
Investment Basics-XXV Volume and the Bull-Bear Cycle

ABSTRACT

Four basic assumptions on the relationship between market behaviour and price action enable a descriptive model of changes in turnover during a complete bull-bear cycle. It is found, contrary to common wisdom, that an increase in volume does not necessarily confirm the ruling trend. Instead, when turnover begins to increase following a period of sustained rising or falling trend, it may well signal the end of that trend. This fact can be used to anticipate changes in the trend.

Go with the money – this is one of the more popular rules of thumb used by many people in the market. It means that one should follow the lead given by an increase in turnover:

*If the price is increasing on high, rising turnover, it must mean that clever people in the know must be buying.

*If the price is falling on increasing turnover, it means that the clever people are selling.

In either case, so the contention goes, high turnover reveals that the clever people are favouring the ruling trend, and to make money one should follow their lead and do exactly the same.

Unfortunately, this is not always so. Consider the following model for market behaviour during a bull-bear cycle. The model is founded on four assumptions:

- a) When demand exceeds supply, the price will rise.
- b) When supply exceeds demand, the price will fall.
- c) In a rising market, sellers tend to withdraw to wait for higher prices.
- d) In a falling market, buyers tend to withdraw, to wait for lower prices.

The first two assumptions, perhaps better described as truisms, are well known, as they have been used by Joseph Granville as the basis of his On Balance Volume indicator.

The other two assumptions are supported by observation. When a market is in a firm upward or downward trend, turnover is generally lower than it had been at the start of the trend.

Consider a complete bear-bull-bear cycle, beginning just after the market had topped out at the end of a bull phase.

The transition from the bull phase into the bear phase of the cycle takes place when prices no longer increase over the previous close, but begin to show a decline.

The first reaction of actual and potential buyers when they detect the change in trend, would be to withdraw from the market and adopt a wait and see attitude. At least initially, their interest in the market would remain high, and their intention would be to delay the purchase of the shares they want only until they could obtain them at a better price.

According to the assumptions, when prices continue to decline, many prospective buyers will elect to remain out of the market until the bear trend has definitely ended.

Holders of shares react in one of two ways when the market turns at the top. Once the down trend is established, holders with firm stop loss discipline will sell aggressively at any price. This will help to bring prices lower. Other holders will withdraw from the market. They will wait for the 'correction' to end, and a resumption of the previous bull market. Only when the bear market shows no sign of an imminent reversal, do these holders become eager sellers.

The net result of the reduction in active buyers and, initially, in the number of sellers, is a sharp fall in the turnover of both the volume of shares traded and in the money value of daily turnover.

During most of a long bear market, the turnover remains low. Prices drift lower. The only reason why prices do not plummet steeply, is the absence of demand. Trades are few and far between, and tend to occur near to previous traded prices. The net effect is that prices decline gradually over time.

At some point in time, prices would have fallen to levels where the shares, particularly those of quality, are good value for money. At this time, institutions will return to the market. Fundamental analysis will identify these opportunities, and will trigger buying of selected shares.

By now, many holders of shares are desperate. They have seen their paper profits evaporate during the bear market and are keen to sell before prices fall even lower.

When buyers begin to return to the market, supply still far exceeds this early demand. In this buyer's market it is relatively easy to obtain shares at a price lower than the previous trade, because the brokers would have been instructed to accept any reasonable bid.

The paradoxical situation now arises where buying interest returns to the market, turnover increases, yet prices decline at a steeper rate. Since the quality shares lead the way, the change is evident to the whole market. The 'Go with the money' syndrome is activated, and sellers flood the market, driving prices even lower.

Of course, the lower prices makes all shares more attractive to the fundamental analyst, so that more and more buyers enter the market. The buying spree that develops sooner or later exhausts the supply, and buyers then find that they have to raise their bids to obtain the shares they want.

Prices bottom on very high volume. When prices begin to recover, a last round of selling takes place, as some holders of shares 'sell into the correction'. Then, as the upward reversal in the trend is confirmed, the sellers withdraw to await higher prices, and buyers continue to raise their bids in competition for the scarce supply.

Turnover is suddenly much lower than at the turn of the market, and it remains low during the now established bull phase.

At some point in time, prices reach a level which some holders of shares consider unrealistically high. They decide to take a profit, and become sellers. Volume picks up, and the outstanding demand is gradually satisfied as more and more sellers decide to take profit.

Soon supply balances demand, and prices levels off. Any further selling pressure will cause prices to decline, and will herald the start of a new bear cycle, and a concomitant fall in volume.

CONCLUSIONS

This descriptive model of how volume varies over a bull-bear cycle, shows that there are two occasions when the rule of thumb, 'Go with the money' will be the wrong advice. Just before a bottom reversal, near the end of an extended bear trend, the initial entry into the market of new buyers will result in an increase in turnover, while, at the same time, prices at first fall steeply.

Secondly, approaching the end of a bull market, there will also be a sharp rise in turnover, on increasing prices, when sellers begin to enter the market.

While the advice may initially seem correct for the duration of the final move in the price, the imminent change in trend will prove it false.

Good turnover just before, during, and just after a bottom reversal at the end of a bear trend is a positive sign, revealing that

it is likely to be more than merely a temporary correction. On the other hand, an increase in turnover following a sustained rise in prices, and accompanied by a leveling off in the bull trend, must be interpreted as a sell signal.

REFERENCES

Joseph Granville. Strategy of daily stock market timing. Prentice-Hall 1960.