Sentiment Speaks: Is The Market Disconnected From Reality, Or Are You?

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Ordinarily, I write one public article every week or so. However, after reading a number of other articles this week, and more importantly, reading the comments section, it has pushed me to consider writing an additional missive this week. And, within this article, I am going to address two topics which seem to have people looking the wrong way all too often.

"The Stock Market Is Disconnected From Reality"

One article after another and one comment after another presents us with the common perception that the stock market is not representing "reality." And, the problem stems from the fact that all of these people view various economic factors as representing "reality," which they then attempt to impute to the stock market price movement. And, when their factors do not match up with price action, their conclusion is that the stock market is not appropriately representative of "reality."

Now, I am going to ask you a simple but key question which should address the main perspective of your thinking that the market is wrong:

Do you invest in the economy or the stock market?

Most people invest in the stock market and not the economy. Yet, too many are easily swayed by various economic factors that lead them to react in one way or another with regard to the stock market. And, then they question why they are often so wrong.

You must begin to recognize that the economy and the stock market are two different entities. And, you will not be consistently successful by analyzing the economy and expecting the stock market to react accordingly on a consistent basis.

The only time that you will perceive that the economy and the stock market coincide and are in alignment is when the stock market is trending. But, at the turns, you will be sorely lagging the stock market, as history has proven that the

stock market turns well before the economy. This is why many believe that the stock market is a leading indicator for the economy.

But, have you ever considered why?

In his seminal book The Socionomic Theory of Finance (a book I strongly urge each and every investor to read), Robert Prechter outlines the reason why the economy and the stock market are to be treated differently. Whereas the law of "supply and demand operates among rational valuers to produce equilibrium in the marketplace for utilitarian goods and services . . . [i]n finance, uncertainty about valuations by other homogenous agents induces unconscious, non-rational herding, which follows endogenously regulated fluctuations in social mood, which in turn determine financial fluctuations. This dynamic produces non-mean reverting dynamism in financial markets, not equilibrium."

Moreover, since the efficient market hypothesis (the basis for fundamental analysis in financial markets) is an outgrowth from the world of economics, it has become quite commonly viewed as an unworkable paradigm for financial markets for various reasons. Understanding that an underlying assumption within economics is ceteris paribus, and an underlying assumption in the efficient market hypothesis is that all investors act rationally and with the same knowledge, you can easily understand why it is simply unworkable in financial markets.

In fact, Benoit Mandelbrot outright stated that one cannot reasonably apply an economic model to the financial markets:

"From the availability of the multifractal alternative, it follows that, today, economics and finance must be sharply distinguished . . ."

From an empirical standpoint, consider that, within economic theory, rising prices result in dropping demand, whereas rising prices in a financial market leads to rising demand. Yet, most continue to incorrectly apply the same analysis paradigm to both environments.

Now, some believe the stock market to be somewhat clairvoyant or omniscient when they recognize that the stock market leads the economy. Well, let's reconsider that perspective and try to delve a bit more deeply into why the stock market could lead the economy, as opposed to some matter of clairvoyance. I have written about this in the past, and I am simply going to reproduce my explanation:

During a negative sentiment trend, the market declines, and the news seems to get worse and worse. Once the negative sentiment has run its course after reaching an extreme level, and it's time for sentiment to change direction, the general public then becomes subconsciously more positive. You see, once you hit a wall, it becomes clear it is time to look in another direction. Some may question how sentiment simply turns on its own at an extreme, and I will explain to you that many studies have been published to explain how it occurs naturally within the limbic system within our brains.

When people begin to subconsciously turn positive about their future (which is a subconscious – and not conscious – reaction within their limbic system, as has been proven by many recent market studies), they are willing to take risks. What is the most immediate way that the public can act on this return to positive sentiment? The easiest and most immediate way is to buy stocks. For this reason, we see the stock market lead in the opposite direction before the economy and fundamentals have turned.

In fact, historically, we know that the stock market is a leading indicator for the economy, as the market has always turned well before the economy does. This is why R.N. Elliott, whose work led to Elliott Wave theory, believed that the stock market is the best barometer of public sentiment.

Let's look at the same change in positive sentiment and what it takes to have an effect on the fundamentals. When the general public's sentiment turns positive, this is the point at which they are willing to take more risks based on their positive feelings about the future. Whereas investors immediately place money to work in the stock market, thereby having an immediate effect upon stock prices, business owners and entrepreneurs seek loans to build or expand a business, and those take time to secure.

They then put the newly acquired funds to work in their business by hiring more people or buying additional equipment, and this takes more time. With this new capacity, they are then able to provide more goods and services to the public and, ultimately, profits and earnings begin to grow - after more time has passed.

When the news of such improved earnings finally hits the market, most market participants have already seen the stock of the company move up strongly because investors effectuated their positive sentiment by buying stock well before evidence of positive fundamentals is evident within the market. This is why so many believe that stock prices present a discounted valuation of future earnings.

