4 Stages of the Market Cycle

~ "A bull market tends to bail you out of all your mistakes. Conversely, bear markets make you PAY for your mistakes."
– Richard Russell (Dow Theory Letters)

There are four stages to the stock market cycle:

1) Basing (Accumulation)
2) Rising (Mark-Up)
3) Topping (Distribution)
4) Declining (Mark-Down)

One of the most common mistakes for most is failure to recognize the fact that like many aspects of life, markets are cyclical. Even when investors recognize this fact, they tend to *easily* forget that the end of the current market phase is eventually going to come.

The next mistake is made when investors attempt to pick the top or bottom of one. This is nearly impossible to do, but using technical indicators that you'll learn from this course will help you to at least come very close.

Understanding the stock market cycles is essential for those who want to maximize returns. More importantly, this understanding makes you less likely to get fooled into buying or selling at the worst possible time.

It's pretty obvious when the stock market is rising or declining. But it isn't as easy to tell when the market is topping or basing unless you are using moving averages, or momentum indicators (which we will discuss later).

You may have learned many trading strategies, but what many people tend to forget is that a particular strategy might work well at one stage of the market cycle, and not at another. By identifying the stage of the market, we can determine the proper (best risk/reward) strategies to employ.

Here, I'll keep it simple by identifying the stages of the market, first by focusing mainly on moving averages, and later on we'll get more detailed, and discuss ways to identify changes in momentum.

Moving Averages

We will go into detail on moving averages in the charting section. But for this discussion, I only need to make sure that you know the basics.

Moving averages are used to smooth data, and they make it easy to spot trends. Smoothing the data is very helpful because it helps reduce the “noise” created by the daily market volatility. Identifying trends goes to the heart of technical analysis and is the basis for all trading decisions.

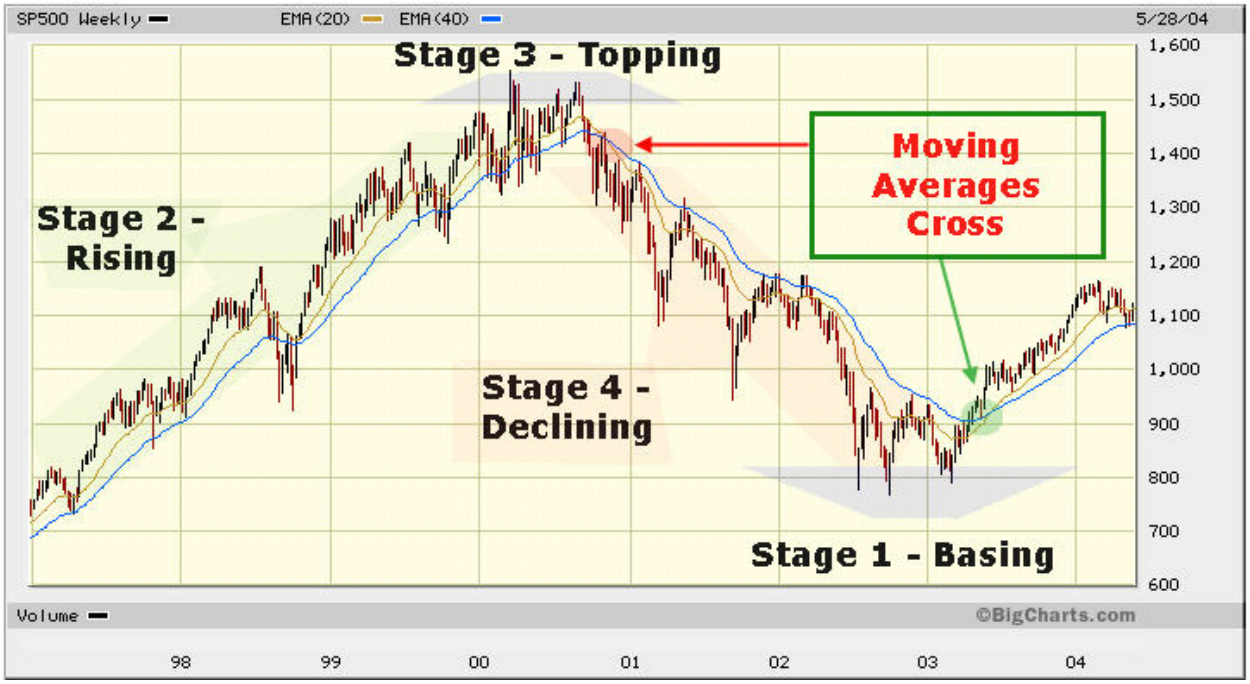
The two most popular types of moving averages are the Simple Moving Average (SMA) and the Exponential Moving Average (EMA).

