

The Pro Shop

A March Massacre?

By Scott Patterson
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DON'T WORRY: WE won't bore you with a lengthy analysis of how economic theory has recently undergone one of the most dramatic upheavals in its history. We won't bandy about terms we last used in college (usually inappropriately) such as "cognitive analysis" and "efficient-market theory." We'll leave that stuff to the experts.

What we will tell you is that people are using all of that fancy technical jargon to make money in the stock market. Interested now?

One such person is Woody Dorsey, author of the recently published "Behavioral Trading" and the publisher of Market Semiotics, a weekly forecast of financial trends emailed to subscribers. Dorsey applies methods learned in behavioral-finance theory, until recently confined to obscure niches of academia, to the real, often messy world of the marketplace. His results have been impressive.

Last summer, for instance, Dorsey noticed, using a metric that tracks certain thought patterns in the market, that the threat of deflation had become a prevailing, dominant trend and had driven bond prices to irrational highs. Accordingly, he issued a call that bond prices had peaked. Soon thereafter, Treasuries began one of their steepest plunges in the last 50 years.

What's Dorsey forecasting for 2004? Read on to find out. (Hint: The word "massacre" comes up.)

SmartMoney.com: Can you briefly explain behavioral finance?

Woody Dorsey: Very simply, behavioral finance is the new investment paradigm that comes after the random walk, efficient-markets paradigm, which posited that markets are innately rational. It's really a very simple idea: Human beings make mistakes. The era of efficiency posited that human beings were these very efficient economic robots, and that was the way everything was modeled. The behavioral paradigm, on the other hand, proposed that people behave irrationally, at least some of the time. Within that random walk, buy-and-hold system, the problem was that there were always a few smart people who were making money, like George Soros and Warren Buffett. There were a few people who were beating the pants off the market, and that shouldn't happen mathematically under the efficiency paradigm.

Trouble Brewing



"What always happens is that there are consequences at the end of the day. Ultimately, the demand boom that's happening in commodities and the reigniting of economies and the ensuing budget deficits will become very problematic down the line."

— Woody Dorsey

SM: Does this mean that investors can time the market?

WD: Yes, exactly. Clearly there are people who regularly do very well in the market. They market-time. They figure the market out, and they know how to work it. I'm very good at predicting markets. Markets are inefficient; there are bubbles. But you also have to remember that everyone makes mistakes, so anyone who tries to time the market is going to make mistakes. It's not a model that totally predicts the markets — we're human beings. That's why things like risk-management strategies such as using stop-loss orders become very important, because you know that you're going to be wrong sometimes. But there definitely are certain basic, large classes of errors and imbalances that one can identify and capitalize on.

SM: You think we're in an "invisible bubble" right now. What do you mean by that?

WD: We had two great extremes last year, and we had the stock-market low in March, what I called the "Iraq-equiphobia low." Those great extremes have produced reversals in the markets and in macroeconomic developments where the economy is recovering. Stocks are doing better, and interest rates have generally been rising, and those trends are still in place. But there always is a bubble developing somewhere, and what I've been saying is that there seems to be an asset dissonance that has been relatively invisible, in that basically, particularly over the last three or four months, everything has been going up — gold, euros, stocks, even bonds had been in recovery range. It's like everybody was winning at musical chairs. As some point, this has to change. Interest rates are going to start rising, and this will produce a lot more volatility in the stock market.

SM: I see you're forecasting a potential "March massacre." How bad?

WD: When you look at the history of markets, they're kind of a narrative. They don't usually go straight up or straight down. We've had a one-way stock market since last March. So I think the market is going to do better through February, and then we're going to get one of these really big corrections in March. It could be somewhere around a 7% to 12% correction. Not the end of the world, but a sharp shakeout.

SM: You also say you expect an interim high in May. So do you advise investors to ride through the volatility, or should they take profits before March and then reinvest after the correction?

WD: That's really up to each individual. The individual investor is quite a varied creature. There are some people who are very aggressive in the market, and I'd say those kind of traders should be looking to put in stop-losses or take some profits, with the chance that we could get one of these shakeouts in March. If you're someone who's putting money into the market every two or three months, I'd say you might want to wait to see if we get a pullback instead of putting it in right here. And don't get freaked out and forced out.

SM: What happens after May?

WD: I think the market will sell off, but it will be kind of choppy for the summer. And I think we might get another violent sell-off in front of the elections as the market has to deal with that uncertainty, and then the elections will come along, and the market will do better until year-end. This may be more of a ho-hum year, not with a huge loss or gain, but with some thrills and spills here and there.

SM: You called for a pullback last fall, but that didn't really happen. Why has the market been so resilient?

WD: The market made a tremendous low in 2003. You had the worst three years in 70 years. You had the longest bear market since the 1929 bear market. So when the market turned around, it had a lot of natural bounce. It is interesting that from the June to the end of October, the market didn't really do that much. It didn't really go up a lot, and it didn't go down a lot. There were some corrections in the fall, but they were short-lived. When a market is unable to correct, it's really a symptom that there's a bigger trend in play. So I think it was the tremendous low that was in place that was driving things.

SM: You say the strong market has been a signal of a "lapdance of liquidity." What do you mean by that?

WD: It's excess assistance from the government and from the Fed, basically. The same thing happened in 1998. The low that happened last year was just like 1998, generically. People were saying that it's the end of the world, there's terrible deflation, everyone is scared of stocks and they're piling into bonds. Meanwhile, central banks are very accommodative. All of that stimulus just comes through and carries the day. It's the primary driver here. It's this sort of obscene initiative by central bankers and governments to pump up the market, and it has worked. Of course, what always happens is that there are consequences at the end of the day. Ultimately, the demand boom that's happening in commodities and the reigniting of economies and the ensuing budget deficits will become very problematic down the line.

SM: How do you read the Fed's signal last week of a change in sentiment toward future tightening of rates?

WD: Isn't it fascinating that it was just a change in sentiment? The Fed is a master of behavioral finance. It's all about expectations and market psychology. The other thing that's fascinating is that this is really about only a couple of words. It's language. And this very subtle interpretation of the language has had billion-dollar moves associated with it. This is a signal that people have been waiting for, and it really is an important structural change. The market had a big reaction to it initially, and it's still digesting it, but this will be important for the next six to nine months, and we will be in a rising interest-rate environment.

SM: Do you think they'll move before the presidential elections?

WD: I do. The interesting thing is that they're in a game where they've already moved the market. We can be in a rising interest-rate environment without them doing anything. But they'll probably move sooner than people think. Once things get going, they tend to happen more quickly. It may depend on what happens with the stock market. But if the Fed feels like it has to move, they'll find some kind of justification. They really have been sitting on their hands for a long time.

SM: It looks like they're waiting for jobs to start to come back.

WD: Yes, at the moment that seems to be what people are fixated on, and that makes the jobs data coming out either this Friday or in March very interesting. My guys are telling me that one of these numbers is going to be a monster, because statistically the last one was so far off base. One of these numbers is going to be a killer, and you're going to get a huge sell-off in bond markets. And that could be a reason why, if we get something that's dramatic and there are some good economic numbers and the stock market is rocking and rolling, the Fed could decide to move sooner rather than later. That could cause an interest-rate shock, which might be what triggers a sharp correction in the market. We'll see.