

Dr. Ed's Morning Briefing

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MAJOR TOPICS: High Frequency Trading (HFT)

BULLET POINTS: (1) Does HFT increase or decrease volatility? (2) Too many markets reduce liquidity and transparency. (3) Pinging, flickering, and stuffing. (4) The CFTC raises, but does not resolve colocation question. (5) Blue Monday was record day for HFTs. (6) Low Frequency Traders turned off. Can't be good for P/Es. (7) US production coming out of soft patch. (8) Not giving up on overweight rated Industrials.

BLOG: Our latest post on blog.yardeni.com focuses on industrial production.

NOTICE: Our Morning Briefings are now available on FactSet.

I) HIGH FREQUENCY TRADING: "Raise your hand if you believe that High Frequency Trading (HFT) contributed significantly to the insane volatility of the market over the past two weeks." I see lots of hands up in the air when I ask our accounts to do so. "Now raise your hand if you disagree." There are much fewer raised hands. Okay, I confess that this isn't a scientific poll and is mostly based on recent phone conversations. Of course, no one knows for sure. However, given that only a tiny group of traders are making a very comfortable living in the HFT trade, why not put them out of business and see if there is less volatility in the market?

Their pitch is that they perform a very important function, providing more liquidity to the market. I seriously doubt that. In recent years, the proliferation of alternative exchanges for buying and selling stocks has diminished liquidity at each one of them. Some are even called "Dark Pools," confirming that this trend is contributing to less transparent markets. Increased competition has narrowed spreads, and there is less volume on both sides of transactions. So volatility has increased significantly. The HFT algorithms are designed to profit from this illiquidity and volatility.

A recent report by Brattle Group on HFT (link below) noted: "In most HFT strategies, quotes only last for a few micro- or milliseconds at a maximum, and therefore are not actionable by the majority of market participants. There is also evidence that some HFT systems deliberately cancel many of their orders almost immediately after placing them, as they do not intend for the trades to carry through. The false orders are used instead as part of a 'pinging' tactic to discover the price other traders are willing to pay. These practices, known as 'flickering quotes' or 'quote stuffing,' have been claimed to generate an overload of data to market centers, potentially increasing systemic risk."

In March 2010, the Commodity Futures Trading Commission (CFTC) launched a study of high-frequency trading in futures markets, as well as of "colocation," the increasingly popular practice of allowing traders to place trading systems next to exchanges' trade-matching computers. Gary Gensler, the chairman of the CFTC, said that his agency was

looking at colocation facilities offered by exchanges and other specialist companies “to best promote open access [to them]” and where such facilities are offered “that there be open and fair access to them.” This is a critically important issue since some observers have charged that HFT amounts to trading on inside information.

The question is whether HFT serves a useful purpose by increasing liquidity among the dispersed markets. Or do they compound the volatility of these markets? Again, no one knows for sure. I’m in favor of regulating the number of exchanges, increasing their transparency, and bringing back more humans into the trading equation. The stock market seemed to function better when specialists were the market makers, not computers. I recognize that this is old-fashioned analog thinking, and out of step with today’s digital revolution. However, isn’t that how we got into the current financial mess? Wall Street sold lots of defective derivative products based on computer models that converted liars’ loans into AAA-rated securities. Let’s also bring back the Uptick Rule while we are at it. It was eliminated by the SEC on July 6, 2007, just in time for speculators to launch numerous bear raids that nearly destroyed the financial system.

I have one more confession: I cribbed most of the above from my *Morning Briefing* dated July 20, 2010. So what’s new since then? Not much really. Let’s review:

(1) HFT traders had a record pay day on Blue Monday. The HFT crowd made lots of money over the past two weeks. Apparently, they do much better when there is volatility than when there isn’t. Doesn’t that contradict the notion that they provide lots of stabilizing liquidity? They don’t seem to do that when we need it most! According to yesterday’s *WSJ*, they roughly tripled their stock trades this month, based on estimates by Tabb Group, a market research firm in New York. Their share of overall US stock trading volume rose to about 65%, up from roughly 53% during the months before the August chaos. On Monday, August 8, when the DJIA plunged 635 points, NYSE composite volume rose to its fourth biggest trading day on record. Also making a record that same day was HFT profits, which Tabb estimated to be \$60 million in US stock markets alone. Not bad for one day’s work on a really bad day for the rest of us.

