Market Cycles and Their Psychological Interpretation (2nd part)

As we said in the first part of the article, the market continually expands and contracts, going through periods of expansions, peak, decline and recovery. This, consequently, affects all type of assets, especially stocks that go through 4 different cycles. In the previous part, we discussed two of them:

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.

In the second part, we will be discussing the last two stages, distribution and decline. A stock in distribution, as in accumulation, is usually correcting after it has experienced a trending move that has temporarily exhausted itself. It's like a runner taking a break. These corrections often occur after a stock has moved to an extreme level due to participation from undisciplined and emotional traders who chase price movement with little regard for risk management. Avoidance of these neutral times allows you to lessen the risk of tying up capital in nonperforming assets. On the other hand, for the majority of market participants, the stage four decline is a dark, scary period that they wish it will never occur. However, if you are objective investor who understands the cyclical nature of the markets, a bear market can represent a terrific. Whether you choose to profit from a decline by selling short or simply wish to avoid the carnage to your long exposure, recognition of a bearish environment is essential to the defensive nature of long-term market prosperity.

Distribution

As buyers slowly lose conviction in their purchases and sellers begin to offer more supply, it becomes difficult for the stock to make any further upside progress. The gradual shift from a bullish phase to a neutral environment occurs as short-term traders no longer view the stock as one in which they can attain quick profits. When the fast money crowd realizes the opportunity for short-term upside profits is gone, they sell out and move on to the next hot stock.

The beginning stages of distribution often see large volatility as the bulls and bears fight for control of the trend. For many investors, the distribution stage can be a trying time. Positive news stories, stock splits or analyst upgrades are released, and the initial reaction is to jump in. However, these fundamentals mean little as rally attempts are met with the supply by the large holders who are paring down their positions. The process of selling into a news release after the stock has experienced an advance is known as "smart money selling to dumb money."

During the middle period of distribution: larger holders who have been net sellers get nervous about shedding shares without negatively impacting the price. Buyers still present in the stock become less aggressive and start lowering their bids in search of more favourable prices. Some previous buyers become net sellers, thus reducing demand and increasing supply simultaneously. Large remaining long positions recognize signs of transition and become more aggressive with sales, increasing bids instead of waiting for buyers to take their offers.

As you can see, there are several conflicting emotions taking hold, all of which add up to an indecisive market. The combination of exhaustion of demand and sellers becoming more methodical in their sales creates a fragile environment for the stock as it seemingly moves on the edge of a breakdown.

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Decline

A bear market is most participants least favourite time to be involved in the markets. Unfortunately, it is a painful time for many market investors who try to catch a falling knife, rather than wait for it to drop and then pick it up. For the perennial doomsayers of the world, a bear market is their time to say "I told you so" as they endlessly preach their pessimistic viewpoints. The fact is, declining equity prices bring about the strongest emotional response, annoyance from longs to jubilance of the shorts, from the average participant.

There have been many attempts to classify exactly what constitutes a bear market, but it can be simply summarized to this: It is an environment where the path of least resistance is lower. The sellers are clearly in control. The supply of stock offered to the market is greater than the demand can absorb at current prices, which forces a move lower in search of liquidity. As more long participants are trapped with losses, fear-driven liquidation is more likely and typically will play out in multiple waves.

Picking bottoms is the hardest job on Wall Street, yet for some reason, there seems to be an attraction to declining prices among most participants. Natural human optimism and learned behaviour of hunting for bargains in a retail environment provide a "slope of hope" along which stocks decline, crushing the dreams and finances of bewildered longs in its path.

For long participants, the decline is marked by fear that the stock's descent will continue to wipe out there and fear of feeling stupid for selling at a point just before the stock turns higher. For short-sellers, greed plays a role in a declining stock as they become enthusiastic about the increasing equity of their account balances. Short sellers are not immune to fear in a primary downtrend. Short term rallies can come suddenly and quickly in a downtrend and the fear of evaporating profits motivates short sellers to buy. There seems to be a general mistrust of the shorting process and, as such, they are often very quick to cover their positions at the very first sign of any short-term strength.

Paradoxically, it is often "bad news" which motivates temporary strength in a declining stock. When a stock has declined for several days without a solid reason and then bad news is released, there often is a knee-jerk sell reaction by the less-informed long holders as they realize the fundamental picture may not be as rosy as their previous research had indicated. When technically weak stock gaps lower on news, shot-sellers will often take advantage of the liquidity provided by the mini panic and cover part or all of their position. When bad news brings weak longs to the surface, the stock they sell often is absorbed by better-positioned shorts who are taking partial profits or by stronger buyers attempting to position for a longer-term hold.

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The end of a decline often finds climatic selling action as the last longs liquidate in fear and disgust. Other sidelined participants who have not been involved in the stock may succumb to the temptation of selling short as it becomes "obvious" that the stock is in trouble. The increased volatility near the end of a decline will begin to taper off as emotional participants get shaken out of their positions and more methodical selling actions of the remaining large positions are gradually overwhelmed by the accumulation of players who are positioning for the next cyclical move higher.

The only true constant in the markets is the participants. Humans tend to act, react and overreact in similar ways to certain situations which are repeated over and over again. In this article, we merely discussed emotions reflected in different cycles. There are many times when the market appears to be acting irrationally, and that, unfortunately, becomes the basis for market sheep to impose their beliefs on the market. Those who herd together to question the market typically suffer losses rather than listening objectively to the message of the market and acting accordingly. Don't fall into this trap. As John Maynard Keynes once said, "**The markets can remain irrational longer than you can stay solvent.**" It is said that the collective intelligence of a market sinks to the level of its dumbest participant. That is a scary truth.

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

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