Could short selling make financial markets tumble?

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Abstract

It is suggested to consider long term trends of financial markets as a growth phenomenon. The question that is asked is what conditions are needed for a long term sustainable growth or contraction in a financial market? The role of traditional market players of long only mutual funds versus hedge funds which take both short and long positions will be discussed. It will be argued that financial markets since their very origin and only till very recently, have been in a state of "broken symmetry" which favored long term growth instead of contraction. The reason for this "broken symmetry" into a long term "bull phase" is the historical almost complete dominance by long only players in financial markets. Dangers connected to short trading are illustrated by the appearence of long term bearish trends seen in analytical results and by simulation results of an agent based market model. Recent short trade data of the Nasdaq Composite index show an increase in the short activity prior to or at the same time as dips in the market, and reveal an steadily increase in the short trading activity, reaching levels never seen before.