Untangling the bearish market psychology

Ng Ee Hwa gives investors an insight on using charts to understand market psychology and its signals.

The recent meltdown in the stock markets has hit hard those investors who refuse to sell on the premise that the price is lower than the value of the company. What they were holding at $2 has theoretically become more valuable at $1 but nevertheless, the price is still dropping drastically. Hundreds of thousands of dollars in investments have dwindled to only thousands of dollars. Retirement funds have been wiped out. CPF funds placed in mutual funds have seen double digits losses. Any investor who refuses to cut losses is now facing an uphill climb to just break even on his investments.

This extremely bearish market has emphasised the importance of market psychology and the need to preserve one's capital. Not everyone can afford to wait ten or twenty years for investments to start paying dividends. Capital is needed to make dreams become a reality – be it buying a car, a condominium or going on a world cruise. Hence, this article will try to give investors an insight on using charts to understand the psychology of the stock market participants and from there interpret signals that will affect trading strategy.

Our understanding of market psychology begins by looking at the Straits Times Index (STI), the most important index in the Singapore market. After attaining its historical high of 3,900 in October 2007, the STI has consistently broken key support levels. Such key levels are formed by the significant tops and bottoms of the index movement. A significant top is formed when the bulls stopped pushing the index higher, thereby implying that they do not see much upside at this point in time. Conversely, a bottom is formed when the bears reduced their selling pressure and the index starts to rise, implying that they do not see much downside at this point in time. The breaking of such levels and failure to rise above them signal to investors that the sentiment is weakening. The first warning was the STI's failure to move above 3,620 in early December 2007 and subsequently making a lower top and finally breaking the key level of 3,300 in mid-January 2008. The second warning occurred when the index tested but failed to break the 3,300 level in May 2008 and instead broke the lower key level of 2,750 in August 2008. These warnings sent a very strong signal to investors that they should reconsider their long trades. Those who failed to heed the warnings are now sitting on huge paper losses. Thus, identifying those significant psychological levels are very important to preserving one's capital and building strategies to trade in any market condition.

STI Chart

Source: www.chartnexus.com

STRAITS TIMES INDEX (STI)

Since May 2008, we observed that the STI refused to break the preceding top. In other words, once the STI starts to approach the previous top, selling pressure starts to mount. In such a market condition, investors may look at shorting opportunities whenever the index reaches resistance levels. We also observed that the 20-day moving average is resisting the upward movement (bear rallies) of the STI.

Here are two more stocks with clear support and resistance levels.