

Living on the Edge

I am standing on the edge of an abyss. I am staring out over it and the deep pit that separates what could be and what is. On one side stands a future that is orderly and the other, chaos. On one side stands David and one side Goliath.

Many, such as me, have lived on this edge for quite a long time. Sometimes falling and barely catching ourselves by the slimmest of edges, then clawing our way back. I am not on the edge of innovation nor Ekpyrosis (the death of the old order and the birth of the new).

I am on the edge that has provided for many others. These others have benefited a great deal, although immeasurably, from my being on the edge. However, these others are in for the shock of a lifetime as the past week has proven.

In this past week, the liquidity in the ten-years and the bonds all but disappeared. [2002]

The professional local is the key to deep liquid markets and the professional local barely exists anymore. If something is not done to alleviate this problem, the financial derivatives market will collapse and with it the US economy. The Mother of all devaluation's is just sitting there; waiting to rear it's ugly head. The slow death of the local trader at the Chicago Board of Trade is the first step towards the vanishing of liquidity. Take away the liquidity and the economy will collapse.

The local trader in the futures market provides a service. They are taking the opposite side of a trade in exchange for the edge. The local takes the other side of a customer order and is usually out of that trade in seconds. The local doesn't trade long-term; he is flat, in most cases by the closing bell. He or she accepts

the risk of blowing out everyday. They accept the physical punishment the trading pits dish out. They also accept trading out in the open, as in open-outcry. If he or she is attempting to do anything under-handed they will be reprimanded in any of several ways. Perhaps through the CFTC, the CBOT or at the hands of their pit-trading colleagues.

By definition, the local is a professional trader. They do not look for a certain percentage return on their money. They expect to make a living trading. The percentage game is left up to the customer trading for hedge funds, etc.

The current trading system in the CBOT is breaking down. Yet, most people just see the internal trading volume going up, with little attention being given to the liquidity. Why isn't the question being asked, "Who is providing that liquidity? Can they provide liquidity in a crisis, as they did in 1987?"

Liquidity is crucial and must remain for the long-term. The trading in the financials this prior week was just a glimpse into what lies ahead. The market volatility had nothing to do with active markets or news driven markets. The volatility was there because the professional local was not

In the 23-years that I have been on the financial floor and watched the financial markets, I have never seen this type of market. No one has. This is because the market has never been structured as it is now.

The oldest exchange in the United States calls a local by a different name, a specialist. On that exchange the local does have several different jobs, yet the theme of an orderly market is the same.

The Philadelphia Stock Exchange defines a specialist this way. "**Specialist:** A participant of the exchange who trades for their firm's or their own account and is responsible for maintaining a fair and orderly market in whatever issue has

been allocated to them by providing bid and ask markets. They are also responsible for orders entrusted to them for execution.”

Personally, I don't exactly agree with the set-up of the NYSE and the 443 specialists working for 7 firms, but that's not the point. The point is the role that they provide in liquidity and orderly markets.

As described by the New York Stock Exchange.

“[A] **Specialist's** responsibility: Specialists must maintain a fair, competitive, orderly and efficient market. This means that all customer orders have an equal opportunity to interact and receive the best price. It also means that once auction trading begins, a customer should be able to buy or sell a reasonable amount of stock close to the last sale. Therefore, a specialist works to avoid large or unreasonable price variations between consecutive sales. The results: almost 98% of all trades take place at 1/8th point or less from the last sale. The auction takes place at the specialist's post where the stocks are traded. This single location -- or point of sale -- combined with rules of trading, guarantees maximum order exposure, interaction and market liquidity.”

The CME writes. “**Locals:** Exchange members who trade for their own account and/or fill orders for customers and whose activities provide market liquidity.”

The CBOT's definition of a local is: Not available. We do not have a definition in our glossary. Kinda makes you think.

With that omission aside, the other exchanges I quoted from are saying the same thing. The local provides liquidity so the markets stay orderly. I contend that the bonds and 10-year notes on the financial floor of the CBOT are anything but orderly and the liquidity is now becoming questionable. The main ingredient is gone for the first time since 1848.

What does it cost the firms to have locals in the pits? Why do these firms want the locals and brokers out of the pits?

We know that they have screamed about the cost of doing business on the floor. What are the costs anyways? Are they ruining the likes of Morgan Stanley, Citi, UBS, etc? A peak at their annual reports says that isn't the case. Well, then what is the problem?

If I worked at one of the brokerage houses I'd be a bit worried. Everything has worked fine until now. Profits rose and business increased. This has not stopped them from trying to secure the order flow by any means. This has not stopped them from taking the business away from the independent traders.

If I worked at one of the brokerage houses I'd be sounding the fire alarm. I'd say, "We are all in severe trouble and I think we are the ones creating the problem."

