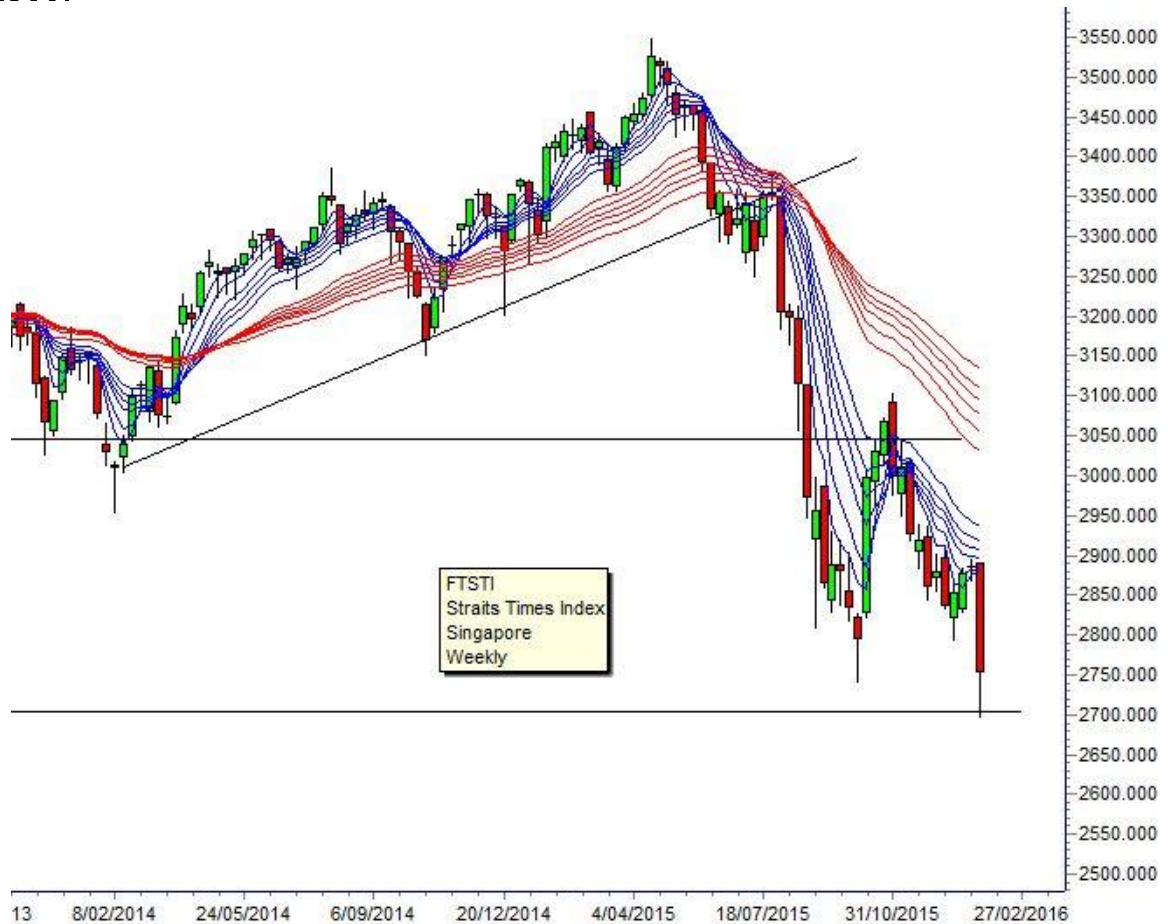
2016 NOT OFF TO A GOOD START

How bad is this? Very very bad. The change is technical conditions on many charts has been dramatically sudden with the very rapid development of bearish chart patterns. This has been the roughest start to a trading year that I have experienced in 25 years of trading. We include analysis of the DOW, S&P and Shanghai. We also look at oil and Gold. For readers with investment in Australia we also include the Australian XJO index.

Support at 2700 has been tested in the Straits Times Index. There is no end of downtrend pattern developing. A fall below 2700 has an initial support target near 2500.



The long term GMMA is well separated showing continued strong selling in this market. This is a severe downtrend where traders will short any rallies.

CHINA TRIGGERS

It's claimed that weakness in the China economy and the dramatic China market falls this week are the trigger for this crisis. We think the proximate cause may be different.

The market plunged 9% in around 30 minutes of hectic trading. The damage was estimated in the trillions as regulators raced to contain the damage. Later the

plunge was repeated with a market collapse of 6.5% with the market dropping 1,100 points in around five minutes. Trading was halted multiple times. These circuit breakers were praised for preventing a full on market crash of epic proportions with some blue chip stocks falling as low as a few cents.

Just goes to show that this is an untrustworthy poorly developed market that has to be managed externally by imposing trading halts.

Just one problem. The 9% plunge comes from the May 6, 2010 Flash Crash on the New York Stock Exchange. The second 6.5% fall is the August 24, 2015 flash crash on the same market. Rather than signalling the end of the financial world as we know it, markets simply shrugged their collective shoulders and moved on. But analysts seem to apply a different yardstick to the China market and use this week's Shanghai flash crash to highlight what they see as Chinas economic disaster.

This is more than easily dismissed double standard analysis. Closer examination suggests some alternative explanations. Let's go back to the US flash crashes. The 2010 crash was widely attributed to the activity of Exchange Traded Funds. The 2015 crash was attributed to High Frequency Trading as sell algorithms cascaded in a falling market. The true reasons are certainly more complex, but it's the nature of these suspects which is interesting because they highlight the connection between the derivative markets and the underlying market.

One of the key connections is the rapid placement and withdrawal of trading orders that lies at the core of high frequency trading. These are placed in the futures and associated markets. In its investigation the Commodity and Futures Trading Commission (CFTC) concluded that this activity was at least significantly responsible for order imbalances in the derivatives market which affected the stock market.

The key feature is that these types of extreme and rapid market collapses are most often associated with markets dominated by derivative trading. These crashes are caused by institutional trading from Exchange Traded Funds and High Frequency Trading. They are not caused by mums and dads trading because mums and dads simply do not act in such a coordinated fashion in such a short time frame. Mums and dads do not have the leverage to shift markets in this way over a 30 minutes or one hour time frame. That power lies in the hands of large scale derivative traders.

Here's the rub. The onshore China market is dominated by retail traders – mums and dads. The offshore derivative market is dominated by institutional funds and Exchange Traded Funds and trading activity has been facilitated by the Cross Connect opening of the Shanghai market in November 2014. Chinese authorities have been concerned for some time with the allegations of QFFI funds being used in offshore shadow derivative trading. In June 2015 there were concerns that the Shanghai Index selloff from the high of 5176 was preceded by a spike in the placement and rapid removal of sell orders – typical of High Frequency Trading activity. It took the CFTC 4 years to deliver a final report on the 2010 Flash Crash so its unreasonable to expect a CSRC report on the June 2015 fall anytime soon.
The January 4 Shanghai Flash Crash has all the characteristics of the NYSE Flash Crashes but in a market that is not dominated by fund managers and institutional trading. It's the imposition of trading circuit breaker thinking imported directly from the flash crash vulnerable NYSE market that stopped this Shanghai Flash Crash.

It’s convenient, but far too simplistic to blame Chinese retail traders. The pattern of order placement in the physical and derivative markets need further investigation.