The Simple Moving Average (SMA) is the average price of a security over a number of periods (days, weeks, months, etc.). A 10-day moving average would take the sum of the last 10 closing prices and divide that number by 10. This number is usually plotted on a stock or index chart along with the price (as seen below).

The Exponential Moving Average (EMA) reduces the lag in simple moving averages by applying more weight to the more recent price data; therefore, it reacts more quickly to the more recent price changes. The calculation isn’t important right now. All you have to do is enter the moving average of your choice into the chart system you are using, and it will plot the average for you.

It’s a matter of personal preference, but I choose to use exponential moving averages because I find that they make much more effective indicators.

The chart below shows all four stages of the market cycle during the rise and fall of the S&P 500 from 1997-2004. As you can see, during the "rising" stage, prices generally stay above their key moving averages and during the declining stage, prices usually stay below their major moving averages.



Generally speaking, different people like to use different moving averages, such as the 10, 20 or 30-week moving averages (depending on their preferred time horizon). But to identify the four stages of the market cycle, it's effective to compare the 20-week and 40-week moving averages to each other, and to market price action.

Moving averages are watched by most professional traders and are used to identify support levels during bull markets and resistance levels during bear-markets. Since moving averages are followed by so many investors, the support and resistance levels actually become a self-fulfilling prophecy.

When using moving averages, it's important to use at least two (sometimes three) different time periods (one time period shorter than the other) as a simple way of identifying the change in momentum.

As we've discussed in the earlier section on moving averages, the shorter the amount of time that's averaged, the more sensitive the moving average will be to change in price.

Notice above how the S&P 500 *crosses* the 20-week moving average (brown line) several times, but usually *bounces* off of the longer-term 40-week moving average (blue line).

The Basing (Accumulation) Stage

Mood: Starts very bearish, finishes neutral.

Moving average (MA): Shorter-term MA starts to move to the upside as longer-term MA continues to decline. Short-term MA moves above long-term MA.

Support/Resistance: Both are established (with the creation of the new trading range), followed by resistance (recent high) being broken for the first time.

Prices: After being below moving averages, prices cross above moving averages.

Trades: Short sellers are covering. Savvy investors are buyers and everyone else is still selling.

Downside Pulses: Show reduced momentum, length and slope.

Action: Slowly start to accumulate stock positions on short-term weakness.

This stage includes the end of the bear market, and usually sets the stage for the new bull market.

This is one of the two most confusing stages for most investors. At this point, the media is usually giving the impression that the world is coming to an end. It seems like the market will never stop declining. At this point, we may be experiencing a recession, or people are at least talking about the possibility of it.

This is the scariest time for investors, as the market has sold off violently, usually finishing the bear market with one of the steepest declines, if not *the steepest* that it has seen in the recent period (red lines).

To someone who's never been deep in the stock market during a time like this, the words that you've read don't come close to describing the mood across Wall Street, and the investing public.

Retirement accounts, nest eggs, and people's net worth have not only disappeared before the eyes of the investing public, but what's worse is that they are selling out, right at the bottom. Professional money managers are being sued by angry investors, families are falling apart, and if the decline is as sharp and violent as the 1987 crash (major indices down 34%-39% in less than a month); people are jumping out of windows on a regular basis. It's not pretty.

Back to technical analysis

Investors who held on through the worst of the bear market have given up and sold the rest of their holdings. But as late sellers are dumping their stock, savvy investors accumulate stocks in anticipation of the next upswing. This marks the beginning of the basing stage.

Usually you see a very sharp rally immediately following the violent decline, and usually the sharp rally will be on high volume. This sharp rally is caused by the "covering" of short positions (when investors, usually large funds, rapidly buy back the stock that they sold short, in order to take their profit before it's too late).

After that sharp rally, there is almost always another corrective dip, which bounces off a level that's very close to the first low, and usually (but not always) at a slightly higher level. This is commonly referred to as "testing support".

There are many indicators to confirm the price action during this stage such as volume, breadth, and other momentum-based indicators that you will learn in later chapters.