(2) The CFTC study on HFT colocation is MIA. That’s the one presumably started last March. Have you seen it? I’m still searching for it. There was a paper (link below) authored by four researchers at the CFTC titled, “Flash Crash: The Impact of High Frequency Trading on an Electronic Market,” dated October 1, 2010. However, it focuses just on the Flash Crash of May 6, 2009 and doesn’t take a position on the colocation issue raised by Mr. Gensler last March. The conclusion of the study certainly doesn’t endorse HFT: As a result, whether under normal market conditions or during periods of high volatility, High Frequency Traders are not willing to accumulate large positions or absorb large losses. Moreover, their contribution to higher trading volumes may be mistaken for liquidity by Fundamental Traders. Finally, when rebalancing their positions, High Frequency Traders may compete for liquidity and amplify price volatility.”

(3) The SEC is on the case, maybe. Yesterday’s *WSJ* reported that the SEC in recent weeks subpoenaed a number of HFT firms to gain information about their roles in market swings including the “flash crash” of May 2010. An SEC spokesman had no comment on this investigation. My question is: If the agency is only starting to collect this information

now, on what basis did the CFTC-SEC Advisory Committee on Emerging Regulatory Issues issue its “Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010”? This committee was set up on May 11, 2010 in response to the Flash Crash, and its recommendations (linked below) were released on February 18, 2011 based on staff studies released on May 18, 2010 and September 30, 2010 (linked below). The colocation issue was not mentioned.

II) STRATEGY: The issue for Low Frequency Traders (LFTs) is whether the HFTs have contributed to the greater volatility of the stock market, which has clearly turned off lots of individual LFTs. Above I argued that HFTs aren’t innocent bystanders. Nor are they Good Samaritans, providing much needed liquidity when markets are especially volatile. On the contrary, they probably worsen volatility during especially volatile days such as Blue Monday (August 8, 2011) and Flash Crash Thursday (May 6, 2010).

Such extreme volatility must be contributing to the decline in the market’s P/E. Over the long run, valuation multiples are more likely to rise if stocks are generating capital gains without a great deal of volatility. That happened during the 1990s. Over the past decade, there have been no capital gains, on average, in the stock market, and there has been greater volatility. In addition, individual stocks seem to have less alpha and more beta in their returns. This explains why valuation multiples have both declined and converged across different sectors, industries, and styles.

* **Fundamental Stock Market Indicator (weekly):** Is the S&P 500 still closely tracking our Fundamental Stock Market Indicator (FSMI)? It was until the recent selloff in the market. Our FSMI is the average of the Weekly Consumer Comfort Index (WCCI) and our Boom-Bust Barometer (BBB). The FSMI slipped 0.3% during the first week of August after climbing three of the prior four weeks by 1.5%. It is currently 9.0% below its cyclical high posted during the final week of February. The BBB rose for the fourth time in five months, up 0.6% w/w and 4.3% over the five-week span. It’s 7.9% below its record high posted during the week ending March 12. Jobless claims fell for the sixth straight week from 427,750 to 405,000, based on 4-wa, with weekly claims dropping to 395,000. The CRB raw industrials spot price index is at its lows for the year. The WCCI sank to its lowest level since mid-May and is less than 5 points from its record low in November 2008.

* **S&P 500 Cyclical vs. Defensive Sectors (weekly):** How are the S&P 500’s Cyclical and Stable sectors performing so far in 2011? Cyclical and Stable sectors are both up from their lows on August 8, but Cyclical are still negative ytd. Cyclical is now down 7.0% ytd, trails the Stable sectors (+1.1% ytd) by 8.1 percentage points, and lags the S&P 500 (-5.1%) by 1.8 points. Cyclical market cap is down 15.8 percentage points from its 2011 peak of 8.8% ytd on April 29, while Stable is down 10.3 percentage points from its peak ytd gain of 11.4% on May 19. Cyclical had outperformed Stables from the beginning of the year until April 29, but both diverged sharply from April 29 to May 24 before trading together during much of June. From June 24 to July 22, Cyclical sectors rose 7.9%, nearly three times the 2.7% gain for Stable sectors. Both fell sharply during the market’s meltdown, but Stable sectors fell less than Cyclical sectors. Since the S&P 500 bottomed on August 8, Cyclical sectors have risen 6.9%, 1.2 percentage points better than the 5.7% rise for the Stable sectors.

