Reading the Stock Market's Tea Leaves, or How Volume Speaks Volumes!

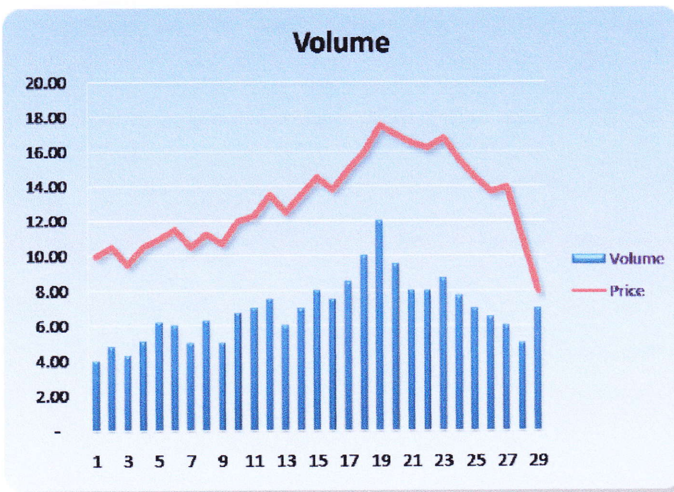
by IMCZ Treasurer John Henry Smith

To succeed in the stock market, an investor not only needs to be in the right stocks, but he also needs to get his timing right! Clearly, the latter has everything to do with analyzing economic and market conditions. As of May 22, the S&P 500 rallied from its March 6 low by 31%, mainly on the mysterious sightings of 'little green shoots'[1]. However today the stock market is awash with pundits forecasting a correction! Whether mild or severe is anyone's guess, but at least we know from five decades of analysis that if a correction does materialize 75% of stocks are likely to decline. While one should take into account a growing body of market sentiment, can investors themselves read the market's tea leaves in order to respond in good time to a fall in the stock market? The answer is clearly yes and lies in the daily interplay between volume patterns and stock prices.

The Interplay of Price and Volume

The biggest drivers of stock prices are the institutional investors, such as the mutual, hedge, pension and electronic traded funds. When they are on the move they tend to generate high volume bursts that significantly affect the market. Therefore, the best way to gauge the market's health and direction is to monitor the daily price and volume actions of leading indexes, such as the Dow Jones Industrials, the S&P 500 and the NASDAQ if not your own stocks.

In bullish markets, as the graph shows, prices and volumes tend to rise and fall together with buying pressure characterized by greater volume on the upside. But as the stock market is never linear, even in the best of bull markets, there will be days when prices fall. Whether this is ominous or not rests with its accompanying volume. Lower volume would tend to indicate normal bullish behavior, since the majority of investors are still holding on to their stocks in the expectation that prices will continue to climb. Consequently, a short-term pattern of falling prices and volume within a period of optimism is not enough to turn a rallying market downward; thus it is no cause for alarm, since markets need to take periodic profits, and retest where they came from so that they can continue to build on firmer ground.



One cause for concern, however, that would certainly require investors to study their tea leaves more carefully is when the market shoots up to new highs on lighter volume, since it would indicate a lack of institutional buying interest, and may be signaling a key market decline.

Sounding a little contradictory, evidence shows that market cycles over the last 50 years have indicated that it takes as little as three to five heavy selling days over a period of up to four weeks to turn a market's uptrend towards more southerly climes. Every major market top in the past 100 years has revealed this negative price-and-volume correlation prior to the market's downtrend.

The normal patterns of bearish markets, as shown on the right side of the graph, are characterized by prolonged falling prices and volumes, interlaced with very short rallies with increased volumes as short-sellers cover their positions and optimists rush in where angels fear to tread.

One severe exception to this is when on singularly bad to catastrophic news, such as the bankruptcy of Lehman Brothers, between October 1 and October 10, 2008, the Dow fell 21.97%. On the last date, volume reached what is known as a 'selling climax', as illustrated on the far right of the graph, from which it began to recede to a normal bear market pattern of declining volumes and prices.

An Example from History

Many people think of the great crash of 1929 as being a sudden, inexplicable event. This is not so. In late 1929, just before the Dow gave way to a selling avalanche, the index posted a flurry of down-days, each on ever heavier volume, all of them saying to investors: "Get out!" This activity pinpointed the mass exodus by institutional and professional investors—the heart and soul of the market. You might be asking how such an event 80 years ago can tell us anything about today's market. The answer is that in the stock market, as everywhere else, history continually repeats itself because human nature (hope, greed, and fear) doesn't change.

The NASDAQ flashed similar warning signs in the spring of 2000, although almost everyone missed it because they were caught up in the predictions and hysteria of the moment. By March 30, the market had logged a series of heavy selling days, a sign that a number of mutual funds, pensions or other big players were selling stock. The market column "The Big Picture" of the U.S. national newspaper Investor's Business Daily even warned people to get off margin, to begin raising cash and only remain invested with extreme caution. The article was not visionary, but only reflected what the market's price actions and volumes were clearly signaling to investors: to sell!

And the Moral in the Cup is ....

That the first priority is to preserve your hard-earned capital! Without a proper understanding of the patterns of price and volume, as amoral as the market is, it will not hesitate to pour much of your wealth down the drain, leaving you with the stinging feeling that each day the market had left a warning in your tea cup to ponder over. However, if you would be responsive and turn your attention to market volume, you will be better able re-tune your assets to a higher level of safety, so that the next time you look at those tea leaves at the bottom of your cup you will certainly see a smiling face.

[1] Frequently discussed on CNBC by market analysts