Shall we take a peak into their balance sheets and see what is happening? Are the independent traders ruining their businesses? No, they are not. They are/where providing a very valuable service.

The concentration of derivatives among the big banks, according to the Office of the Comptroller of the Currency, reported that the total value of derivatives held by U.S. commercial banks rose \$5.3 trillion to \$61.4 trillion in the first quarter from the fourth quarter's \$56.1 trillion. The OCC noted that in the first quarter, the seven largest U.S. banks held 96% of outstanding derivatives contracts by volume.

That's in this country.

The global over-the-counter (OTC) derivatives market has grown to nearly \$142 trillion according to the Bank for International Settlements.

Now what is the cost of hedging in a deep-liquid market? Or, for that matter, the cost of just outright trading. I'll site the Mann Study.

"Sources of Market Making Profits: Man Does Not Live by Spread Alone". By, Steven Manaster, Virginia Tech and Steven C. Mann, Texas Christian University February 1999.

"Using directly observed trade direction we find that customers' total trading costs were only \$100 million: \$38 million in execution costs and \$62 million in timing losses.

Market Makers are the Informed Traders.

Contrary to most theoretical predictions, we find that market makers profit both from timing and execution. This finding is consistent and conclusive across all pits in our sample and for nearly every individual trader. For the first six months of 1992 our data show that Chicago Mercantile Exchange market makers' trading revenues totaled \$130 million. Of the total revenue, only \$45 million (34 percent) was due to execution profits. These execution profits occurred within one minute of trade execution. The remaining \$85 million was due to favorable timing. From this evidence we conclude that market makers have better information regarding short-term price movements than other market participants.

These [two] empirical observations demonstrate that futures market floor traders can have both an execution advantage and a timing advantage relative to other market participants. The data show that they are willing to reduce, or eliminate, the execution advantage to exploit the information advantage."

[End paper.]

Ya'll better read that paper closely. It is stating that the FLOOR local is better informed. They can and do make money, while providing the MUCH NEEDED LIQUIDITY. That's why the locals kept coming to the markets in the 80's and 90's.

This thing we call the Futures Market is really a delicate eco-system that needs every part of the system to work. Take away one aspect and it all falls apart.

It is impossible to create a whole new local market by inducting new blood, tossing them in front of a screen, placing a few commodity books in their hands and holding weekly strategy meetings and then call them locals. They are not locals, they are day traders, and day trading does not work.

The new breed of video trader will not be there when the market is trying to absorb a bank or a brokerage house's orders when they are trying to hedge TRILLIONS of dollars in derivatives. Sure they'll be there when the markets are rotating. But where were they last week when everyone suddenly figured out that the Fed had to sell 120 billion in notes and bonds over the next two quarters? They ran for the hills and customers could not get orders filled. Ask Harold Lavender what happened on the close (Thursday) with a spread order in the Ten-Years. This is just the beginning, *if* something isn't done.

The powers that be, of which I am not one, had best wake up to a coming disaster. That disaster can be averted if they act now by reinstating the local trader on the floor of the financial room. If they don't, there will be no liquidity to help the 142 trillion dollar derivative market when they need to hedge. And they will need to hedge, in a big way.

My question to you is, how are they going to do that? Please do not hand me the BUND argument. "There's plenty of liquidity in the BUND, it works fine!" The bonds and notes that our government sells are not the German bund; they

are US bonds and notes. I've got news for you anyways the Germans have serious problems.

Please do not give me the S&P argument. "The S&P mini's are doing fine!" S&P's are not bonds and notes. The banks will not be able to hedge in that market when it is hitting the fan, so to speak.

Think back to 1987 and read the countless number of reports out there that state how our market saved the NYSE from a catastrophic melt down. This is just one example.

Bite the bullet now before we are in too deep to turn around. Take the bonds and the notes off of the screen and replace them with a mini contract. This is a start.

There are many more things that can be done. I will not list them here because most of them have already been listed on the Member Net board.

Why is it that everyone always waits for the crisis to come when there are so many signs telling you to act preventatively? Take advantage of the greatest resource since the invention of the printing press, start reading for yourself, and stop the crisis before it happens. At least stop it from being catastrophic.

Lastly, I did not write this paper to get into debates over details. This paper was written to alert you of a problem. A problem that can be fixed. I do not wish to engage in debates over non-relevant issues that simply deter from the coming crisis. Said in a nutshell, after reading all that I have read over the last 2 years, nothing can convince me that the crisis isn't coming so don't waste your time. Instead, read. Act.

References

"Sources of Market Making Profits: Man Does Not Live by Spread Alone".

Steven Manaster, Virginia Tech and Steven C. Mann, Texas Christian University, February 1999. (Reprinted with permission)

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