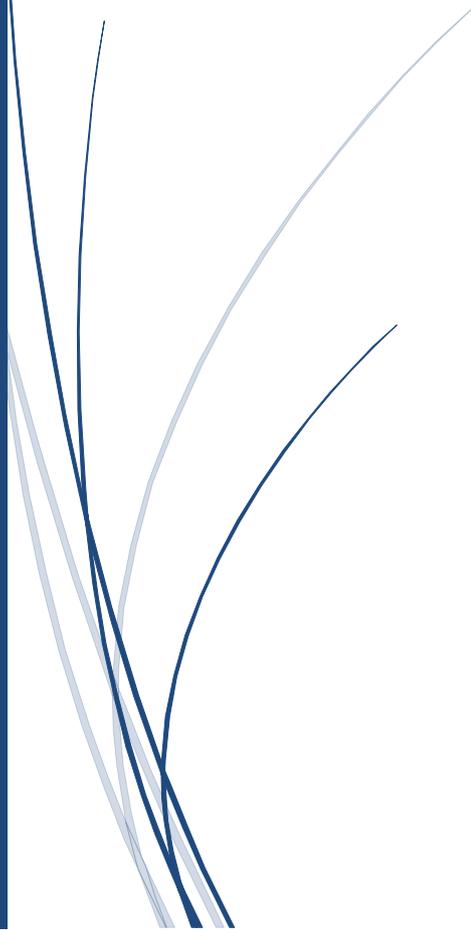




August 2014

Market Review

*The importance of dominant
sentiment cycles*



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Understanding the sentiment cycles in financial stress is critical to generating returns in the current market environment. Sentiment cycles influence the movement of financial markets and are directly related to people's moods. Getting a handle on sentiment cycles in the market would substantially improve one's trading ability.

The present report demonstrates the power and importance of sentiment cycles. In this report, we highlight the importance of detecting cycles in sentiment to spot turning points in financial data. The following case study exemplifies the importance of sentiment cycles and the predictive power of the Dynamic Cycle Explorer (DCE).

The Dynamic Cycle Explorer works on the assumption that cycles are not static over time. Static cycles are misleading for trading purposes. Dominant cycles morph over time because of the inherent nature of the parameters of length and phase. Typically, one dominant cycle will remain active for a longer period and vary around the core parameters compared to other cycles. As real cyclic motions are not perfectly even, the period varies slightly from one cycle to the next because of changing physical environmental factors. This dynamic behavior is valid for financial market cycles as well.

How does the approach work? Every time a new bar appears on the chart, the Dynamic Cycle Explorer reassesses the state of the current dominant cycle in terms of length, strength, and phasing. Subsequently, it updates this cycle by plotting it onto future projections. However, a trader will focus only on the next expected turning point, which is what a market analyst is interested in. The DCE is not used to predict a complete static cycle far into the future. We are interested in determining and monitoring the next turning point based on the detected dominant carrier wave phasing, which is the point in time where we expect the market to turn.

As we move forward in time, every bar signifies an update of the expected turning point by a reassessment of the current state of the dominant cycle length and phase. This dynamic forecast based on the actual state of the dominant cycle provides information about the time and direction of the next turning point. We obtain real-time information about when to expect the next major turning point in the market as we continuously reassess the parameters of the dominant carrier wave. This information is updated every time a new bar appears. This technique was used in the following market report that was published on 8 June 2014 in the publicly available *When To Trade* magazine section.

The St. Louis Fed Financial Stress Index (STLFISI) is a vehicle that can be used to analyze sentiment data. It is created using principal component analysis, a statistical method for extracting the factors responsible for the correlation of a set of variables. Financial stress has been identified as the chief factor influencing the co-movement of its designated market variables; extracting this factor allows St. Louis Fed to create an interpretable index. The index is constructed using weekly data series for a variety of interest rate, credit spread, and volatility measures.

We can apply our dynamic cycle tools to this dataset and see if we can detect important dominant cycles that forecast financial stress extremes. This exercise was performed on 8 June with the DCE. This tool can automatically detect the current active dominant cycle and track the current phasing to forecast the next expected turn. The approach is described in detail in the book *Decoding The Hidden Market Rhythm- Part 1: Dynamic Cycles*.

