

Forecasting Short-term Moves in Stock Prices

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Over long periods of time (years) stock prices move in response to economic fundamentals. Over shorter periods (6 to 9 months) monetary policy has an important impact. During very shorter time periods (days and weeks), stock prices tend to move in response to investor psychology.

Gauging investor psychology can provide useful insights to forecasting short-term moves in stock prices. For over 4 years I have included a measure of investor psychology in my weekly economic and financial updates. Measures of investor psychology are positive (numbers greater than 5), neutral (the number 5) or negative (numbers less than 5). The specific numbers depend on technical factors, primarily the momentum of recent market moves and the volume associated with those moves. For purposes of gauging psychology I analyze a broad proprietary index of more than 8,000 stocks. The average price of a typical share is currently about \$26 a share. Since you cannot purchase this broad Index of stocks, I use the S&P 500 Index to measure the success of this technique.

Analysis of investor psychology (sometimes referred to as technical analysis) is somewhat subjective. It will seldom signal the exact peak or trough in stock prices. The analysis is strictly a market-timing tool. In a strong up market the best the timing indicator can do is make sure you are in the market to take full advantage of the upward move. Given the assumption of purchasing the S&P 500 Index, the approach would not be able to outperform the S&P in an up market. The main value of the tool comes in down markets, when getting out of the market before a major decline can prevent significant losses.

The chart below shows the S&P 500 with a color code denoting the *actual* readings presented in my weekly reports over the course of the past 4+ years. My personal investment strategy has been to buy stocks whenever psychology turns positive and sell whenever it is not positive. This is a fairly conservative strategy. A more aggressive strategy would be to sell or sell short when psychology turns negative or leverage up when psychology is positive. Over this time period, the S&P 500 increased by 18.6%. My relatively conservative strategy (shown by the solid blue line) produced a gain of 30%. Most of the gain was the result of being out of the market during much of the decline in 2002.

Investor Psychology & Subsequent S&P 500 Moves

(Positive psychology in green; Neutral in yellow; negative in red)



Investor psychology as it appeared in Dr. G's weekly update and subsequent moves in S&P 500.