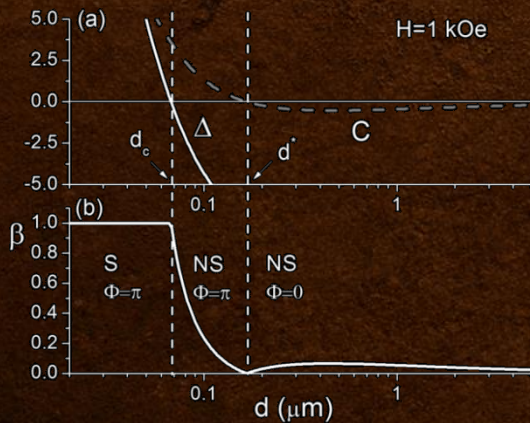


Trading Market Cycles

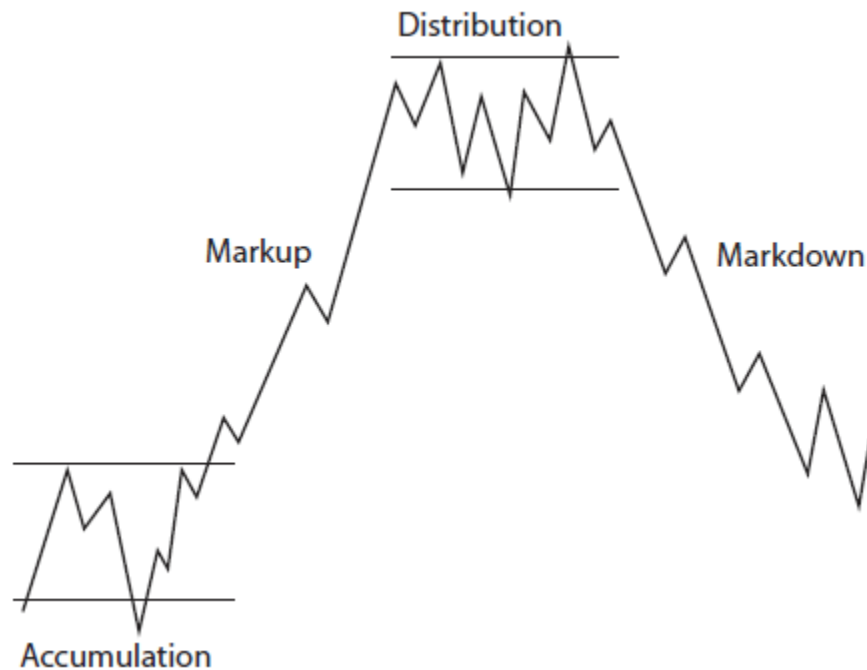


Adam Grimes
Waverly Advisors, CIO

Market Cycles

- The Wyckoff Cycle
- Behavioral and Psychological Cycles
- Cycles in prices
- Cycles in volatility
- Cycles in equilibrium/disequilibrium

The Wyckoff Cycle



The Wyckoff Cycle

- Accumulation
 - Smart money buys without lifting prices
 - Look for possible failure tests below support
- Uptrend
 - At some point, the public catches on and buys
 - Smart money sells to the public
 - There are common structures in trends
- Distribution
 - Trend ends and smart money finishes selling
 - Public still optimistic
 - Look for failure tests above resistance
- Downtrend
 - Public still behind the curve, but eventually they panic
 - And that panic ends the trend

Applying the Wyckoff Cycle

- Not always possible to tell accumulation from distribution.
- The cycle is a highly simplified market model.
 - Reality is much more complicated.
 - Anything can happen at any time.
 - If there is an underlying structure, it is often hidden behind random noise.
 - Difficult to tell where Acc/Dist end
 - Accumulation does not always lead to uptrend, etc.
- Very difficult to find idealized examples in real market data, so it has limited utility as a trading structure.
- What can the cycle teach us, then?