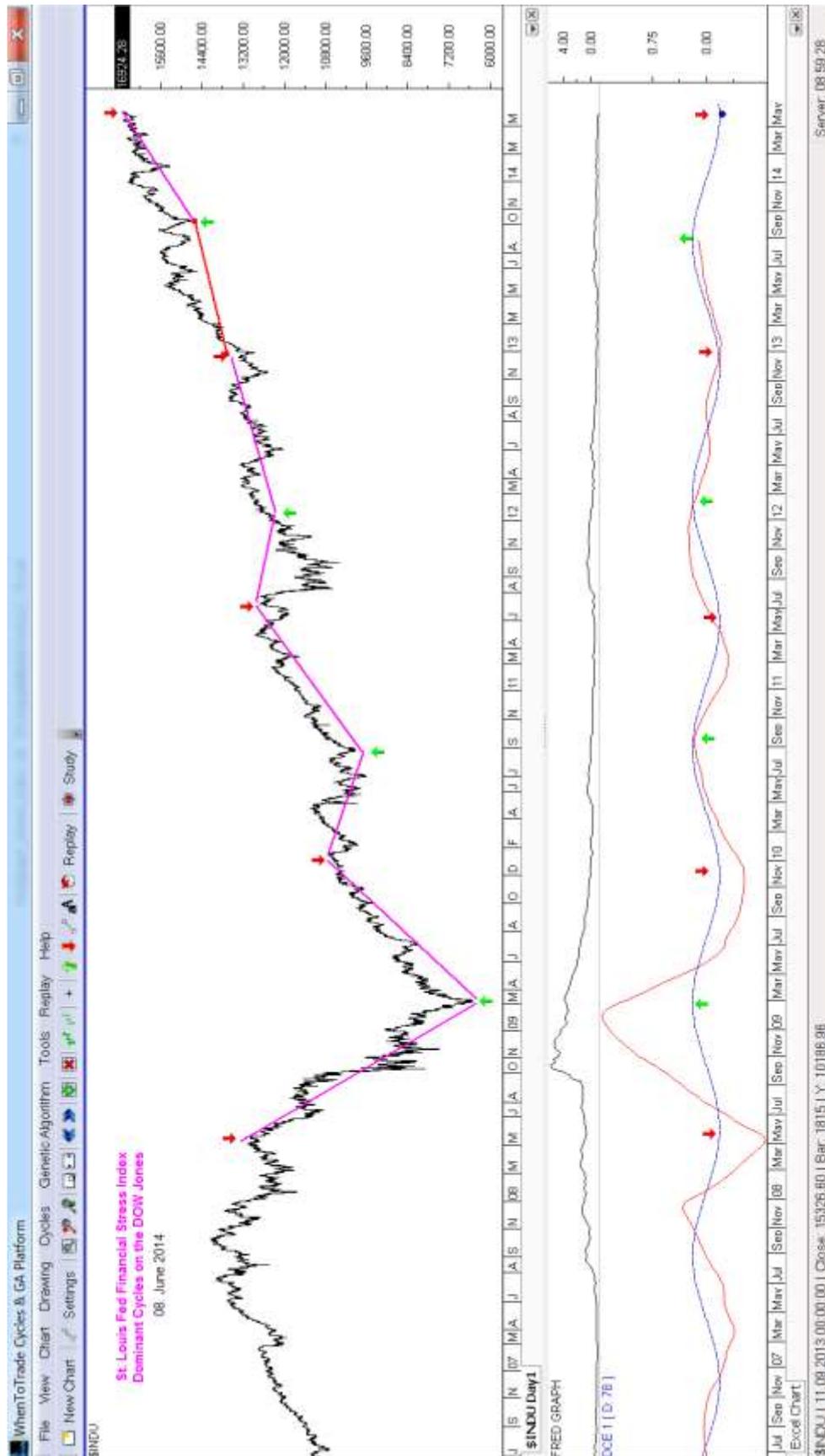


Chart 1: St. Louis Fed Financial Stress Index with Detected Dominant Cycle—78 weeks/cycle low (8 June 2014)

The cycle explorer detected an active “financial stress” cycle with a length of 78 weeks that tracked the latest major market movements. This is shown in the lower panel of the chart where the cycle analysis on the FRED data took place. The source data was accessed via the free Quandl data feed through the symbol FRED/STLFSI and was analyzed with the Dynamic Cycle Explorer in the *WhenToTrade* platform. The blue cycle shows the automatically detected dominant cycle; the major turns are indicated with red and green arrows on the price chart to show the correlation with the Dow Jones Index.

The integrated, dynamic phasing analysis projected a current extreme low in the financial stress index at the point of the analysis (8 June). An extreme low in the financial stress index correlates to market highs. The current low in the financial stress index is also spotted as an expected major low of the current dominant “stress” cycle. Therefore, the DCE pointed to a possible market high at the time of the analysis.