* **S&P 500 Technicals (weekly):** How’s the technical picture looking for the S&P 500 and its 10 sectors? The S&P 500 is trading below both its 50-dma and 200-dma, and both its 50-dma and 200-dma are falling too. The S&P 500 is down 12.5% from a three-year

high on April 29 and is now down 5.2% ytd, but that's up from this year's low of -11.0% ytd on Monday, August 8. The S&P 500 is trading 6.8% below its 50-dma, and 7.4% below its 200-dma, compared to -9.3% and -9.1% a week ago. The S&P 500's 50-dma has been falling or flat since June 3, and its 200-dma has been falling since Monday, August 8, for the first time since October. The S&P 500's 50-dma is now 0.7% below its 200-dma, putting the index into a bearish Death Cross pattern. Here's how much the 50-dma trades below the 200-dma for the 10 sectors: Tech (-0.4%), Utilities (-0.4), Consumer Staples (-0.7), Consumer Discretionary (-0.8), Telecom (-0.9), Materials (-0.9), Financials (-1.1), Health Care (-1.1), Energy (-1.2), and Industrials (-1.3). All 10 sectors are trading below their 50-dmas and all except Utilities are trading below their 200-dmas. All 10 sectors also have a falling 50-dma, but three sectors still have a rising 200-dma: Consumer Staples, Energy, and Utilities. Five sectors are in a Death Cross: Financials, Industrials, Materials, Tech, and Telecom.

* **Stock Market Sentiment Indicators:** Investors Intelligence Bull/Bear Ratio slipped to 1.95 this week after climbing from 1.87 to 2.00 last week. Bullish sentiment fell from 47.3% to 46.2%, while bearish sentiment was unchanged at 23.7%. The percentage of advisors predicting a correction edged up to 30.1% from 29.0% the prior three weeks. The AAI Bull Ratio rose to 42.7% during the week ending August 10 after falling four straight weeks from 62.9% to 35.3%. Bullish sentiment climbed to 33.4% after falling from 41.7% to 27.2% over the prior four-week span, while bearish sentiment dropped to 44.8% after rising from 24.7% to 49.9% the previous four weeks. In the futures pits, large speculators have turned very bearish on the S&P 500 and slightly bearish on the Nasdaq. S&P 500 Put-Call Ratio slipped to 1.95, based on 4-wa, after increasing from 1.72 to 2.04 over the previous two-week period, based on 4-wa. VIX charts show markets more volatile.

III) GLOBAL PRODUCTION: Are we starting to come out of the soft patch just as investors are discounting a double dip recession? Debbie and I think so. The latest evidence is in July's industrial production report for the US. Let's review (see blog):

(1) Industrial production rose 0.9% in July, while manufacturing production increased 0.6%. There was a 2.8% surge in the output of utilities, as extremely hot weather increased demand for electricity. Manufacturing is at a new cyclical high and at its best level since October 2008.

(2) Industrial production was disrupted in the US by a shortage of parts made in Japan following the devastating earthquake and tsunami over there in March. It fell 0.3% during April, followed by increases of 0.2% in May and 0.4% in June. (Both May and June's increases were double the preliminary estimates.)

(3) Auto assemblies were hard hit by the shortage of parts. They fell from 8.8 million units (saar) during March to 7.9 million units during April, remaining at that level through June. They jumped 10.6% during July to 8.7 million units. They are likely to make new highs for 2011 over the rest of the year.

(4) Excluding auto assemblies, manufacturing output rose only 0.3% during July. The problem seems to be that the IT industry still had some parts shortages in July. The total output of selected high-tech industries was little changed in July. Computer hardware

production did rebound 1.1% in July to a record high. However, communication equipment output declined 0.4%, and semiconductor output fell 0.5%.