Lessons of the Wyckoff Cycle

- Price movements are driven by interaction of supply and demand.
- Evaluating price action can give insights into the balance of supply and demand.
- It is useful to think of the market in simplified groups of participants, their actions, and effects on prices.
 - Insiders (smart money)
 - Public (emotional?)
- There is a psychological aspect to market structure.
- Markets alternate between trends and trading ranges

Behavioral Cycles



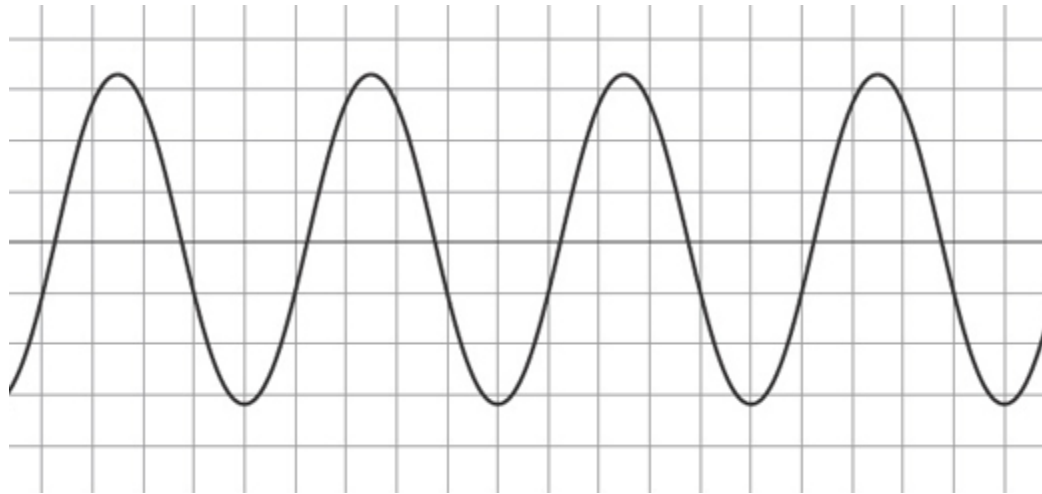
Psychological Aspects

- Price movements are interpreted through the filter of human experience and emotion.
- Human behavior is more predictable in aggregate (crowds) than individuals.
- The market has evolved to encourage individuals to do the wrong things at the wrong time.
- Psychological dynamics alternate between extremes of fear and greed.
- Market moves are often driven by trapped market participants.
 - You can be trapped out of a move as effectively as in.
 - Panic and fear of missing a move can be real motivators.
- People have made the same mistakes for a long time.
- Crowd psychology can reach extremes.

“Risk On / Risk Off”

- Theory that says price movements are driven by investors’ risk tolerance.
- During periods of risk on, investors seek “risky” assets. Money flows to “safe” assets during risk off.
- A methodology that works well to explain price movements after the fact, but harder to apply in real time.
- Probably most useful when looking at global markets across multiple asset classes.

Price Cycles



Price Cycles

- Can find with complex signal processing tools.
- Can also find by counting periods between highs and lows on charts.
- Cycles can be ephemeral. They shift, abort into trends, change periods, etc.
- Just because you can see it, don't assume you could have traded it.
- Consider the dampening effect of natural buying and selling on a visible cycle.
- Market dynamics will work to erode simple cycles.

Volatility Cycles

- What is volatility?
 - Measure of uncertainty
 - Used as a measure of risk, but...
 - “How prices move around”
 - Can be traded via options and other derivatives
- How to measure it?
 - Relationship of price movement to time
 - Implied volatility: reflection of supply/demand in options.
 - Historical (realized) volatility: usually calculated as the standard deviation of returns.
 - Range-based methods: averages of the range covered during a fixed time period.

Volatility Cycles

- There are more predictable cycles in volatility than in price.
- Volatility tends to be mean-reverting in the short-term (i.e., comes back to an average price) and show some trending behavior in the long-term.
- There exists no mechanism to dampen swings and cycles in volatility as there does in prices.