As is often discussed in our articles, one should always crosscheck for other dominant cycles, especially in other timeframes/vehicles. Another sentiment vehicle that is commonly referred to is the Volatility Index (VIX)—often called the “fear” index. A dominant cycle analysis on the VIX showed another sentiment extreme on the daily timeframe. The daily dominant cycle, which was automatically detected with a length of 152 bars, projected a daily sentiment “fear” low on 8 June. Fear index lows also correlate to market highs.

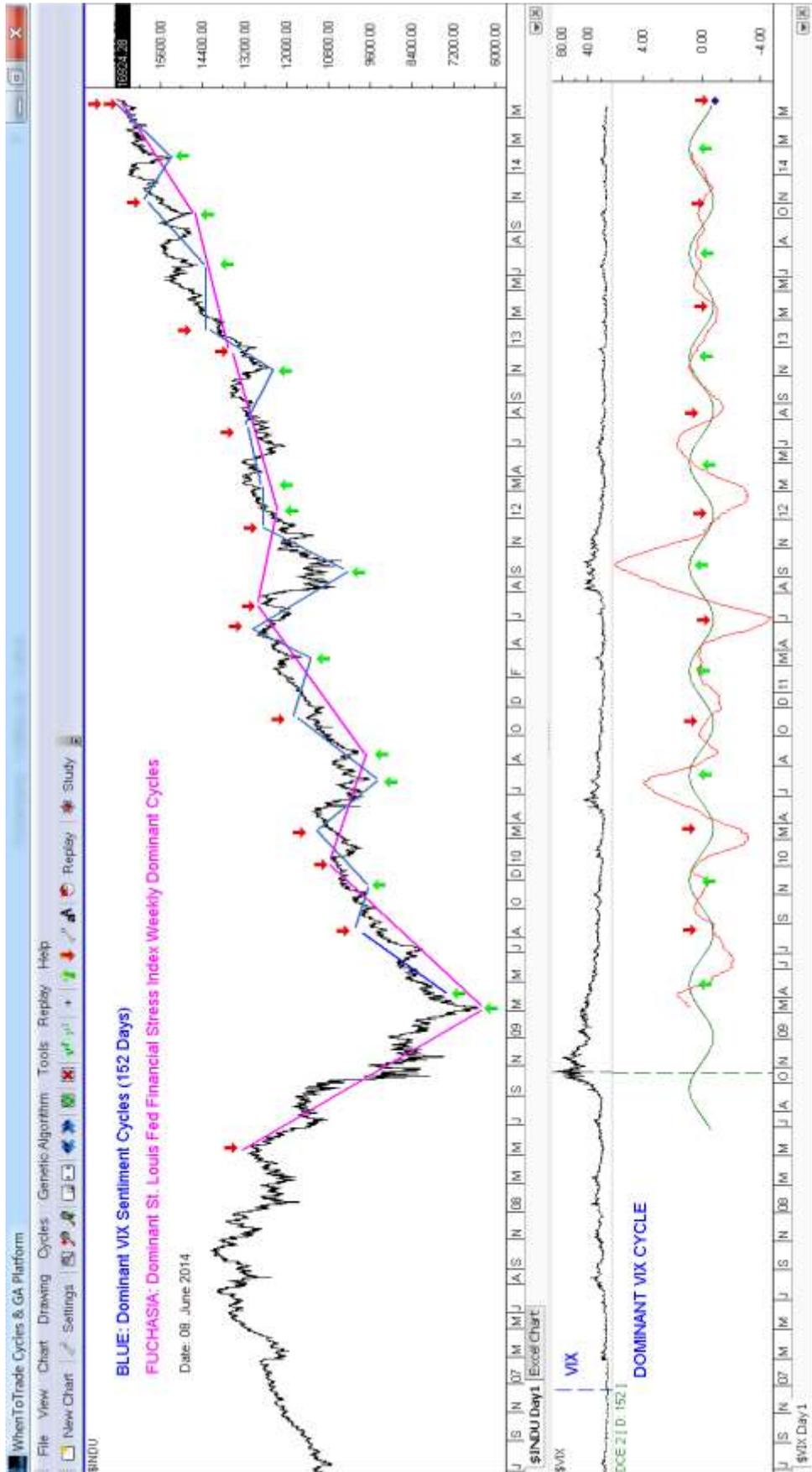


Chart 2: VIX with Detected Dominant Cycle—152 days/cycle low (8 June 2014)

The VIX and the dominant cycle are shown in the lower chart panel of Chart 2. The green cycle was detected automatically by the DCE on the daily data. This cycle (blue line), together with the long-term weekly cycle from the financial stress index (fuchsia line), were mapped to the price chart in the upper window. At the time of the analysis (on 8 June 2014), these two cycles were in perfect alignment, which is a very important cycles-within-cycles alignment.

The interesting point is that we have two different dominant sentiment cycles from different datasets and different timeframes coming into alignment, and both dominant cycles project a current market high.