* **Global Industrial Production:** How goes global manufacturing? It is still robust, but the growth rate slowed from March-May as a result of parts shortages. Asian production indexes are at or near cyclical highs in the countries we track. The exceptions: Japan and Taiwan, though Japanese production has rebounded 12.0% the past three months through June since plummeting 15.5% in March. Taiwan production has slumped 11.0% the past four months through June. In Latin America, Mexican factory output is little changed at record high, while Brazilian production continues to move sideways near its cyclical high. In Europe, German and French production stalling recently. Italian output has flattened out in recent months. Recovery in UK factories has weakened. In North America, US production remains solid, recovering from its auto-related setback. Canadian production is moving sideways around recent highs. In Eastern Europe, Polish and Russian output remain on steep uptrends near cyclical highs.

* **US Industrial Production:** Is the Japanese auto parts shortage still depressing US manufacturing? No. A rebound in auto production during July accounted for the largest increase in industrial production this year. Total output jumped 0.9%, following revised gains of 0.4% and 0.2% the prior two months which were double preliminary estimates. July factory output climbed 0.6%, triple the 0.2% gains in each of the prior two months. Auto production rebounded 5.2%, following a three-month slide of 7.8%. Excluding autos, factory output rose 0.3%, following increases of 0.2% and 0.3% in June and May. Total output rose 3.1% (saar) in the 3 months ending July, based on 3-ma, triple June's gain. Factory output increased 1.8% (saar) over the same 3-month period, up from under 1.0% in June. Nonauto output was up 2.7% vs. 2.1% in June. High-tech output advanced 2.6% (saar) over the 3-month period, with low-tech up 2.1%, both improving some after recent slowing. For the month of July, business equipment production rose 0.6%, while June's 0.7% loss was revised to a 0.2% gain. Transit and high-tech output each rose 1.0% for the month, while industrial output slipped 0.4% after a three-month gain. Consumer goods production jumped 1.1%, led by durable goods production.

* **Capacity Utilization:** How much excess capacity is there in US manufacturing? Still plenty to contain inflation. The capacity utilization rate for total industry rose from 76.9% in June to 77.5% in July, the highest since August 2008. It had hovered in a flat trend just south of 77.0% since the end of last year. The rate was 10.2pps above June 2009 low of 67.3%, but still 2.0pps below the 79.5% average over the past 20 years. The capacity utilization rate for manufacturing climbed to 75.0% from 74.6% the prior two months. It was the highest rate since July 2008 but 2.9pps points below its 20-year average of 77.9%.

IV) FOCUS ON INDUSTRIALS (overweight): The stock price index for the overweight rated Industrials sector is down 8.6% ytd for the third worst performance of the 10 S&P 500 sectors, down from a 7.8% gain in 2010. The sector's forward earnings is still down 3.3% from its record high in August 2008, but increased 3.2% m/m in July, and has risen for 23 straight months. Analysts expect annual earnings growth of 20.3% in 2011 and 18.4% in 2012 after rising 24.4% in 2010. Forward P/E of 13.6 is fourth highest in the S&P 500 and trades at a relatively high 11% premium to the market. NERI down to 15.6% in July from 16.1%, but positive for 23 straight months. The profit margin rose to a nine-quarter high of 7.8% in Q1 from 7.7%, and is up from a six-year low of 6.4% in Q4-2009. The profit margin has been below the S&P 500 since Q3-2009, but this is typical for the sector during profit recoveries.

* **Aerospace & Defense** (overweight): The stock price index for overweight rated Aerospace & Defense is down 6.7% ytd, after rising 12.4% in 2010, and is down 18.0% from a cyclical high in early July. Orders are starting to rise again, but analysts expect annual earnings growth of only 8.5% in 2011 and 15.3% in 2012, after rising 14.1% in 2010. Forward earnings up 1.4% m/m in July and up in 18 of the past 19 months. Forward earnings at a record high for the first time since September 2008, but hasn't been in the V-shaped recovery experienced by other industries in the Industrials sector. The industry's forward P/E edged up to 12.7 in July from 12.6, but is down from a 23-month high of 14.1 in April 2010. NERI up to 13.3% from 11.6% in June, and positive for seven straight months. NERI had been positive for a record high 63 straight months through October 2008. Profit margin steady at a nine-quarter high of 6.6% in Q1, and should continue to edge higher due to the huge order backlog.

