Market Cycles and Their Psychological Interpretation (1st part)

Introduction

While it is true that market conditions change, there is an underlying cyclical movement of capital through markets, sectors and individual stocks. The market is simply a function of supply and demand, with price as the final arbiter. Factors that affect supply and demand vary at different times based on overall risk levels in the market, pending news and other considerations. What defies the logic of academics who believe in random movement is the emotional responses of the participants. The market does not always move in a logical way because emotions play such a large role, and emotions are not random. While it is impossible to accurately gauge the emotional condition of all market participants, it is possible to grasp the psychological make-up of the markets.

The market continually expands and contracts. The directional expansions in price seek out volume to facilitate trade which, when found, halts price movement and forces price to retreat and recover. This process is repeated countless times as the markets continually seek out the "fair value." The sum of these rallies and declines forms cycles that can be found on all stocks on different timeframes. All stocks go through their periods during which the public embraces them to times when the participants discard them. Similar to the economic cycle, which consists of expansion, peak, decline and recovery, stocks can be categorized into four different stages.

1- *Accumulation:* After a period of decline; it is the process of buyers fighting for control of the trend.
2- *Markup:* Once buyers have gained control of the stock, a bull market begins as price expands higher in search of supply.
3- *Distribution:* After the market has exhausted the majority of buying demand, sellers become more aggressive, which turns the market neutral.
4- *Decline:* Price expands to the downside in search of demand to satisfy the aggressive supply being offered.

An understanding of crowd psychology can help you gain an emotional advantage over the average participant who thinks only of his actions. While we never know for sure what the feelings and motivations of all the participants are, there are certain emotions that are shared at various stages of a stock's life. The range of possible emotions may take an investor several years to experience, or for shorter-term traders, can occur in as little as a day, particularly if leverage is used.

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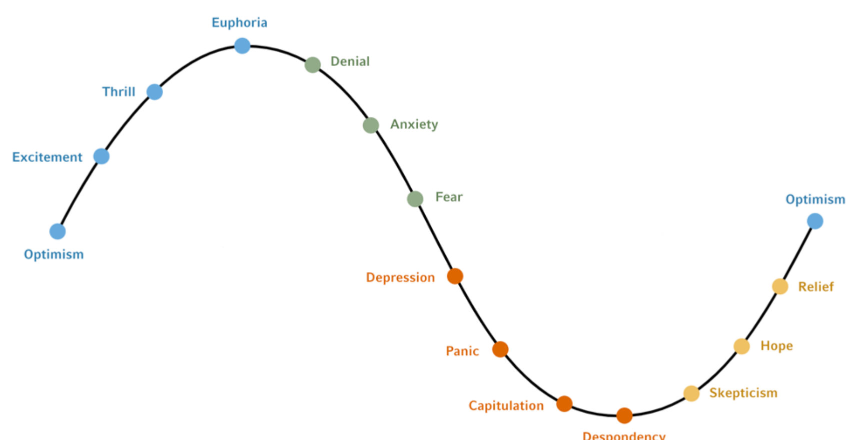
Figure 1 Psychology of the long holder at various stages of the cycle



Accumulation

Accumulation begins with the completion of a downtrend and is a transitional period where the once-aggressive sellers begin to ease their activities. Short sellers realize some of their profits and sidelined cash is slowly attracted to a perception of value. During accumulation, there is a gradual shift in control from sellers to a more neutral environment. Near the beginning of an accumulative phase, there still may be negative news released by the company, but the response from sellers becomes muted as they grow immune to negative fundamental developments, start to ignore past news and become more forward-thinking.

Large institutional holders of long stock who were unable or unwilling to liquidate their positions in a declining environment will recognize the chances of the stock recovering to previous highs diminishes as time passes and trading volume declines. These institutions often become consistent passive sellers of the stock, which keeps pressure on prices. On the demand side are the value players who methodically absorb supply and patiently build positions they will stay with for years until the market once again recognizes "value" they perceive to be overlooked. The value players attempt to be the "smart money" group that takes advantage of a stock that was sold off to what they view as a discount to the true value. While a stock in the accumulative phase may bore a trend trader, a large longer-term focused institution welcomes these times because it allows them to accumulate a position that will be meaningful to their portfolio. Remember that a large institution does not have the flexibility to enter and exit its full position over a short period in the same way smaller traders do. Buying millions of shares can take months to accomplish unless the institution is willing to sacrifice the quality of execution and drive the share price higher with more hurried purchases. The accumulation stage is a time of healing for, not just the price of the stock as it stabilizes from the previous damaging sell-off, but also for the perception of the stock and even the company. After a large sell-off, people who lost money in the stock often feel as though they have been burned and depending on the circumstances it can take years for them to trust the stock again. The perception of management of the company may also be tainted by those who lost in the stock. If a stock is down after a period of management mistakes, market participants may be unwilling to commit their capital to the company's stock until there are significant changes in upper management.