Volume – The first low is the "selling climax" which is almost always accompanied by the highest volume. In other words, when that low (support) is tested, it usually happens on lighter volume than the selling climax.

Breadth – Readings move higher. Even though major averages have moved lower, the number of stocks making new 52-week lows actually decreases. A smaller number of stocks are participating in the decline and we see a shift as an increasing number of stocks move up. (We will discuss "breadth" soon.)

Momentum – The rate at which the market declines often slows after the first low creating the support level is reached. Momentum indicators often show a "positive divergence" when the support level is tested.

Again, both will be discussed in detail in later chapters.

At this point the stock market usually changes from a major bear market to a major bull market. The stage is set for an advance as a base is built. In the basing stage, new support and resistance levels are set.

The shorter-term moving averages (20-week moving average - brown line), which had previously been below the longer-term moving averages, cross over and above the longer-term average (40-week moving average – blue line).

The final part of the basing stage usually begins the market's next move higher as recent "resistance" levels (highlighted in green) are crossed through.

The Rising (Mark-UP) Stage

During the rising stage, the market tends to stay above its key moving averages.

Mood: Average investors are still skeptical to neutral, and still getting over the bear market shock during early rising stages. Investors become bullish after the rising trend is completely obvious.

Moving average: Short-term moving averages continue moving higher. Long-term moving averages begin to move higher with the short-term moving averages, further confirming the change in trend.

Support/Resistance: Recent resistance levels (recent highs) are broken. Support is found at key moving averages (which are advancing).

Prices: Confirmed by penetration of past resistance levels. Early part of rising stage usually begins with strong burst of energy.

Trades: Institutions continue to buy, as individuals join the party.

Buying Pulses: Show increased momentum, are longer than selling pulses and are at sharper angles than selling pulses.

Breadth: Readings move up, showing a strong internal market, especially in the first half of the accumulation stage.

Volume: Continues to confirm price action. Usually advancing days and weeks are accompanied by higher volume, while declining days or weeks are accompanied by lower volume.

Action: Long-term positions should be established early, short-term or long-term positions best initiated at or below 20-week moving average.

This stage usually starts with a rapid move to the upside. This is usually when the fastest price advances are made.

At this point, institutions have covered their short positions (stock which had been sold short has been bought back), so those institutions that previously were betting on the market's decline are no longer willing to establish new short positions (for the most part), thus eliminating a large contributor to the selling pressure.

Why is the early upside move so rapid? Because at the same time that most of the institutional selling pressure is relieved from the stock market, institutions, which had immediately identified the basing stage, now rapidly accumulate stocks.

Individual investors are very skeptical about the beginning of the "rising" stage. Most are licking their wounds, while the institutions are buying stock.

The moving averages that you choose to use to guide you in and out of positions depend on your personal trading style and preferred time frame. If you have a long-term outlook you might continue to use weekly charts, and 20- and 40-*week* moving averages. But since the advancing stage has been established and confirmed, investors with shorter-term outlook might use the 200-*day* or 50-day moving average for entry points.

The 50-day is used as a major support or resistance level for *intermediate trends,* and the 200-day moving average is used as a major support or resistance level for *long-term* *trends*. (The 200-day is the about same as the 40-week, but we use the 200-day when we want to be more specific.)

During the advancing stage, prices tend to find support at these levels. Prices usually don't stay below the 50-day moving average for long, and dips below the 200-day moving average are usually considered major buying opportunities.

The Topping (Distribution) Stage

The early topping stage is a result of discontinued institutional accumulation, followed by strategic sell programs (distribution days).

Mood: Individual investors are overly complacent. ** Investors are much more afraid of missing out on the next huge gain than they are about taking a loss. **

Moving average: Shorter-term MA usually loses upside momentum and neutralizes (flattens), later followed by the same action in the long-term MA. The two MAs move close together and eventually cross paths.

Support/Resistance: Moving averages, which had been considered to be the level of support, are usually violated on more frequent occasions. Compare this difference, on the chart, between 1997 & 1998 to 1999 and 2000.

Prices: Trading range consolidates, and is usually closer to major MAs. Instead of up trends, the price action becomes neutral (sideways).

Trades: Savvy investors are distributing stock to latecomers.

Upside Pulses: Show reduced momentum, length and slope.

Breadth: Usually weakening (readings are moving lower). Usually, breadth indicators are not confirming what appears to be strength in the external market (discussed soon).

