

# STOCK MARKET TRADING IN TURBULENT TIMES REFLECTS THE PICTURE OF THE MARKETS



Stock market prices are always subject to fluctuations. However, the current uncertainty of investors is leading to sometimes violent daily fluctuations. Rarely have so many political and economic uncertainty factors collided, which will massively influence the future development of the global economy.

Dr. Gregor Bauer, Portfolio Manager at Dr. Bauer Consult and Member of the Board of the International Federation of Technical Analysts, examines the explosive topics on the table:

- What other effects will the aftermath of the Covid-19 related lockdowns have, especially with regard to economic developments in China?
- What will be the impact of rising inflation and the announcement of further interest rate hikes?
- How long will the Russian invasion of Ukraine last?

As is well known, the stock market anticipates future macro and microeconomic developments. However, these estimates can be unreliable, especially in the current economic situation. News generates price reactions. But it is not always clear whether the content of the news prompts investors to buy or sell. This also depends, for example, on whether the message has already been priced into decisions made beforehand, or whether investors were hoping for even better data, or worse. In particular, the latter often leads to rising prices.

## The classic decision problem of investors: When do I buy and when do I sell?

A company delivers disappointing quarterly figures, the share price collapses. But the outlook for the coming quarters is positive. The price targets calculated on the basis of the expected earnings figures are significantly higher than the current share price.

The question: act now or wait and see? And if so, what are we waiting for?

Of course, no one can predict the future. But how can traders and investors position themselves in the market in order to achieve the best possible performance?

## The interplay between fundamental and technical analysis.

A price target based on future corporate earnings may seem attractive. But medium to short term oriented investors and traders ask themselves the question of the "right" time, in order not to catch the proverbial falling knife. And when is the "best" time?

## The psychology of market participants (behavioral finance) also plays an important role.

The theory of efficient markets necessarily assumes that investors behave rationally in their investment decisions, i.e., like the "Homo Economicus", the ideal image of the rational investor. However, this is not the case. In recent years, therefore, a research direction has come into focus that deals with the psychological behavior of investors: Behavioral Finance (BF) or Behavioral Capital Market Analysis. The premise of BF is that humans behave rationally only to a limited extent. Therefore, BF investigates the psychology of an investor's decision-making processes in terms of information intake, processing and evaluation. BF thus explains the psychologically conditioned, irrational behavior of an investor when they absorb and evaluate information.

## The charts make emotions visible.

The human psyche influences the investment behaviour of market participants to a large extent. The charts make this behaviour visible. In particular, the psychological influences, which often lead to the erratic price fluctuations, can be recognised in the price charts as emotional patterns.

## The picture of the markets: When do consensus valuations of market participants move prices?

The psychological factors, as described by the research direction of BF, thus play a role in the evaluation and in particular in the change in the valuation of a market. Short to medium-term oriented traders and investors (for example in "swing trading", the trading of the wave movements of a market) wait for the entry for the majority of market participants before finally evaluating new information and implementing it in their trading decisions through corresponding purchases or sales. These can be quarterly figures from companies, economic forecasts or announcements from central banks. The changes in the fundamental-economic consensus valuation are then reflected in the price charts on the basis of the change in the trend pattern.

## The tools of technical analysis help to identify and act on trend changes.

### Changing the trend can generate trading signals

Three directions of trends are distinguished: upward, downward and sideways trends. An uptrend is defined by a sequence of higher highs and lows, a downtrend by a sequence of lower highs and lows and a sideways trend by a sequence of highs and lows of equal amplitude.

Trend changes - and thus possible trading signals - are indicated by diminishing buying or selling pressure. For example, no new positions are built up at prices that are too high according to fundamental valuation standards. The upward trend is broken and turns into a sideways or downward trend, so the selling pressure prevails. For example, if price targets calculated on the basis of profit estimates have been achieved.

## Supports and resistances can reflect fundamental marginal valuations

The term support or resistance is defined by the direction from which the price moves towards such a price range. Resistances are defined as chart zones in which selling pressure prevailed in the recent past and the price has therefore bounced downwards: the underlying market was considered overvalued.

Supports are price areas where prices bounced upwards as a result of strong buying pressure: the market was accordingly considered undervalued. For example, when new information justifies higher earnings estimates.

The recognisable change in a trend direction, therefore, acts as a signal for positioning and repositioning.

## Indicators help to calculate evaluation changes

In addition to the trend changes directly visible in the course of the chart, technical indicators can also help to detect changes in valuation and generate corresponding trading signals. Indicators are mathematical derivations of the price movement, including statistical and stochastic methods, such as moving averages or frequency distributions.

Indicators are divided into classes according to their informative content. These include among others:

### Trend following indicators:

The simplest trend following indicator is a moving average. Common are the 50-day, 100-day or 200-day line. Moving averages are, by definition, the average price over a defined period of time. For example, if the price breaks through its moving average, this may indicate the beginning of an upward movement. A downwards breakthrough can accordingly signal the beginning of a downward movement.

Trend following indicators give time-delayed signals due to their design and, therefore, generate more frequent false signals in sideways markets.

### Oscillators:

The term oscillator describes the property of these indicators. In their graphical representation, these oscillate around the zero line. Oscillators are a useful addition to trend following indicators. They work in places where trend followers increasingly deliver false signals, especially in trendless markets. Oscillators generate the best signals in sideways markets that have high volatility - i.e., those that are subject to greater fluctuations - but still do not find a constant direction. The highs and lows of these wave movements, the swings, can be detected with oscillators and traded profitably.

Other well-known oscillators are the momentum, the RSI and various forms of calculation of the stochastic oscillator (the mathematical construction of the oscillators and the exact interpretation of the signals are referenced to the literature).

### Trend strength indicators:

Trend phase or not, this question determines the reliability of the trading signals of trend following indicators and oscillators. Trend strength indicators can be used to distinguish between trend and non-trend markets. The ADX indicator is a particularly good example. For exact calculation and application, please refer to the literature.

### Volatility indicators:

The best-known volatility indicator is the Bollinger Bands, propounded by John Bollinger. Bollinger Bands lie between lines calculated at a distance of two standard deviations above and below a moving average. The distance of two standard deviations means that 95 percent of all prices are between the bands. The centre line is calculated in the standard application as a 20-day moving average. The distance between the bands is therefore dynamic. The lower the volatility of the prices, the narrower the bands, so very narrow bandwidth suggests a stable trend. If the band expands sharply afterwards, this indicates higher volatility, indicating a declining trend strength. The bands, therefore, mark upper and lower limiting levels. The prices tend to run to the opposite band. For further application, please refer to the relevant literature.

## Conclusion

From the fundamental analytical valuations, upper and lower price targets can be derived. However, traders and investors can use technical analysis to concretise and optimise their trading decisions. Trading signals based on the chart technique provide indications of when a consensus assessment of market participants changes and thus signals for entry and exit. In this way, "swimming against the current" or "catching the falling knife" can often be avoided.

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