

Forecasting Short-term Moves in Stock Prices: An Update

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Over long periods of time (years) stock prices move in response to economic fundamentals—earnings and interest rates. Over shorter periods (6 to 9 months) monetary policy has a major influence. For shorter time periods (days and weeks), prices tend to move in response to investor psychology. Efforts to measure investor psychology are referred to as technical analysis.

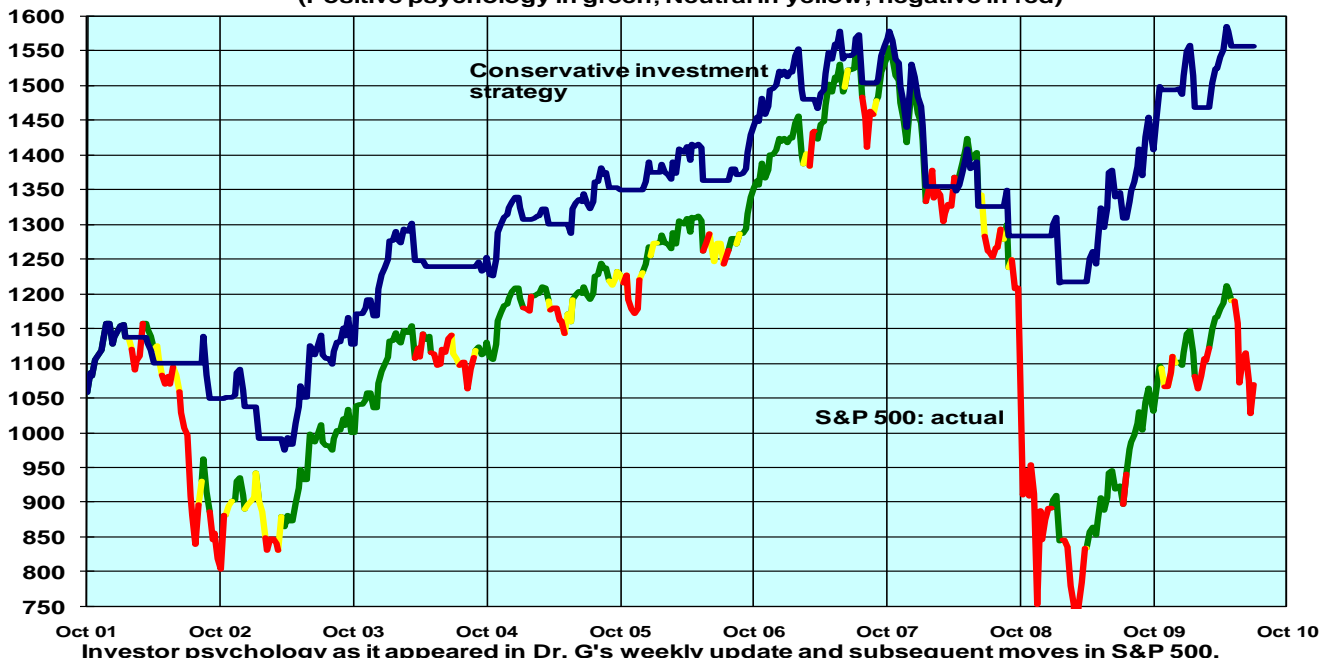
For the past 9 years I have included an estimate of investor psychology in my weekly financial reports. My indicator is presented on a scale of 0 to 10, where five corresponds to a neutral position. Numbers greater than 5 correspond to positive psychology and suggest that the odds favor rising stock prices. Numbers less than five correspond to negative psychology and suggest that stock prices are likely to fall.

A Real-Time Record

The chart below shows the S&P 500 with a color code denoting the *actual* readings presented in my weekly reports. My personal investment strategy over this period has been to be almost fully invested in stocks whenever psychology turns positive (green) and sell almost all stocks whenever sentiment turns either neutral (yellow) or negative (red).

Over the period that I have provided this indicator the S&P 500 gained 1% while my strategy (shown by the solid blue line) has produced a gain of 47%. The value of correctly gauging investor sentiment comes from being out of stocks during down markets. An opportunity cost is associated with being out of the market when stock prices are increasing.

Investor Psychology & Subsequent S&P 500 Moves
(Positive psychology in green; Neutral in yellow; negative in red)



During bull markets, the best this approach can do is to match the gains in the S&P 500 by consistently maintaining a fully-invested position. As the chart shows, on several occasions my assessment of investor sentiment had me out of the market when stocks were moving higher and invested when the market was moving lower.

Should We Always Be Fully-Invested?

It's clearly a mistake to be out of the market when stocks are moving higher. If the long-term market trend is up, holding stocks all the time makes sense. However, if economic fundamentals turn negative, stock prices can suffer for an extended period of time. Moreover, negative psychology and monetary policy mistakes can send markets lower even during the best of times.

It's also possible that a shift toward negative psychology can provide advanced warning of an upcoming negative change in either economic fundamentals or monetary policy mistakes. This is what appears to have happened in the recent bear market when the possibility of a negative shift in these factors may have shown up first in the market's technical indicators.

The current shift away from classical economic principles means that long-term economic fundamentals are likely to deteriorate. Unless there is a shift back to sound economic policies, the longer-term trend in the market is not likely to be positive. During periods when economic fundamentals are negative, technical analysis can be helpful in timing purchases and sales of stocks to take advantage of shorter-term moves in stock prices.

Different investors have different objectives and alternative tolerances for risk. My own preference is to place a premium on protecting assets while still attempting to take advantage of the market's potential for gains. During the first part of this year (up to the close on July 8th) the S&P 500 was down 4%. My strategy produced an increase of 3%.

Gauging Investor Psychology

Determining investor psychology involves analyzing technical factors. The idea behind technical analysis is that markets in motion tend to stay in motion until a contrary force sends them in another direction. In assessing the market's direction, 10 and 50-day moving averages have often provided useful guides. When the 10-day average of stock prices moves above the 50-day average it has been termed the "cross of gold." As its name suggests, the "cross of gold" is associated with positive psychology and further upward momentum. When the 10-day average moves below the 50-day average it has been referred to as the "cross of death." The "cross of death" has been associated with downward momentum.

It's important to determine the appropriate market index that provides the best assessment of the market's momentum. After analyzing daily stock movements for almost two decades, my main choice is an equal-weighted index of more than 8,000 stocks produced by vectorvest.com. In addition to moving averages, trading volume and the behavior of other popular indexes can provide additional clues to investor sentiment.

Determining investor psychology can be somewhat subjective. This is particularly true when factors such as Fed policy come into play, as is currently the case.

Stock prices incorporate the collective wisdom of all investors. My objective is to respect and interpret this wisdom so as to profit from gains when conditions are positive and get out of the way when they turn negative.

While my approach has been personally rewarding, I have never made a major decision to buy or sell with complete confidence. Predicting short-term moves in stock prices is a lot like playing golf. Both are often humbling experiences, where embarrassing moments are inevitable. Anyone with an ego should avoid such activities.