Volume: Although the stock market may be moving higher, heavy (above average) volume during down days or weeks in increasingly noticeable.

Action: Employ protective strategies. Reduce bullish exposure. Tighten stop losses. Sell covered calls on bullish positions. Consider buying in-the-money put options on weak stocks within the weakest sectors. (Discussed soon.) Sell on market rallies. Look for “negative divergences” (discussed in later chapters).

There are two kinds of trading activity at market tops. The action that we saw in the NASDAQ in the year 2000 is rarely what you see at a market top. But when the market advances that far, that fast, we see a heavy volume “buying climax”. This type of stock market top follows a sense of euphoria and mania.

The price action that we witnessed with the S&P, NYSE, and Dow Jones was more typical of the topping stage. However, we saw similar characteristics in terms of market breadth across all of the major averages, not to mention several other sell signals given by momentum indicators.

We will discuss market breadth in great length in later chapters, but the general idea is that for most stocks and sectors, the bear market began in April or October of 1998. A much larger number of stocks were declining while only a few stocks, which had mind-boggling gains, pushed the averages higher until March of 2000.

The Typical Topping Stage

Years of watching the stock market make new highs again and again tend to give investors what can be sort of a hypnotic, optimistic mindset. Expectations that the stock market will continue to rise cause investors to continue to buy when the market dips. They either don’t know what to look for in terms of the signs of a topping market, or they know darn well what a top looks like, but they’re too caught up in the hype to take the signs seriously.

But the topping stage (*aka* distribution period) will show the shorter-term, followed by the longer-term moving averages losing momentum, and neutralizing (moving sideways).

Unlike market bottoms, which tend to reverse to the upside swiftly, market tops are usually *gradual*. Momentum diminishes *slowly*, and sectors lose strength practically one at a time. Instead of rising sharply, industry groups only rise slightly.

There are usually a select few individual "big story" stocks that are widely publicized which keep investors in the market, searching for the next big winner. **At this point, investors are much more afraid of missing out on the next huge gain than they are about taking a loss.**

At this point, it is more important than ever to establish selling strategies and rules that you stick to in order to eliminate emotion, as this stage is often where the most money in the market is lost.

"Never overpay for a stock. More money is lost than in any other way by projecting above-average growth and paying on extra multiple for it." ~ Charles Neuhauser (Bear Sterns).

Selling at the top is arguably the most difficult thing to do as a trader or investor. A good trader knows that it's best not to even try to sell at the top, and is happy to sell anywhere *near* the top.

To help take the emotion out of trading at this crucial time, it's extremely helpful to use momentum indicators.

This section is meant to help us clearly identify each of the four stages of the market, and not to get too deep into momentum indicators yet.

But since the topping stage is where the *biggest mistakes are made*, I'm going to give you a peek at what a "negative divergence" (*aka* "bearish divergence") looks like with two of my favorite indicators: the RSI (Relative Strength Index) and the MACD (Moving Average Convergence Divergence).

At the bottom of the S&P 500 chart you can see that both indicators which measure momentum gave several signals that momentum was slowing, and therefore failing to confirm the strength and sustainability of higher prices.

We know this because, as you can see, both momentum indicators showed successively *lower* ***tops***, or *lower* ***highs,*** while the S&P 500 continued making higher highs.

<u>SIDE NOTE</u>: Don't sweat it. This will be reviewed several times throughout the course. But keep in mind that when looking for divergences, it's best to compare the action of the indicator to the <u>HIGHS of the index or stock</u> that you're analyzing.

- *When looking for **<u>NEGATIVE</u>** (bearish) divergences, be sure to compare the <u>HIGHS</u> of the <u>indicator</u> to the <u>highs</u> of the <u>index</u> as seen above. (Not the lows of either.) "Are the higher highs in the index confirmed by higher highs in the indicator, or is the indicator disagreeing with the index by making lower highs?"*

- *When looking for **<u>POSITIVE</u>** divergences (discussed later,) be sure to compare the <u>LOWS</u> of the <u>indicator</u> to the <u>highs</u> of the <u>index</u> as seen below. Are the lower highs in the index confirmed by lower <u>lows</u> in the indicator, or is the indicator disagreeing with the index by making higher highs?*

Traders who stuck with their rules and respected these indicators' negative divergence signals were out of the market in late 1999 – early 2000.