This analysis together with the forecast of a current market high was posted on 8 June 2014 in the public magazine on whentotrade.com. This real-time cycle analysis that forecast the market high is available at <https://www.whentotrade.com/financial-stress-low-low-low-low-low/>.

Today, on 8 August 2014, a review of the blue chip indexes reveals that the high occurred the very next day after the forecast was published, on 9 June 2014. Both markets registered a sharp decline after the cycle analysis was published.

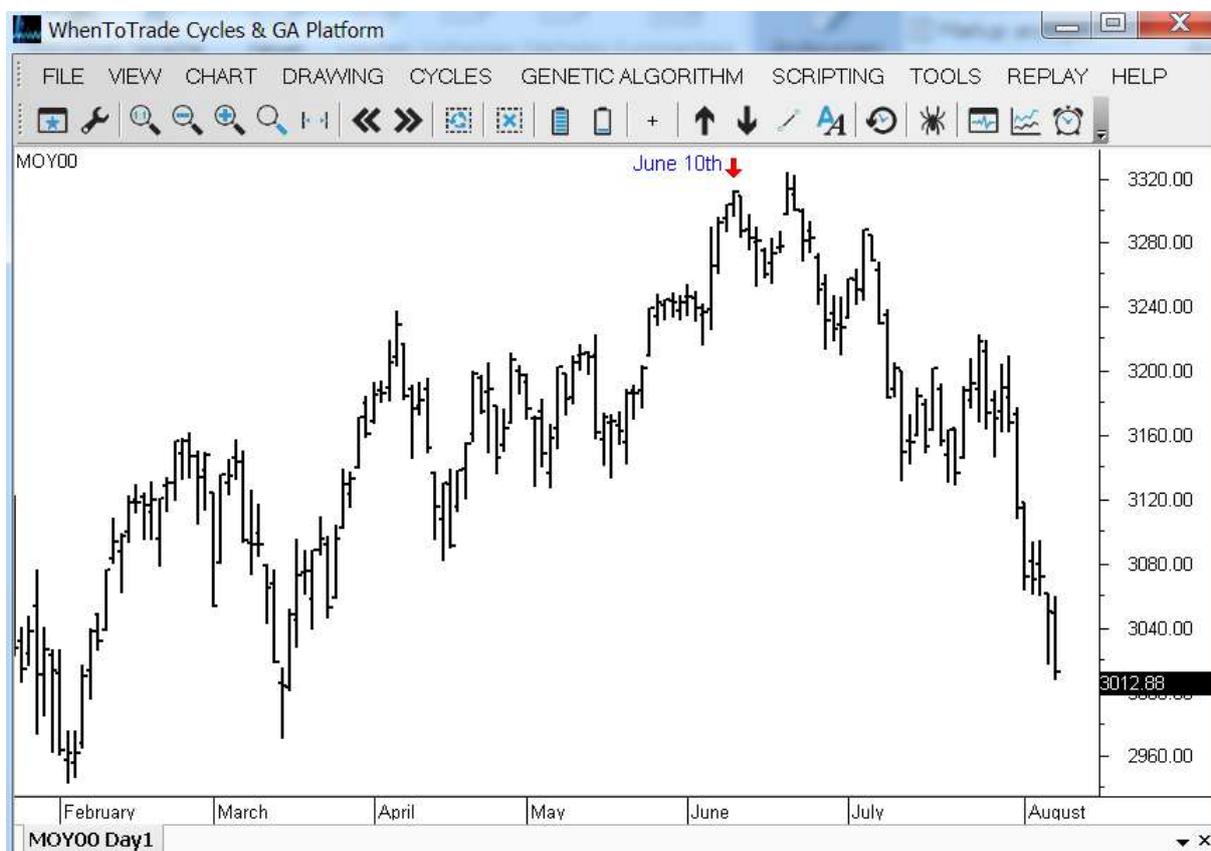


Chart 3: Drop of -10% in European Blue Chips (Euro Stoxx 50) After Cycles Signal on 8 June 2014

International Blue chips registered in Europe dropped by 10% (Chart 3) and the US blue chips of the Major Market Index (Chart 4) dropped over 5% after the cycles signal in the sentiment vehicles.



Chart 4: Drop of over 5% in US Major Market Index (MXI) After Cycles Signal on 8 June 2014

This example not only proves the ability of the DCE to predict sentiment cycles ahead of time but also emphasizes the importance of analyzing dominant sentiment cycles as leading indicators of market turns.

Additional examples and real-time forecasts based on this technique are included in the book *Decoding the Hidden Market Rhythm– Part 1: Dynamic Cycles*.

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