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How to treat markets in times of crisis

Nomura Research Institute, Ltd.

Calls for equity market closure

The earthquake that struck offshore Tohoku on Friday, March 11 and ensuing mega-tsunami inflicted severe damage across much of eastern Japan. Most notably, the tsunami destroyed critical equipment at Tokyo Electric Power Co.'s Fukushima Daiichi Nuclear Power Plant. On the 12th, a hydrogen explosion at the plant raised concerns about radioactive emissions.

Such crises tend to roil financial markets and the Tohoku earthquake was no exception. The Japanese equity market plunged for two days upon reopening the following Monday, with the Nikkei 225 Average falling 6.18% on the 14th and 10.55% on the 15th [1]. On the 16th, the yen spiked to a new all-time high of ¥76.25 to the dollar in the New York forex market.

Such market dislocations almost invariably elicit calls for intervention. This time, in addition to talk of a need for intervention to prop up stock prices, some foreign financial institutions (including investment banks and asset management firms) reportedly urged that the equity market be closed down. On the 16th, the Sankei Shimbun published a front-page article by its chief political correspondent advocating temporary closure of the equity market. On the 17th, Takeo Nishioka, president of the Upper House of parliament, recommended closing Japan's equity and forex markets for a week to prevent market turmoil.

In contrast, Minister for Economic and Fiscal Policy Kaoru Yosano and Minister for Financial Services and Postal Reform Shozaburo Jimi opposed equity market intervention as "premature." They favored allowing markets to continue trading as usual while calmly monitoring market action. Tokyo Stock Exchange President Atsushi Saito likewise refused to close the equity market on the grounds that doing so would send a misleading message about the severity of situation. Meanwhile, Mr. Saito issued a statement calling for investors and traders to act calmly and requested that listed companies adequately disclose information regarding the disaster's impact on their operations.

Past cases of market closure

I entirely agree with the authorities and stock exchanges' decision to keep the equity market open for regular trading.

To be sure, equity markets have closed down in the past in response to catastrophic events. For example, the NYSE halted trading in all stocks in response to the November 1963 assassination of President Kennedy and March 1981 shooting of President Reagan. It also closed for four days in the aftermath of the terrorist attacks of September 11, 2001.

Presidential assassinations and assassination attempts are sudden events that severely shock American society. The NYSE halted trading in these instances because needless market turmoil would have ensued otherwise. In addition to having halted trading as an emergency response to catastrophic events, US exchanges adopted automatic "circuit breakers" following the 1987 Black Monday crash. Triggered by precipitous price declines, the circuit breakers halt trading to quell panic among market participants[2] (Exhibit 1).

The market closure in response to the September 11 terrorist attacks was due to physical destruction of market participants' trading infrastructure and disruption of communication networks. It is fair to say that the authorities had no alternative but to close the markets. The Japanese equity market was closed under similar circumstances for a week in March 1945 in the aftermath of the Great Tokyo Air Raid[3].

Market panic averted

The March 11 earthquake, by contrast, did not significantly damage the physical infrastructure of stock exchanges or many market participants. Additionally, by the time the markets reopened after the earthquake, preliminary information on the overall extent of the damage was widely known by virtue of media coverage over the intervening weekend. Markets were of course rife with speculation

Exhibit 1. Current US circuit breaker rules

Trigger event	Time of occurrence	Duration of trading halt
10% decline in Dow Jones Industrial Average (DJIA)	Before 2:00 p.m. Between 2:00 and 2:30 p.m. After 2:30 p.m.	1 hour 30 minutes No halt
20% decline in DJIA	Before 1:00 p.m. Between 1:00 and 2:00 p.m. After 2:00 p.m.	2 hours 1 hour All trading halted for remainder of day
30% decline in DJIA	Trading halted for remainder of day irrespective of time	
10% decline in Russell 1000-constituent stock or major ETF's price within 5 minutes	Trading in the individual stock/ETF halted for 5 minutes when trigger event occurs between 09:45 and 15:35 ET	

Source: US Securities and Exchange Commission, US stock exchanges

about the status of nuclear power plants, but such uncertainties always exist in markets to some degree.

While the equity market's selloff on the 14th and 15th was indeed drastic[4], the presumption that a major natural disaster will be detrimental to corporate profits is perfectly rational. Many investors likely sought to liquidate their equity holdings and retreat to the sidelines for the time being. Given such a "sell first" mentality, it is no surprise that the vast majority of stocks fell sharply in price.

Moreover, upon closer examination, equity market action on the 15th, the day of the Nikkei's steepest selloff, was not indiscriminate. Although most stocks fell sharply, some stocks, including many in the construction sector, sold off only modestly or even rallied. Those who claim based solely on the magnitude of the overall market's decline that investors panicked have jumped to too hasty a conclusion.

As long as investors do not panic and trading remains orderly, large price declines will induce an influx of buy orders from bargain hunters. Indeed, from the time the earthquake first struck, some market participants took the view that post-disaster reconstruction demand would be bullish for corporate earnings over the medium to long term. I met some investors who subscribed to such a perspective in the US, where I spent a week visiting financial institutions from the 13th. Moreover, this view was propagated by the US media also.

