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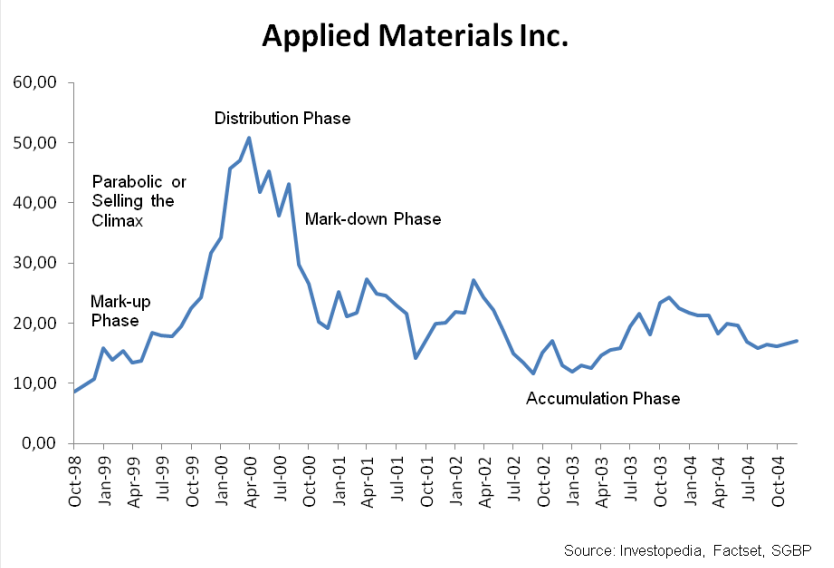
LEVEL

Market Cycles – Understanding the Principles

All markets move in a cycle, they go up, peak, go down, bottom out and then start rising again. The end of one cycle marks the beginning of the next one. Understanding cycles is essential to make the right investment decisions and maximise returns. A cycle could last for a few weeks to a few years. Most of the time, investors fail to recognise the beginning or the end of a market phase. It is difficult to identify the top or the bottom of a market cycle. Market cycle is characterised by four phases: (1) Accumulation Phase, (2) Mark-up Phase, (3) Distribution Phase and (4) Mark-down Phase.

Accumulation Phase

This phase begins when the market has bottomed and value investors and smart money managers enter the market on the expectation of a pick-up in growth. The valuations are attractive in this phase; however, the market sentiment is still bearish. Even those investors who were holding on to stocks in the worst of the bear market lose their patience and sell their holdings. In this phase, the asset prices have bottomed and there are a few value pickers willing to buy assets at a healthy discount. Overall, market sentiment begins to turn neutral from negative, and this is where long-term investors should buy to maximise their long-term gains. The accumulation phase is characterized by rounding bottom or an inverted head and shoulder pattern, also called a 'W' pattern. The rounding bottom is the most accurate pattern for determining the accumulation phase. The figure beside shows the different market phases of Applied Materials during late-1998 to end-2004. In this chart, the accumulation phase can be seen in the period from October 2002 to October 2003.



Monthly chart of Applied Materials Inc. (AMAT) from late 1998 to end-2004 showing different market phases.

Mark-up Phase

In this phase, the market direction and sentiment have changed. The market begins to move up higher and is characterized by higher lows and higher highs. The price breaks out of the range and begins an up move. The institutional investors have already established a position and some retail investors begin to enter the market. This is the most profitable time to own a stock.

The earlier this phase is recognised, the higher is the profit potential. The best way to recognise this phase is to determine if assets are forming higher lows and higher highs, confirming the start of a new uptrend. As this phase comes to an end, the late majority (mostly retail investors) begins to enter the market. The valuations begin to look expensive as investors get greedy and begin to follow the herd.

The smart money takes advantage of the increasing demand for stocks and begins to offload its asset positions. As the stock price rise slows down or may even see a minor correction, the retail investors sitting on the sidelines see this as a buying opportunity and jump in en masse. At this stage, the prices are near to the peak, and make one last parabolic move, showing rising volumes before hitting a climax. This phase of the market cycle is near the culmination of the bubble as sentiment shifts from neutral to extreme bullishness. As can be observed in Figure 1, the mark-up phase for Applied Materials began in the last quarter of 1998 and extended to March 2000 when the market neared the buying climax, indicated by high trading volumes and a dramatic upward movement in price. At this stage, the smart money would have started offloading its stock positions. The stock made the last parabolic move as retail investors continued to buy and it reached the top in April 2000.

Distribution Phase

In this phase, the bullish sentiment witnessed in the mark-up phase begins to turn into nervousness. Here, the smart money has exited its stock positions as sellers begin to dominate. Prices can stay in the trading range for a few weeks or even months. At the end of this phase, the market reverses its direction and begins to retreat. The valuations in this phase are very expensive and the investors begin to experience fear combined with hope and even greed as the market may at times appear to be rising again. The best way to identify a top in this phase is through understanding chart patterns, most notably, the head-and-shoulder pattern and double-top formations combined with a breakdown the 200-day moving average. This phase is characterized by the end of bull market and the start of bear market. On the chart, the distribution phase began in May 2000 and ended in July 2000 when the stock broke below the 200-day moving average.

Mark-down phase

The final phase in the market cycle is when the market sets on a downward trend; however, many investors still hold on to their investments hoping that markets would recover, and they would get an opportunity to exit. This is the most painful period for those still holding a position as they would have incurred heavy losses and would be forced to sell at low prices. This phase is characterized by a loss in asset value of as high as 50%. Conversely, this is a buy signal for many value investors and smart money that now enters the market and buys stocks at deep discounts enjoys the upside in the mark-up phase. Ideally, investors should be buying at the end of this phase; however, it is difficult to determine the bottom. Thus, rather than trying to identify the end of this phase (bottom-fishing), which is like catching a falling knife, the best strategy for the investors would be to wait for the accumulation phase. Conversely, traders short the stocks in this phase. In the chart of Applied Materials, the mark-down phase is a period from July 2000 to September 2001 during which the stock corrected more than 50%.

In addition to the above stages of the market cycle, there is also a sentiment cycle which is based on the premise that human emotions are backward looking. The investors/traders get influenced by the performance of their previous trades. However, the drawback is that these emotions often lead traders/investors to a wrong direction as they have no predictive value.

As financial markets price in the state of the economy about three to six months in advance, the market cycle is a leading indicator of the economic cycle. For Instance, if the economy is in recession, the market begins to look ahead to a recovery. There are five stages of an economic cycle: (a) Initial Recovery, (b) Early Expansion, (c) Late Expansion, (d) Slowdown and (e) Recession.

Conclusion

Despite the well-defined phases of the market cycle and the economic cycle, it is difficult for investors and traders to correctly anticipate the beginning of a phase in a market cycle and an economic cycle. The market takes into consideration both fundamental and technical indicators, such as historical price and the volume data, to gauge the cyclical behaviour. It is difficult to clearly differentiate the various phases of a market cycle as it rarely has specific beginning and ending points. Watching carefully the signs the market is exhibiting on the future economic conditions can give great insights into which stage the economy is in.

Reference /Sources: Investopedia