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During the latter stages of accumulation, sellers who are still liquidating long-standing positions become more patient in offering out their shares as they realize their greatly reduced level of inventory is attracting more demand from a larger group of participants. As these longer-term holders begin to recognize that the worst may be behind them, they become less aggressive in offering stock out. Another scenario that sometimes plays out is that the institution which had been offering stock out during much of the accumulation period not only stops selling its remaining shares but starts to repurchase them late in the accumulation. As crazy as it may sound, a mutual fund may be a net seller one month and a net buyer of the same stock the next month. Mutual funds' decisions to buy and sell are not always motivated solely on making money for their investors. They may still believe in the prospects for a company in the longer term, but because they must disclose their equity holdings at the end of each calendar quarter, they are forced to sell an underperforming stock. The motive is simple: they don't want to look foolish with a large position in a weak stock. The motivation to buy or sell based on how a portfolio looks to the public is known as "window dressing."

MarkUp

The favourite time for the majority of market participants to be involved in the markets is during the bullish markup periods. A healthy bull market puts people, even nations, in a good mood as this is when their account values can swell, and profits seem to come with ease. The bullish uptrend begins to emerge as the prior accumulation absorbed all significant sources of supply and new buyers compete to own a limited number of shares, thus the path of least resistance is higher. Quite typically, the strong directional move higher will catch a large group of participants off guard and unprepared for the new environment, which then causes them to become emotional, lose discipline and enthusiastically chase prices higher.

The increased competition to buy the tight supply of stock offered to the market creates an environment in which prices move higher with ease. Short-sellers, who failed to cover their positions at lower prices, will create another source of demand as they chase prices higher in an attempt to contain growing losses. The early moves in an uptrend have a low failure rate simply because the supply and demand dynamics, which have set up during stage one and continue with the increased buying pressure from various groups, are quite favourable.

Greed and fear are the two most used words when it comes to investor psychology, and nowhere are they more prevalent than in an up-trending market. From an emotional standpoint, the uptrend is a market atmosphere marked by the greed of the long participants who crave greater profits. Often overlooked in an uptrend is the role of fear, anyone who's ever sold short a stock that's moving higher begins to fear his equity will be wiped out;

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this motivates him to chase prices higher or theoretically risk unlimited losses. The fear of missing out on a big move higher is another common mental phenomenon in an uptrend. It encourages undisciplined long traders to “graze" in the market after a meaningful short-term rally.

The latter stages of an uptrend are influenced in large part by emotional participants who are attracted to the stock by increasing greed and fear. As earlier, fear plays a large role in an uptrend from the short-sellers who feel trapped; the buy button is the only relief for trapped short sellers whose losses grow each time the stock ticks higher.

While it may seem like common sense that the stock cannot continue higher when the momentum expands, the late stage of an uptrend is ruled by emotion, not reason. It is common for late gains to come quickly and travel beyond “reasonable valuations” as optimism builds with late-stage positive news releases. Besides, the role of the early shorts being squeezed creates a buying frenzy.

The lure of easy money from a runaway trend tempts some of the most reluctant buyers of stock to let their guard down and chase the momentum with little regard for risk management. The increased speed of rallies gives the illusion that trading is easy, a situation that is often “relieved” by sudden and sharp bouts of profit taking. Evidence of greed-driven fast rallies late in an uptrend should alert you, as with all market cycles, those we would like to go on forever gradually lose their steam. Bull markets live their day and then come to an end. Thus, we enter stage 3 distribution, which we will discuss in the second part of the article.

TAGS: Market Cycles, Bull market, Bear market, Accumulation, Distribution, Market Psychology, Euphoria, Panic

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