

Market Update 4-14-14 and Is Wall Street Rigged!?

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Thomas Cymer CFP® CRPC® Presents:

# WEEKLY ECONOMIC UPDATE

April 14, 2014

**WEEKLY QUOTE**

"The world is full of people whose notion of a satisfactory future is, in fact, a return to the idealized past."  
- Robertson Davies

**WEEKLY TIP**

If you're wondering about going Roth with your IRA, talk with a financial professional to determine whether or not the move makes sense. If you are a younger IRA owner who anticipates retiring to a higher tax bracket, it might.

**WEEKLY RIDDLE**

I can certainly run, but I will never be able to walk by myself. Wherever I go, thoughts are close behind me. What am I?

**Last week's riddle:**

It can only be broken with force, yet it can be dulled by contact with a piece of paper. What is it?

**Last week's answer:**

A pencil.

**HOUSEHOLD SENTIMENT REACHES 9-MONTH PEAK**

The University of Michigan's index of consumer sentiment rose 2.6 points in its preliminary April reading, bouncing back from a 4-month low of 80.0 at the end of March to a high unseen since last July. From 2003-07, the index averaged a reading of 89.0; during the 2007-09 recession, its average mark was just 64.2.<sup>1</sup>

**PRODUCER PRICES ROSE 0.5% IN MARCH**

You have to go back to last June (when wholesale inflation spiked 0.8%) to find such a sizable monthly advance in the Producer Price Index. The PPI had retreated 0.1% in February. A 1.1% monthly increase in wholesale food costs was a big factor. Annualized wholesale inflation rose to 1.4% in March, up from 0.9% for February.<sup>1,2</sup>

**OIL, GAS, GOLD LOG NOTABLE GAINS**

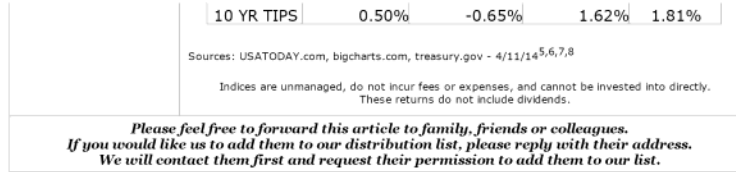
NYMEX crude was worth \$103.74 per barrel at Friday's close thanks to a 2.6% advance during the week. On April 10, AAA's weekly survey found a gallon of unleaded averaging \$3.62 nationally, which was an 8-month peak. An ounce of gold was worth \$1,319.00 as the COMEX trading week ended, with futures up 1.2% in five days; an ounce of palladium was worth \$806.80, a high unseen since 2011.<sup>1,3</sup>

**NASDAQ SETTLES BELOW 4,000**

A 3.10% plunge across five trading days took the Nasdaq Composite to a Friday close of 3,999.73. The Dow and S&P 500 also went red on the week - the blue chips retreated 2.35% to 16,026.75 and the S&P fell 2.64% to 1,815.69.<sup>4,5</sup>

**THIS WEEK:** Earnings from Citigroup, Capital One, Piper Jaffray, Overstock.com and American Airlines arrive Monday, complementing data on March retail sales and February business inventories. Yahoo!, Coca-Cola, Intel and Charles Schwab report quarterly results Tuesday, which is also when the March CPI and the April NAHB housing market index appear. Wednesday offers a new Beige Book and a report on March industrial output from the Federal Reserve, Census Bureau data on March housing starts and building permits, and earnings from IBM, Google, SanDisk, US Bancorp, American Express, Bank of America, First Republic Bank, PNC and Kinder Morgan. Thursday, earnings from Philip Morris, BlackRock, AutoNation, Mattel, Fifth Third, Chipotle, Morgan Stanley, General Electric, Honeywell, BB&T, UnitedHealth, Sherwin Williams, Union Pacific and PepsiCo appear along with new initial claims numbers; the bond market will close early. March 18 is Good Friday: U.S. financial markets will be closed, and no economic data or major earnings news will be released.

% CHANGE	Y-T-D	1-YR CHG	5-YR AVG	10-YR AVG
DJIA	-3.32	+7.81	+19.65	+5.24
NASDAQ	-4.23	+21.20	+28.41	+9.36
S&P 500	-1.77	+13.95	+22.39	+5.85
<b>REAL YIELD</b>	4/11 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO



### Flash Boys Takes Aim at Wall Street

*A new best-seller makes two provocative assertions. But how true are they?*

Provided by Thomas Cymer CFP® CRPC®

**Is Wall Street out of control?** Main Street and Wall Street are abuzz over *Flash Boys: A Wall Street Revolt*, the new book from Berkeley-based journalist Michael Lewis (author of *Moneyball* and *The Blind Side*, London School of Economics graduate and former bond salesman).