This is also seen in this chart of the NASDAQ's March 2000 top. When we look at the weekly chart, we see a major negative divergence when the NASDAQ made three higher highs which were unconfirmed by the RSI which showed three ***lower*** highs (marked by the red lines and red circles).

We also see that the MACD gave us a sell signal (marked in blue) at the end of March. This sell signal would have gotten you out when the NASDAQ was at 4,500, the week before it dropped another 1,200 points.

Both the RSI and the MACD shouted "SELL" before the 20- or 40-week moving average even started to move sideways, let alone downward.

These and many other indicators will be discussed in depth in later chapters. You WILL master these indicators by the end of this course. The question is; will you use them and listen to them even when your gut tells you not to?

Why do I ask?

Many institutions and savvy professional traders who've relied on these indicators for *decades* didn't listen in March of 2000. This speaks volumes to the overwhelming power of stock market mania!

"Uncontrolled optimism can lead to mania, and one of the chief characteristics of mania is its inability to recall the lessons of history."
~ Benjamin Graham (Warren Buffet's mentor)

Mania:

1) Excessive excitement or enthusiasm; craze: The country has a mania for soccer.
2) c.1400, "mental derangement characterized by excitement and delusion," from L.L. mania "insanity, madness," from Gk. mania "madness," related to *mainesthai* "to rage, go mad."
3) An irrational but irresistible motive for a belief or action.

The Declining (Mark-Down) Stage

During the declining stage, the market is below its key moving averages.

Mood: Average investors have been watching the markets rise for years, and most decide to hold on for an expected market recovery. They seem to feel that the market owes them something. They are usually in a state of denial.

Moving average: Short-term moving averages turn down, crossing the long-term moving averages which soon follow in the same direction.

Support/Resistance: Key moving averages now become the new resistance levels.

Prices: Typically decline twice as fast as they had increased. Volatility significantly increases.

Trades: Institutions have already put enormous selling pressure on prices as institutions tend to distribute huge stock positions, millions of shares at a time (as opposed to quietly selling stock a little at a time). Institutions sell at a MUCH faster pace than they buy.

Selling Pulses: Show increased momentum, are much longer than buying pulses and are at sharper angles than buying pulses.

Breadth: Continues to weaken (readings moving lower), confirming the down trend of the external markets such as the Dow-30, NASDAQ, and S&P500.

Action: Keep in mind that market declines happen *much faster* than advances. At the very least, immediately reduce risk exposure by selling partial or entire stock positions, or use hedging strategies using options. Preferably, sell bullish positions into strength (when major moving averages are touching or close). Initiate long, in-the-money, put positions. (Note: long put positions have the same exact risk/reward features as a short-stock position coupled with a protective call option.) These strategies will be covered in later chapters.

This is the stage that enters the bear market, when downside movements accelerate. Weakness broadens across most, if not all sectors and industry groups. This stage is often marked by rising interest rates.

Just as investors were skeptical of the validity of price action during the beginning of the rising stage, they are also skeptical of validity of price action during the beginning of the declining stage.

At this point, investors have seen stocks move lower right after they bought them. Even investors who do decide that it's time to get out decide that they'll do so "just as soon as their stocks come back up."
This period very often begins when economic news is still favorable, so investors abandon their trading rules, and ignore what the price action of the stock market is telling them.

As Warren Buffett says; "Investors are hopeful when they should be fearful and fearful when they should be hopeful."

Short-term and long-term moving averages turn down at an accelerating rate, and they become key *resistance levels* instead of the *support levels* which they represented during the *rising* stage.

If you have a long-term outlook, you might continue to use weekly charts, and 20- and 40-week moving averages. But since the declining stage has been established and confirmed, investors with shorter-term outlook might use the 200-day or 50-day moving average for exit points on their long positions and entry points to initiate short positions (to bet on and profit from the downward movement).

