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It can be a scary time when volatility rules the day

By Colin Read, Everybody's Business

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— (Editor's note: This is the first of two parts on the current volatility in the financial markets.)

Breath a sigh of relief that October is over. The month of dread since 1929 and 1987 registered the greatest monthly fall in the Dow Jones Industrial Average since 1931, and the second largest daily percentage rise in DJIA history.

It seems like each week is full of surprises. America has perhaps become hooked on drama of late, but I think we still long for the days when earth-shaking news occurs once a decade instead of once a week.

This week began with early news that the main Japan stock market Index, the Nikkei 225, has plunged to the lowest daily close in its history. And the Dow Jones Industrial Average hit a new low in this business cycle. Inflation adjusted, it is now equivalent to the DJIA 12 years ago, in October of 1996, and about half the inflation-adjusted peak of 14,892 in December 1999. Not surprisingly, the Consumer Confidence Index has dropped to the lowest level in its 41-year history.

The Press-Republican headline on Wednesday said it all: Dow Soars, Future Grim. This barrage of news has turned the usually rational and staid blue-chips average into a manic market. The DJIA has moved from steady and logical to highly emotionally charged. It jumps between manic extremes, from extreme pessimism, even when confronted with good news, to extreme optimism on days when the Consumer Confidence Index reaches an all-time low and housing prices record a record drop. What can explain this extreme volatility?

Some of the downside volatility arises from margin calls or forced liquidations. Those that borrowed heavily to invest have put only a fraction, or a margin, of the cash up front, in hopes of gaining increased leverage if the asset rises. They have tried the best they can to ride out these dramatic drops.

At some point though, investors are forced to sell because they no longer have sufficient stock value to collateralize their borrowing. Brokers demand they sell some of their portfolio within five business days, even at distressed prices, to meet federal and investment-house margin guidelines. This in turn causes further selling pressure about a week after the first drop.

This selling pressure can induce a secondary drop in the stock market, resulting in yet another margin-induced sale. In essence, investment based on borrowed money can induce waves of selling each week until the market can regain its feet.

A second source of volatility arises from the very democratization of financial markets that led to its run up. At one time, the market was ruled by large sophisticated investors and institutional investors. Over the past couple of decades, IRA accounts and discretionary wealth from the housing bubble allowed millions more individual investors to participate directly in the market place. These smaller players are not the market movers and shakers, but will jump on the bandwagon when they see a run up, and jump off when the market declines. This strategy amplifies volatility.

The bandwagon effect is even more apparent as the market is globalized. By creating a worldwide financial market, investors from emerging countries are becoming significant participants. Financial markets to some of these investors are little more than legalized gambling opportunities, fueled by emotion rather than rationality. It should come as no surprise that the internationalization of markets has increased volatility.

Has the market lost all touch with reality? Not really. While we talk about the market as a monolithic institution, the temperature of the market is determined by only a small fraction of stockholders. The Dow

Jones Industrial Average, for instance, measures only the trades of a relatively few buyers and sellers participating in a given day on the purchase of fewer than 1% of U.S. publicly traded companies. The vast majority of the market is on the sidelines at any given time because most investors are in no mood or do not have the capital to buy, or because they are unwilling to sell at the current lowball prices. The current price of stocks may not be at all indicative of their true intrinsic value. Rather, the market reflects the price determined by the tiny minority distressed or opportunistic enough to participate in a highly volatile environment. It is the action of these manic few that dictate today's value of our retirement nest eggs.
A future column will outline the role of hedge funds and market manipulators in increasing volatility.
Colin Read is Dean of the School of Business and Economics at SUNY Plattsburgh and has taught economics for 25 years. His current book, "Global Financial Meltdown: How We Can Avoid the Next Economic Crisis" is forthcoming by MacMillan Palgrave. He also writes a blog on North Country economic development issues at www.ncbizconect.com. Colin Read can be reached at economicinsights@gmail.com.

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