STUDY

Reasons behind the Lack of Liquidity on the Arab Financial Markets

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Since a while, analysts have been racing to define the reasons lying behind the lack of liquidity on the Arab Markets and they're still struggling to reach an answer.

Whenever the Arab Markets rose, their turnover velocity exceeded for some Exchanges the global liquidity ratios. On the other hand, whenever their prices dropped or stabilized, their liquidity fell-off to the third or even below.

I've been drowned by confusion while hearing analysts explaining the lack of liquidity through the following reasons; some have attributed it to the summer vacation or to the Ramadan fasting period. Others referred the reasons to the anticipation of the Fed rate hike decision, to the European crisis, to the China Slowdown and even to the geopolitical situation in our Arab region. Many have also blamed the absence of Market-Makers, the lack of investors education, and many other legitimate reasons, yet not sufficient enough to persuade me.

As one of the observers, I've wondered: Why the above factors weren't fully applicable during the years 2012, 2013 and 2014?

The above causes weren't valid back then. Summer vacations didn't affect traders, our region has never been clear of geopolitical crisis, and Market Making has never reached an optimum. Despite all that, everyone was caught up monitoring the prices on screens and trading actively.

As I'm not persuaded by generalities, I will be treating some of the reasons mentioned above and their implications on the liquidity Markets fluctuations.

First: The Education of the Arab Investor and the One-Way Market Trend

I get confused while hearing that the main defect in our Markets is due to the lack of investor education, leading to the One-Way Market. This reason might be true, but the question is: how can the Arab investor follow the International Markets fluctuation anticipating their impact on the Arab Markets, but once it comes to the Arab Markets we accuse him of lack of knowledge and education?

In every Market there are experts and newcomers. Yet, Arab Markets might suffer more than others from the effects of the so-called One-Way Market; still let's not blame the investor education. It is mainly due to other factors that we might have chosen to overlook.

Second: Market-Making

Market-Making plays an essential role in enhancing liquidity which I can summarize with this parable:

Imagine with me people screaming for two lifeguards by the shore while watching a man drowning into a rough sea, unfortunately both lifeguards are unequipped with the necessary tools to save a life. One of the lifeguards, driven by his impulsivity, jumped into the water and was able to reach the man in struggle. As for the second lifeguard, his rational thinking kept him on the shore watching with the rest of the people as he doesn't have the safety kit. Meanwhile, it took very few minutes to watch the impulsive lifeguard and the man in struggle both drowning into the water. However, the society never stopped criticizing the lifeguard who stood by the shore instead of fulfilling his duty.

The moral of the story: do not push the Market-Maker to jump into a rough sea unequipped; it will result in drowning himself along with the investor. Provide him with the right tools then judge the result, knowing that the Market-Maker is a profit organization; it isn't a charity sacrificing its funds and time to save drowning investors. Without the right tools, we will be waiting an eternity for Market-Makers to jump into the water.

Third: The Three Phases of a Price Cycle and its Techniques

The hectic fluctuation in the Arab markets liquidity is essentially due to both technical and legislative reasons. As known, the three phases of a Stock Market cycle are: Up-trend move, Correction and Horizontal Consolidation. Most of technicians agree that any market spend the third of its cycle in a Trend phase and the remaining two thirds between Correction and Horizontal Consolidation.

Up-trend Phase:
Usually, all players on the Market try to follow the trend putting their entire liquidity in. In this phase; most of them realize profits as it is not a zero sum game Market like the Forex Market. All traders, investors, stock exchanges, CSDs, CMAs and brokers feel at ease during this phase. It is normal that at the end of this up-trend move, the Market becomes saturated and technically overbought. How the market players react normally in such situation? In case they have the possibility of protecting their positions with hedging tools, they might keep some of their positions looking for the trend to resume after a while. But in case of the absence of any derivatives or other hedging instruments, most of the professionals will withdraw from the Market at a time, pushing for an edgy reversal and initiating a sharp correction.
This phenomenon can be smoothened if the hedging tools are available on the market as some of the players might keep their protected position in the Market for a while, softening the reversal. This explains in a way the sharp variation in the liquidity on the Arab Markets in absence of derivatives.

Correction and Consolidation Phases:
Same principle applies during the correction and consolidation phases when the possibility of protecting the positions is completely absent:

- Players will prefer to stay out of the Market until the first signs of the recovery are confirmed. Meanwhile they'll refrain from taking the risk by investing any unprotected liquidity in the Market.

- Those holding high leveraged positions will be forced to sell due to the margin calls if they are not able to hedge their positions even if they are convinced that the Market will be recovering shortly. This will put high selling pressures on the Market, maybe bringing short-term liquidity for the Market which is not the one really needed at this point.
- Those who bought at the top, without the derivatives they will find themselves prisoners of their losses refraining from taking any action. This is where we will hear even short term traders talking about becoming long term investors, even sometimes planning to inherit their stocks to their children.

In the all above mentioned cases, it is clear that the absence of the derivatives and other hedging tools like ETFs is a crucial reason behind the lack of liquidity during those phases. Talking about ETFs, it might look weird considering them as a hedging tool, still during the corrections considerable part of the long term investors tend to shift their investments from individual stocks to ETFs, first because ETFs cannot get bankrupt, and second because of the diversification offered usually by funds.

Fourth: The Importance of Short-Selling in Increasing the Liquidity Level

The most important question remains: If derivatives and ETFs are so important for the Arab Markets, why those instruments do still almost not exist on our Markets?
Several trials to list ETFs and few other financial instruments took place on the Arab Markets since the year 2006, without noticeable success. Some ETFs issuers feel trapped in their initiative and they are even trying to find a way to withdraw their ETFs from the Market due to the lack of liquidity making them unprofitable for the company.
The reasons behind all failures on this level were the absence of the shorting and securities lending possibilities on those Markets due mainly to two factors:

- Religious reasons: The fact that the Islamic Sharia doesn't allow selling what we don't own, several explanations and efforts are now in-course to find a Sharia compliant financial instruments and tools that can offer to the Markets the flexibility needed. By observing the progression of those efforts, we have positive hopes to see such instruments in place in the coming two years.
- Regulatory reasons: The Capital Market Authorities are mostly afraid of seeing an increase in selling pressures during corrections and crisis created by the short selling if authorized. The Capital Market Authorities are by nature risk averters, which is completely understandable in short-selling case. Still by comparing the pros and cons of the short-selling, we will notice that its pros prevail on its cons.

  The short-selling can challenge the Market with an excess temporary drop during the down moves. Still, this selling will provide to the Market the necessary velocity needed for a sharp bounce up in a V shape pattern, which is normally originated by the short covering process. Knowing that allowing the short-selling means automatically encouraging the hedging tools, which will soften in counter-part the negative effects of the margin calls selling.

Fifth: Are we Really Protecting our Markets by Banning Short-Selling?

The controversial of short-selling will never end. The best way to reach a conclusion about this important issue is to compare the Arab Markets indices historical charts with the International Markets, specifically the American Markets where shorting and derivatives are allowed. Observers can immediately deduct that the Arab Markets weren't enough protected and didn't recover as much as the American Markets since 2008. With or without shorting and derivatives, we were always affected by international and regional crisis as much as other Markets and sometimes even longer.

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