Clearly, there is a significant lag between a positive turn in public sentiment and the resulting positive change in the underlying fundamentals of a stock or the economy, especially relative to the more immediate stock-buying activity that comes from the same causative underlying sentiment change.

This is why I claim that fundamentals are a lagging indicator relative to market sentiment. This lag is a much more plausible reason as to why the stock market is a leading indicator, as opposed to some form of investor omniscience. This also provides a plausible reason as to why earnings lag stock prices, as earnings are the last segment in the chain of positive-mood effects on a business-growth cycle.
It is also why those analysts who attempt to predict stock prices based on earnings fail so miserably at market turns. By the time earnings are affected by a change in social mood, the social mood trend has already been negative for some time. And this is why economists fail as well – the social mood has shifted well before they see evidence of it in their "indicators."

And, as I mentioned about earnings, I have written an article outlining why following earnings will also have you missing the major market turns:

At the end of the day, there is no reality other than price. Therefore, the stock market is reality. And, if you are following anything that suggests that the stock market is disconnected from reality or wrong, well, then it is you who are disconnected from reality.

As Jesse Livermore aptly noted:

"A prudent speculator never argues with the tape. Markets are never wrong, opinions often are."

Therefore, if you want to be a more profitable investor/trader, then you have to learn how to align your reality with that of stock market price.

"Something Bad Is About To Happen"

When bearishness reaches an extreme, it truly has an effect upon investor's psyche, which lingers for quite some time. We can all admit that it is most difficult to buy when the market is most bearish. Yet, many carry that bearish view with them even though the market rallies well off the low. And, have you ever considered why?'

I want to show you a typical discussion that I found in a comments section in a recent article. The first commenter has learned their lesson, and seems to get it. Yet, the response to the first comment seems to be the typical fearful response

which causes many investors to underperform throughout their investment career.

First Comment: “The past few years have proven beyond any doubt, that we all simply need to turn off the news. Put less focus on the macro. And simply follow the charts. Period.

I started investing in the 90's and over the years, made the mistake of letting smart sounding 'experts' influence me several times with their negativity. And my family missed out on tremendous, life-changing opportunities because of it. Never again. Follow the charts. Tune out the noise. Ignore the headlines.”

Response: “yu r correct, until one day yu wake up to a market lock limit down for days…”

The respondent has an issue that affects way too many investors. They develop a bias based upon what they hear and read in the media about the market, and it causes a fear towards investing. This hinders most investors and causes a great deal of underperformance.

Now, while there may be a fear of a massive gap down, it is not a reasonable or logical fear. In fact, I have not seen a single massive gap down without a set up for it. In other words, massive gaps down do not happen out of the blue.

But, have you ever wondered why so many investors gravitate to the bearish thesis more so than the bullish ones? Have you ever heard the term “bearishness sells?”

Well, Roy F. Baumeister, a professor of social psychology at Florida State University, captured the idea in the title of a journal article he co-authored in 2001, "Bad Is Stronger Than Good," which appeared in The Review of General Psychology.

In that article, he explained that those who are "more attuned to bad things would have been more likely to survive threats and, consequently, would have increased the probability of passing along their genes... Survival requires urgent attention to possible bad outcomes but less urgent with regard to good ones."

This seems to cause man to become hyper-focused on the negative, which is driven by his innate desire to survive. Furthermore, when we consider that fear is the strongest emotion generated by our brain stem, we can develop a negativity loop that drives us to continually focus upon the negative by our strongest natural tendencies.

Now, we have a better understanding as to why fear or bearishness sells. Our innate tendencies seem to drive us in that direction, despite all the empirical data to the contrary. While our innate tendencies seem to have been pre-programmed within our brain stems to assist man to survive in a life and death struggle, I am not sure such hyper-focused tendencies help us in all aspects of our current lives in which we clearly allow them to reign, such as the stock market.

But, understanding the market psychology is half the battle. The other half is being able to control your emotions to do what is most prudent. As Daniel Crosby wrote in The Behavioral Investor:

“There is no understanding markets without understanding people . . . trusting in common myths is what makes you human. But learning not to is what will make you a successful investor.”

And, as the members of my services have noted:

“It seems the role of a market participant should be to make money, not browbeat the market for being "irrational". I was beginning to realize that when I found your articles, but your analysis gave me the lifeline I needed to pull myself out of that muck.”

“March 2020 I stopped doing what everyone else was doing, stopped doing the same thing over and over and blowing up accounts, and started listening to Avi. My IRA has experienced 300% return since then.”

So, I am going to conclude with a quote by Isaac Asimov, which I think every investor must take to heart and internalize:

“Your assumptions are your windows on the world. Scrub them off every once in a while, or the light won't come in.”

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