One of financial markets' most important functions, in addition to fairly and efficiently pricing stocks and other financial instruments to reflect the broad spectrum of information known to market participants, is meeting market participants' demand to cash in financial assets. Market closure in the absence of disorderly trading would only trigger genuine panic among market participants deprived of the opportunity to liquidate their financial asset holdings.

Rationale behind calls for market closure and problems therewith

Why then did certain foreign financial institutions (including investment banks and asset management firms) that are supposed to be market professionals call for closure of Japanese markets? The rationale cited in support of market closure was that stock prices' decline was excessive, but is such an assertion valid?

One possible justification is that these foreign financial institutions concluded that the market should be closed based on the Nikkei's March 15 decline in excess of the 10% threshold that would trigger US circuit breakers. However, equity market trading regimes differ substantially between the US and Japan, where individual stocks are subject to daily price fluctuation limits. It is therefore not appropriate to apply the US market's trading halt trigger of a 10% decline in a key equity market index as a one-size-fits-all rule.

Additionally, circuit breakers are designed only to allow time for information to circulate through the market by temporarily halting trading. They were never intended to close down the market for an entire day or several consecutive days. Moreover, US authorities have proposed shortening the duration of circuit-breaker trading halts on the grounds that even the minimum halt of 30 minutes is too long in today's markets, where the vast majority of trades are executed electronically. The argument that a large decline in stock prices alone justifies market closure is not rational.

I suspect that some foreign financial institutions (including investment banks and asset management firms) advocated market closure because they were evacuating staff from the Tokyo area or from Japan out of concern about the spread of radiation from the Fukushima Daiichi Nuclear Power Plant and wanted to avoid being the only ones to suspend trading in the Japanese market[5]. At the time, however, the Japanese government had ordered evacuation only within a 20-kilometer radius of the nuclear power plant. Foreign financial institutions' personnel are free to evacuate in disregard of the government's advisory out of an excess of caution, but if doing so disrupts their normal operations, such an outcome would be severely problematic from the standpoint of crisis management by financial institutions charged with major societal responsibilities.[6]

Why not tighten price fluctuation limits?

Following the US terrorist attacks of September 11, 2001, Japanese equity markets opened 30 minutes late on the 12th and reduced price fluctuation limits to half their normal levels for three days. With derivative markets continuing to trade as usual, these measures were opposed by many market participants on the grounds that they impeded normal trading and encouraged speculative trading aimed at profiting from the temporary measures.

In retrospect, some may argue that because Japanese stocks are now generally trading above their March 15 lows, there was no need for prices to fall as far as they did. However, stock prices at any point in time represent an investor consensus based on contemporaneously available information. Arguing that stocks "fell too far" because they subsequently rebounded is merely hindsight. As noted above, if stock prices fall sufficiently, their bargain appeal will trigger an influx of buy orders. Artificially constraining stock prices' downside by tightening price fluctuation limits would only discourage market participants from actively submitting buy orders, thereby detracting from market liquidity.

Conclusion

Stock market selloffs are certainly not happy events, but as long as market pricing remains untainted by panic, selloffs must be regarded as simply the result of market participants' decisions at that point in time. Market participants that believe prices have fallen excessively should place buy orders. Whether market participants' decisions are correct should be determined by the market, not politicians or regulatory authorities.

People, including government officials, are of course free to express opinions on stocks' fair value from their respective standpoints. However, closing the market just because stock prices are falling is analogous to someone with a high fever destroying a thermometer just because its reading is high. Doing so serves no purpose except averting one's eyes from reality. In Japan, calls for equity market intervention in the form of publicly funded stock purchases periodically arise on the grounds that stock prices have fallen "too low." However, such intervention to artificially prop up stock prices formed in the course of orderly trading only distorts fair and efficient pricing, undermines confidence in markets, and provides opportunities for speculative trading that capitalizes on the intervention.

Note

1) The equity market sold off nearly across the board after the earthquake struck on Friday the 11th also, with the Nikkei 225 Average closing down 1.72% from the previous day's close. The earthquake's impact on stock prices on the 11th was limited by the timing of the earthquake, which occurred with only 14 minutes remaining until the scheduled close of trading.

2) Proposals are currently pending to change the index to which market-wide circuit breakers are tied from the DJIA to the S&P 500 and to expand the universe of individual stocks and ETFs subject to circuit breakers to all listed stocks and ETFs except those that are extremely illiquid.

3) Although the market reopened after a week, it closed again on August 10, 1945, in response to the preceding day's atomic bombing of Nagasaki and remained closed through the war's end on August 15.

4) The Nikkei 225 Average's percentage decline on the 15th was the third largest on record, surpassing the March 5, 1953, crash triggered by Josef Stalin's death (-10.00%). The Nikkei's largest-ever percentage decline (-14.90%) occurred on October 20, 1987, in the aftermath of the US market's Black Monday crash. Its second-largest decline (-11.41%) occurred on October 16, 2008, in response to Lehman Brothers' bankruptcy.

5) Of course, not all foreign financial institutions sought closure of Japanese markets. I would be remiss not to mention that certain financial institutions dispatched top executives to Japan from their home countries to support operations in the Japanese market, as reported in the *Nikkei Shimbun's* morning edition on March 29.

6) Financial institutions are required to formulate business continuity plans to enable them to continue to function even in the event of a major earthquake or other such contingencies.

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