex Benjamin specializes in Market Profile and is the author of MP101 and MP102 as used by the Chicago Board of Trade. Alex can be contacted via e-mail at Alex@tradingclinic.com or via his Web site www.tradingclinic.com.

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