Part I

The Liquidity Theory

Money is like the 'hot potato' of a children's game:[1] one individual may pass it to another, but the group as a whole cannot get rid of it. If the economy and the supply of money are out of equilibrium, it is the economy that must do the adjusting (Tobin, 1963).

Academic readers may like to read Chapter 14 'Forms of Analysis' first, in particular Section 14.3, which asserts that the market for money is most frequently out of equilibrium. Attention is also drawn to footnotes 1 and 2 in Chapter 1 about cash-flow accounting.

[1] Children sit in a circle with music playing, and pass the 'hot potato' round the circle. When the music stops, the child holding the potato loses a 'life'. One child can pass the potato to another, but the group as a whole cannot get rid of it.

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Types of Trades in Securities

A corporation's annual accounts normally consist of a trading account, a balance sheet and a cash-flow statement. The trading account gives details of the corporation's income, expenditure and profit or loss during the corporation's financial year. The balance sheet gives details of its assets and liabilities at the end of the year. The cash-flow statement reconciles the changes in the balance sheet between the start and the end of the year. Managers of small businesses, who may never produce a trading account or a balance sheet, understand the vital need to watch their cash flow. Individuals with bank accounts normally have a bank balance below which they are unhappy and have to take action, either by curtailing expenditure or selling something. Similarly, they have a maximum for a balance that is not expected to be temporary. If their current balance exceeds this amount, either they will be tempted into incurring additional expenditure or they will take action to find a better medium of investment for their surplus funds. In each case, they manage their cash.[1] For non-accountants, cash-flow accounting is simpler than trading accounts and balance sheets.[2]

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[1] Even large firms monitor their cash. Budgets are prepared at the start of a financial year. The main elements of the trading account are predicted, as described in Section 20.5, together with certain key elements of the balance sheet. Emerging data are scrutinised, usually monthly (as part of the Management Information System), to detect how the year is progressing. Questions are asked immediately if cash or net liquid assets have done anything unexpected. Chapter 21 elaborates on how industrial and commercial companies and non-bank financial institutions are likely to respond.

[2] In the UK, the National Income Accounts are the trading accounts of the nation. Analysis of the economy as a whole (macroeconomic analysis) is based largely on this trading-account approach, although some balance sheet analysis is included, for example, a rise in wealth leads to additional consumption. Monetary analysis, in contrast, is based on cash-flow accounting plus balance sheet analysis. Reconciliation between the trading account, balance sheet and cash-flow statement can be difficult. In theory, if two out of the three are available, the third can be derived, the cash-flow statement being merely a reconciliation of the change in the balance sheet. In practice, the information that is available may be incomplete. Accountants are well aware that it can be difficult to reconcile the cash-flow statement if there are gaps in either the trading account or the balance sheet, for example, if the classification of items is different. Similarly, reconciliation between monetary analysis and other types of analysis can be very troublesome, because the National Income Accounts are neither accurate nor fully comprehensive. 'Residuals' and 'balancing items' are needed to make them add up.

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1.1 LIQUIDITY TRADES AND PORTFOLIO TRADES

There are two basic reasons why someone purchases or sells a security. The first type of transaction occurs when someone either needs to raise cash or has surplus money to invest. This type of transaction may be called a *liquidity trade*. The second type of transaction occurs when someone switches from one stock into another, or into or out of cash, in the hope that the transaction will improve the return on a portfolio. A transaction of this second type may be called a *portfolio trade* (Figure 1.1).

1.2 INFORMATION TRADES AND PRICE TRADES

Another distinction is between two types of portfolio trade. A trade can occur either because there has been some unexpected new information that affects the value of a stock, or because the price of a stock has altered in spite of there not being any new information justifying the alteration. The first type of portfolio trade may be called an *information trade*; the second may be called a *price trade* (Figure 1.1).

1.3 'EFFICIENT PRICES'

When new information becomes available, market-makers adjust their prices, and information traders act very quickly if they think that they can make a profit, with prices responding until no one else can do so. Prices then become *efficient* once again.

Information trades establish efficient prices, but liquidity trades move prices away from the efficient level. A sale of a stock to raise money will

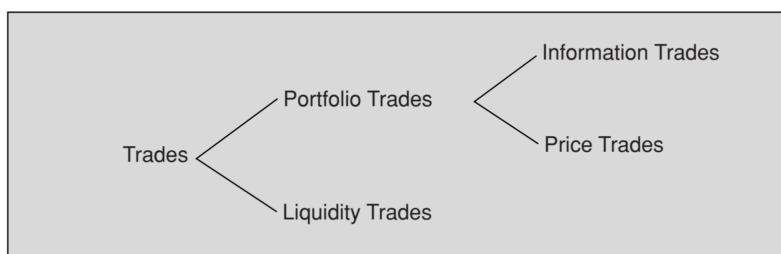

Figure 1.1 Types of trade

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initially depress the stock's price. If the price falls without there being any news justifying the fall, price traders will normally judge the stock to be cheap and will purchase it until the price reverts to the efficient level. In the opposite case of a liquidity purchase, the price of the stock will initially rise. If there is no news justifying the rise, price traders will normally judge the stock to be dear and will sell until the prices revert to the efficient level.

Summarising, liquidity trades move prices away from the efficient level and price trades normally push prices back again. There is an enormous number of potential price traders. Anyone can buy stock. Potential sellers include everyone who holds stock and anyone who is prepared to sell stock that they do not own.[3] The potential number of price trades is, accordingly, very large compared with liquidity trades, and they are usually sufficient to be able to correct any price discrepancies caused by liquidity trades.

1.4 EXPECTATIONS OF FURTHER RISES OR FALLS

The analysis so far has been conventional. There should be no dispute about it. Disagreement comes because there is a remaining possibility, which some academics ignore. It is that a rise in the price of a stock can lead to expectations of a further rise in price, and a fall in price can lead to expectations of a further fall; in other words, expectations can become extrapolative (that is, expectations assume that the current trend in prices continues).[4] If this happens, prices will depart further from the previous level.

It might be thought that there is a remote possibility of expectations becoming extrapolative. Indeed they are rarely so for an individual stock, but expectations can easily become extrapolative for a market as a whole. It will be argued that they do so when liquidity transactions persist in one direction: that is, when there are more liquidity purchases than sales, or vice versa, for any length of time. There are three stages to

[3] By dealing in the market for financial futures or tradable options.

[4] Monetary analysts who understand the behaviour of the market will have expected it to rise and will expect the rise to continue in the short term. Their expectations are not myopic or adaptive, see footnote 1 in Chapter 4.

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the argument. Each will be described in turn in the following three chapters.

1. The balance of liquidity transactions can persist in one direction for many months.
2. This leads to extrapolative expectations.
3. Why price traders who understand what is happening do not push prices back to the level justified by fundamentals.