A Lesson in Behavioral Psychology

by David Walter

Investors have learned that over many decades, stocks are the best place to be in terms of returns. Therefore, the simplest approach is to have one's money in a passive stock market index fund and forget about it. One problem: It doesn't take into account people's propensity to run like lemmings when everybody else is jumping off the cliff. There's a reason Wall Street is known as the herd.

The ending of a bull market is a long-term process. That's because greed is a long-lasting emotion, whereas fear is over quickly. Bear market bottoms are **V**-shaped. Bull markets can roll over a few years with quick declines in corrections that may make us think it's over. The current correction has been like few in the past. The "selling stampede" we had recently is likewise rare in its intensity. In our opinion, this has much to do with the impact of algorithm-based computerized trading.

So how do we know whether we're entering a bear market with another 50 to 60% to go down from current levels, or the correction has ended and we're now headed for higher levels?

In addition to fundamental and economic analysis, we use technical analysis to guide us. This includes charts and measurements of momentum.

Here's a snapshot of the current situation:

1. Economy – It's doing pretty well overall, with cautionary signals of a slowdown in housing. Lower interest rates resulting from the recent stock market decline should help the situation. Consumer confidence is still at high levels, but confidence about future expectations is starting to signal caution.
2. Employment – Opportunities are very tight for those with the skills. Unskilled workers can find jobs if they want them.
3. Company earnings fundamentals – They're slowing down to some extent, but are still pretty good this late in the cycle.
4. Technical – We saw a total wipeout until the day before Christmas. Since then, things have been volatile with breakneck speed rallies.
5. The market decline has resulted in a sizable drop in interest rates. This is bullish. As a result, the Federal Reserve Chairman has changed his tone and messaging because of his concern of further declines in stocks. This is also bullish for now. The speculative juices of traders have returned as if December never happened.
6. This may present one of the better buying opportunities we've seen in years. The alternative is that we're on the cusp of a sizable bear market.

So, how do we know which alternative will win out? We don't. What we do know is that the sizable rallies we've had in the past week presage further gains most likely in the 5 to 10% range. As I write this, the current index level for the S&P500 is 2550. Based on our technical work, we estimate that these rallies will take us back to between 2650 and 2750. If it gets to 2750, we'll reassess the situation.

Apparently, Chairman Powell was coached on how to change his messaging. He did so on Friday, and the public responded accordingly. At an economic roundtable discussion in Atlanta on Friday with former Chairmen Yellen and Bernanke, his words reassured those who had panicked into selling. This resulted in a huge gain for the day. All that needs to happen now is for the tariff situation with China to be solved and the US government funded, and 2650 to 2750 on the S&P500 won't be far away.

In the end, it will be the real economy and consumer confidence that determine where we're headed over the next few years.

In the last thirty years, most corrections within bull markets ended with declines in the 15 to 25% range. This one was 20% if it is now over. If, going forward, any month ends below the long-term support trendline from 2009 shown below, then in our opinion a bear market will have begun.

See chart below:

It shows the three major corrections since the beginning of the bull market in 2009: 2011, 2015, and now. The green arrows are from a technical indicator we developed to show deeply oversold stock market levels. Since 1987, it has gone off only 8 times. In each case during this bull market, a green arrow in the chart below presaged higher levels going forward and at a minimum back to the blue line which represents the 200-day moving average. It will eventually happen after this correction. The 200-day moving average currently sits around 2750, or about 10% higher than the current price, before rolling over. No one knows exactly where it will go, but more likely than not, there will be much volatility in 2019.

January 2009 – Present