*Flash Boys* makes a couple of bold conclusions, which the media have had a field day with. One, Wall Street is rigged. Two, the little guy can't win. To put it less sensationally: high-speed traders have a marked advantage on Wall Street, one that the little day trader (and even the astute money manager) can't equal.

**Can the individual investor still win?** If you define "winning" in terms of day trading, maybe not; if you're in the market for the long run, it is still quite possible to grow wealth through equity investing. Millions of Americans have, and in all probability millions more will. To seasoned investors, much of what *Flash Boys* has to say is hardly revelatory. While the financially semi-literate are hailing the book as a confirmation of all they suspected, the fact is that high-speed trading may have some benefits for investors (which even Lewis concedes).

**In the last several years, a new Wall Street has emerged.** *Flash Boys* focuses on Brad Katsuyama, who in 2007 was the head of stock trading for the Royal Bank of Canada. In buying and selling shares on various exchanges, Katsuyama began to wonder if he was being left in the dust (and even being manipulated) by cutting-edge high-frequency trading programs. Eighteen months later, he concluded this was true. He campaigned to educate fellow traders and investment managers, asserting that the big American exchanges (NASDAQ, NYSE, BATS, etc.) were set up to benefit a handful of insiders (high-frequency traders, banks and brokerages) at the expense of fund managers and individual investors.<sup>1</sup>

In response, Katsuyama spearheaded the creation of the IEX exchange, which opened in late 2013 and disallowed HFTs their usual speed advantage. The IEX stands as the new model of a Wall Street exchange; the NYSE has been trying to buy it, as pressure has increased for banks and brokerages

to conduct more trading there.<sup>1,2</sup>

To the general public, "Wall Street" equals the floor of the NYSE and pictures of Peter Tuchman. (He's the oft-photographed floor trader who has become sort of an unofficial Wall Street mascot; Google his name and you'll recognize him.) But as Lewis points out, the beating heart of the stock market is now in northern New Jersey, home to the massive NYSE Euronext data center and other key exchanges. These titans west of the Hudson sell access to their premises to HFTs, and even in this fiber optic era, physical proximity matters. The speediest computers with the fastest connections that are physically closest to the actual exchange computer get price changes an instant before the others and may trade with a competitive advantage.<sup>1,3</sup>

How does it work? An HFT (a proprietary software program) detects another trader about to buy shares at a specific price, and reacts by purchasing those shares a fraction of a second sooner. Milliseconds later, it sells the shares back to the trader that first wanted to buy them at a higher price, for a transaction fee. This amounts to front-running, and unsurprisingly the Securities and Exchange Commission, the Commodity Futures Trading Commission and the FBI are investigating the whole process.<sup>4</sup>

As Lewis notes, HFTs essentially exact a tax on individual investors via all this trading and dumping - probably a penny or less per trade, but still a kind of penalty. The macro problem, he finds, is an erosion of trust in the markets resulting from the ascension of HFT and the flash crashes, interruptions and share price fluctuations that can accompany it.<sup>1,4</sup>

**High-frequency trading may have an upside.** It is not going away, and some market analysts feel it creates more liquidity and cuts trading costs. Some empirical studies have stated that HFT makes trading cheaper and more efficient. One study (*Does Algorithmic Trading Improve Liquidity?* by Terrence Hendershott, Charles Jones, and Albert Menkveld) shows that such trading reduces bid-ask spreads by about 50%. Another (*High Frequency Trading and End-of-Day Price Dislocation* by Douglas Cumming, Feng Zhan, and Michael Aitken) concludes that HFT has reduced distortion in settlement prices across stock exchanges worldwide.<sup>5</sup>

**In this new stock market, you can still enjoy old-school success.** After reading *Flash Boys*, you might think that day trading is a fool's errand. Maybe it is: it is so easy to buy high and sell low, and you are up against algobots that are swift and unemotional. They will be first in line for that hot IPO, and they will be on top of market movers faster than you will.

On the other hand, if you want to build wealth, save for retirement, and take advantage of equity investing and compounding, the stock market still provides you with the long-range potential to do just that. That potential is not going away, and you should take advantage of it.

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