Weekly Perspectives

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A Weekly View of Global Economies

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The Dow industrial index has hit new highs and other stock-market indices, in the United States and elsewhere, are also doing well as investors price in a soft landing for the US economy. Volatility indicators show few signs of rising from their low level and risk appetite remains high. There is an old saying among traders that you shouldn't fight a trend. But it is also well to remember that this is a momentum-driven market and at some point the trend will end.

Market moves are as much about psychology as about fundamentals. Often people will buy merely because prices are moving higher, and this applies to amateur as well as professional behaviour. A bull-run can be sustained as investors jump on the bandwagon. And, of course, in a falling market there may be incentive for further selling as folks cram through the exit door.

Once a trend gets underway, possibly because of a positive set of fundamental information, a number of psychological factors may come into play. Those who had not participated in the initial upward move feel regret about having missed the boat and are wont to jump in. Others are motivated to enter because of what behaviouralists call hindsight bias. In other words - - after the fact that the trend has already started - - they, now, think that they always knew it was going to happen and start buying.

Due to the above actions, a positive feedback loop gets under way; rising prices beget further price rises. At this point, technical analysts, who are always on the lookout for trends that they can ride, get in on the action. The momentum strengthens and the further upward move in prices convinces many others that the trend will continue.

Meanwhile, the media start to run a multitude of stories on the bullish trend. A lot of headlines attract further attention. Not to be outdone, Wall Street analysts, whose optimistic bias is well known, join in the cheering. In this atmosphere, people become selective in exposing themselves only to information that seems to confirm their behaviour and attitudes. Not only that, but they may also misinterpret information in the direction of their biases.

At this stage of the bull-run we also notice the prevalence of adaptive attitudes and consensus-forming behaviour. Another factor that may extend the trend is the action of short-sellers, who are forced to issue stop-loss buy orders. However, at some point, the trend starts to lose momentum as doubts arise, among certain groups of investors, about the sustainability of further price rises. The smart money will quietly exit the market before a top is reached.

In understanding how trends are formed and propagated, we have drawn freely from the psychological insights of the behavioural school in economics, which has been gaining stature in the past couple of years. The gist of their analysis is that it is very difficult even for experienced market participants to override deep-seated psychological tendencies.

The best traders, such as the famous Jesse Livermore, are adept at reading the mind of the market as well as understanding their own motivation. For most people, this takes a lot of practice and experience. Riding a trend, exiting the market and closing out losing positions require independent thinking, as well as a good risk-management system. As for the role of the media, it is said that Livermore always interpreted media content not in terms of what was being propounded but what its impact would be on the way other investors think.

Turning to the Fed, it is playing it cool and saying nothing that would upset investor calculations. Its stance is still very much data dependent. Some Fed notables have made comments about being vigilant regarding inflationary pressures. Others are saying that the housing market has stabilised and poses few risks. Well, one would hardly expect policymakers to fuel worries about the state of the housing market.

But historically, it would be unusual for this sector to make such a fast turnaround. Currently, there are few signs of an upturn in the majority of housing-market indicators. So the best bet is that housing will act as a drag on GDP growth for the next few quarters. There are offsets for the household sector, of course. The labour market and wages are holding up well and oil prices have moderated.

Low oil prices are premised on a prospective slowdown in global growth, as well as high production rates by oil producers. However, both of these factors may see a degree of reversal. Soft-pedalling by central banks could result in a more modest growth slowdown than expected. Also, OPEC appears to show some resolve in implementing production cuts to defend a minimum price for oil.

High US crude oil inventories, indicating oversupply, have prompted the cartel to formulate a response. Earlier, there were doubts among traders whether OPEC was united enough to take effective action. But it looks like squabbling among its members has been replaced with a measure of cohesion. Still, over the next few months, people will be watching carefully to see if cheating breaks out. If the global growth-slowdown is sharper than expected then the chances of OPEC members producing above quota increases.

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