* **Construction & Farm Machinery & Heavy Trucks** (overweight): Overweight rated Construction & Farm Machinery & Heavy Trucks is down 10.2% ytd after soaring 69.1% in 2010, and is down 21.6% from a record high in April. Forward earnings in a V-shaped recovery, and rose 2.3% m/m in July to a record high. Annual earnings growth expected to be 57.3% in 2011 and 24.7% in 2012 following an 86.6% surge in 2010. The forward P/E was at 12.9 in July and up to a 4% premium to the market from a 29-month low of a slight discount in June. NERI up to 32.0% in July and has been positive for 23 straight months. The profit margin was up again in Q1 to an 11-quarter high of 7.4% from 7.1%, and should rise further as food commodities prices remain high and industry shipments rebound. The y/y change in pricing edged higher in June. Shipments are still rising and are up in 18 of the past 21 months.

* **Electrical Components & Equipment** (overweight): The stock price index for overweight rated Electrical Components & Equipment is down 14.9% ytd after rising 35.0% in 2010, has fallen 21.6% from its record high in February, and trades 16% below its falling 200-dma. Forward earnings has risen in 18 of the 19 months, and was up 1.3% m/m in July to its first record high since August 2008. Analysts expect annual earnings growth of 26.2% in 2011 and 17.9% in 2012 after rising 25.5% in 2010. Forward P/E at 15.4 in July and up to a 24% premium to the market from a 21-month low of 21% in May. NERI down to 9.1% in July from 13.8%, but positive for 21 straight months. The profit margin was steady at a record high of 11.0% in Q1. The 12-month sum of electrical equipment orders is up since April 2010, and correlated well with the industry's forward earnings cycle in the past.

* **Industrial Conglomerates** (market weight): The price index for market weight rated Industrial Conglomerates is down 8.4% ytd after rising 15.6% in 2010, and is now 20.4% below its cyclical high and 65.0% below the record high in late 2000. The industry's forward earnings is up in 19 of the past 21 months, but fell 0.8% m/m in July and remains 32.0% below the record high in early 2008. Analysts expect annual earnings growth to improve to 16.6% in 2011 and 19.4% in 2012 from 12.1% in 2010, but reduced their annual forecasts in July. Forward P/E up to 12.9 in July from 12.6, but its premium to the market edged down to a 24-month low of 3%. The profit margin was up to a 10-quarter high of 9.4% in Q1 from 8.8%, and is likely to improve along with orders for aircraft engines and power generation equipment. The industry accounted for 24% of the sector's market cap and 25% of forward earnings in July, down from 33% in April 2008.

* **Industrial Machinery** (overweight): The stock price index for overweight rated Industrial Machinery is down 14.5% ytd after rising 33.5% in 2010, and is now 23.3% below its record high. Forward earnings is in a V-shaped recovery, and up for 23 straight months in July to a record high. Analysts expect annual earnings growth of 35.6% in

2011 and 18.8% in 2012 following a gain of 44.9% in 2010. Forward P/E down to 12.8 in July and down to a still relatively high 3% premium to the market as investors likely expect forward earnings to rise even further. NERI down to 22.3% in July from 26.9%, but has been positive for 23 straight months. Profit margin up to an 11-quarter high of 9.1% in Q1, and back near the record high of 9.3% recorded in 2007. Machinery orders has improved in 21 of the past 26 months, and is less than 0.1% below the record high in July 2008. Machinery orders has been positive y/y since April 2010, and has coincided well with the industry's forward earnings forecasts and the profit margin in the past.

V) UPDATES & LINKS: We have updated *Stock Market Sentiment Indicators*, *Global Industrial Production*, *Analyst's Handbook: Industrials*, and *Valuation* on our website. Questions, comments, downloading problems: yardeni_requests@yardeni.com or call 480-664-1333.

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[Brattle Group Report on HFT \(Issue No. 2, 2011\)](#)

["Flash Crash: The Impact of High Frequency Trading on an Electronic Market,"](#)

[\(October 1, 2010\)](#)

[CFTC-SEC Summary Report \(February 18, 2011\)](#)

["Preliminary Findings Regarding the Market Events of May 6, 2010," \(May 18, 2010\)](#)

["Findings Regarding The Market Events of May 6, 2010," \(September 30, 2010\)](#)

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