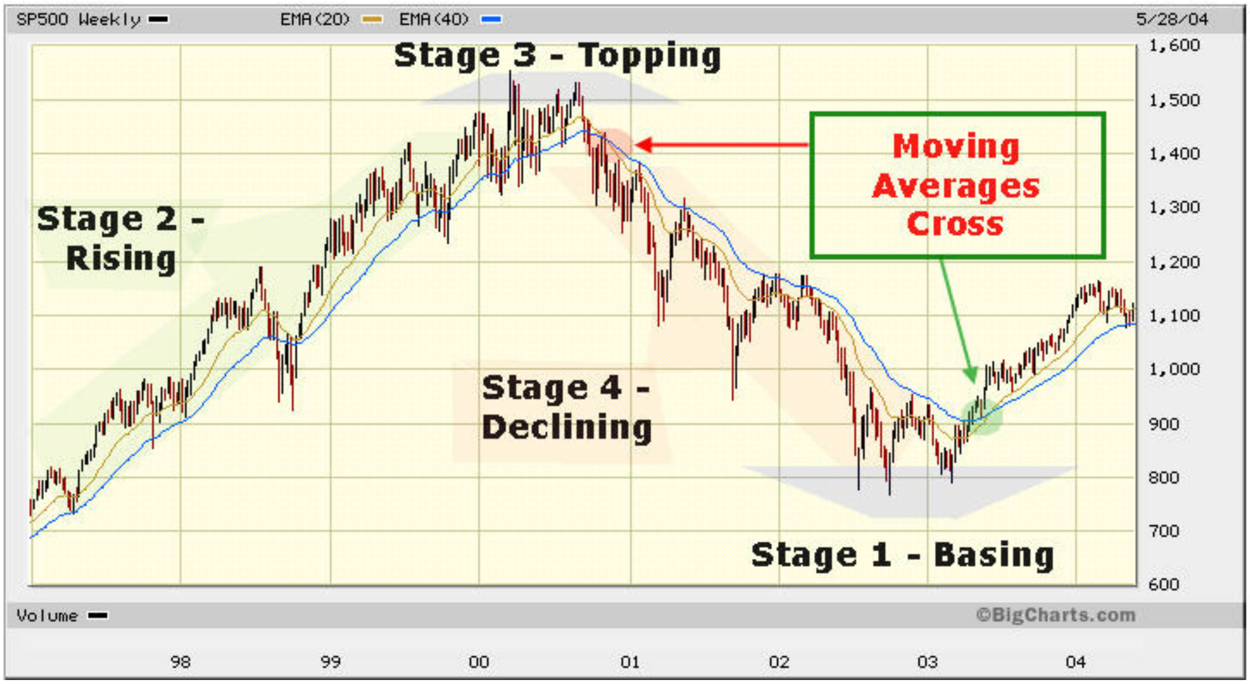
During the declining stage, prices tend to find resistance at these levels. Prices usually don't stay above the 50-day moving average for long, and any moves above the 200-day moving average are usually considered major selling (or shorting) opportunities.

Selling at what may appear to be a relatively large loss during this stage is the hardest thing for investors of any caliber to do. Most investors hold on, as they have been trained to believe that the very long-term trend of the market is up and, therefore, that they will be okay. But as we saw from 2000-2002, the NASDAQ dropped by over 77%, and even investors who owned a portfolio of stocks on the New York Stock Exchange lost 70%, 80% or 90% if they were in the wrong stocks.

In hindsight, these investors would love to have had the chance in early to mid-2000 to sell at what, at first, appeared to be a relatively large loss.

Review

This section is meant to clearly identify the technical characteristics of each of the four market stages. However, we took it a step or two further, so let's review the four stages of the market in relation to the key moving averages.



Basing

Moving average: Shorter-term MA starts to move to the upside as longer-term MA continues to decline. Short-term MA moves above long-term MA.

Support/Resistance: Both are established (with the creation of the new trading range), followed by resistance (recent high) being broken for the first time.

Prices: After being below moving averages, cross above moving averages.

Rising

Moving average: Short-term moving averages continue moving higher. Long-term moving averages turn around and begin to move higher with the short-term moving averages (further confirming the change in trend).

Support/Resistance: Recent resistance levels (recent highs) broken. Support found at key moving averages (which are advancing).

Prices: Confirmed by penetration of past resistance levels. Early part of rising stage usually begins with *strong* burst of energy.

Topping

Moving average: Shorter-term MA usually loses upside momentum and neutralizes (flattens), later followed by the same action in the long-term MA. The two MAs move close together and eventually cross paths.

Support/Resistance: Moving averages, which had been considered to be the level of support, are usually violated on more frequent occasions.

Prices: Trading range consolidates, and is usually closer to major MAs. Instead of up trends, the price action becomes neutral (sideways).

Declining

Moving average: Short-term moving averages turn down, crossing the long-term moving averages which soon follow them in the same direction.

Support/Resistance: Key moving averages now become the new resistance levels.

Prices: Typically decline twice as fast as they had increased. Volatility significantly increases.