Volatility Cycles

- Volatility clustering
 - Volatile moments in markets tend to be followed by other volatile moments.
 - Think of the effect of rocks randomly thrown into a pond. Splash and decay.
 - This is modeled quantitatively via models (EGARCH, etc.) that assume random price shocks that decay over time.
- Volatility contraction
 - Leads to a period with strong directional tendencies.
- Volatility expansion
 - Naturally follows contraction (mean-reverting?)
 - Can reach extremes and climaxes

Volatility Clustering



Volatility Cycles (10 day ATR)



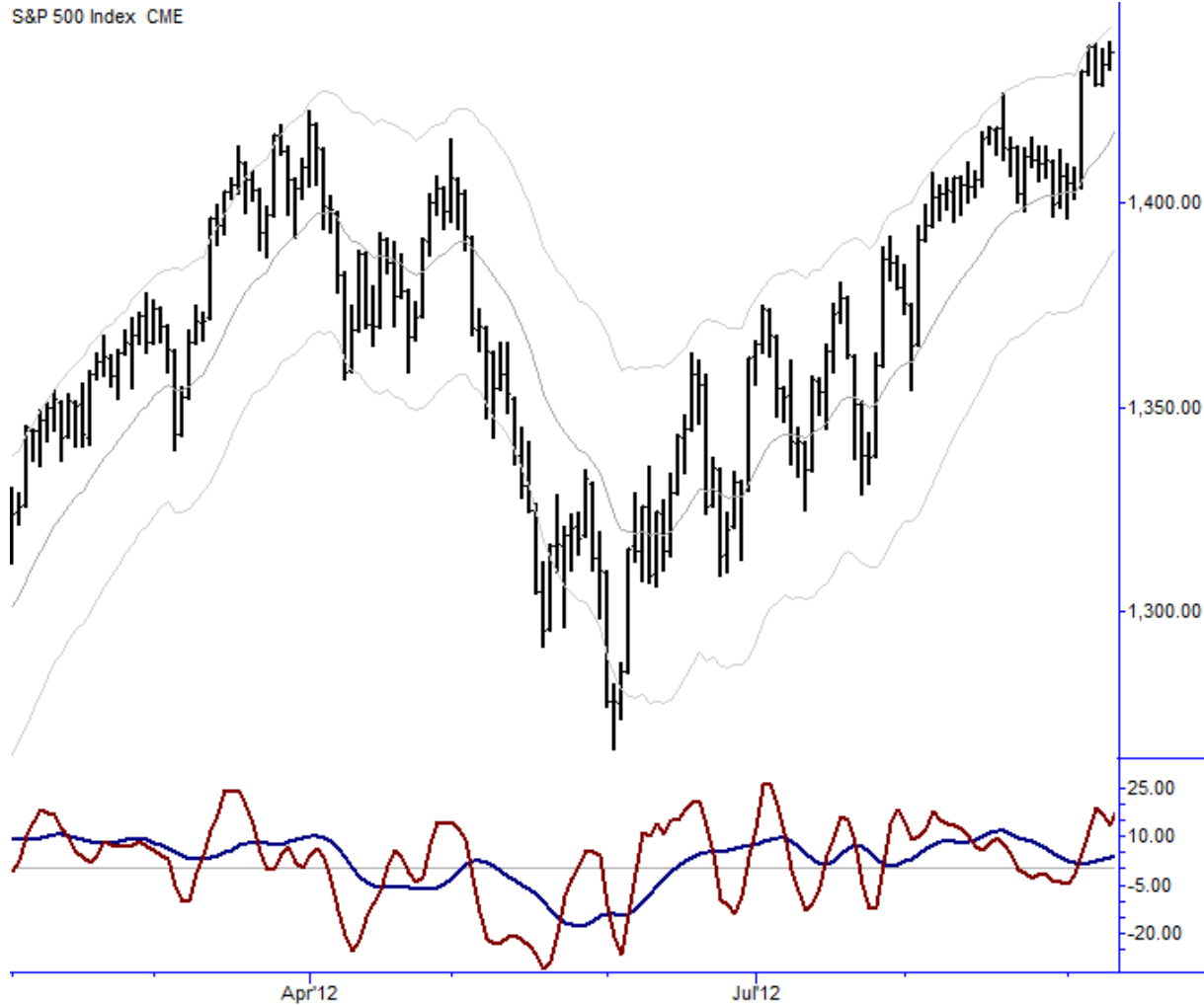
Volatility Contraction on Charts



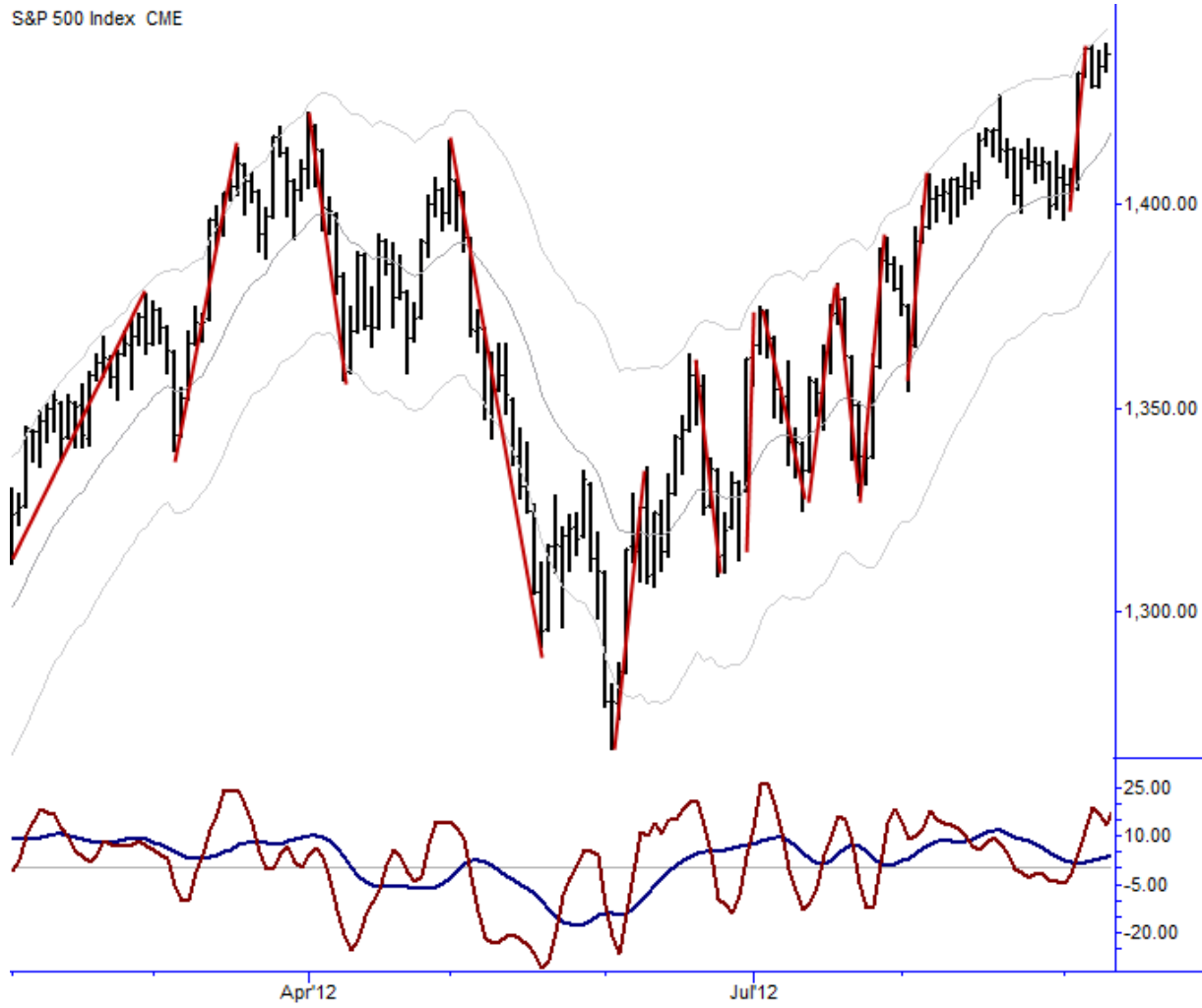
The Cycle that Matters Most

- Markets alternate between periods of trend and trading range.
- Trends
 - Directional movement
 - Driven by supply/demand imbalance
 - Disagreement
 - Volatility expansion
 - Basic structure: ABC
- Ranges
 - Sideways movement
 - Suggests equilibrium
 - Agreement
 - Volatility contraction
 - Basic structure: support/resistance holding

Trend / Trading Range

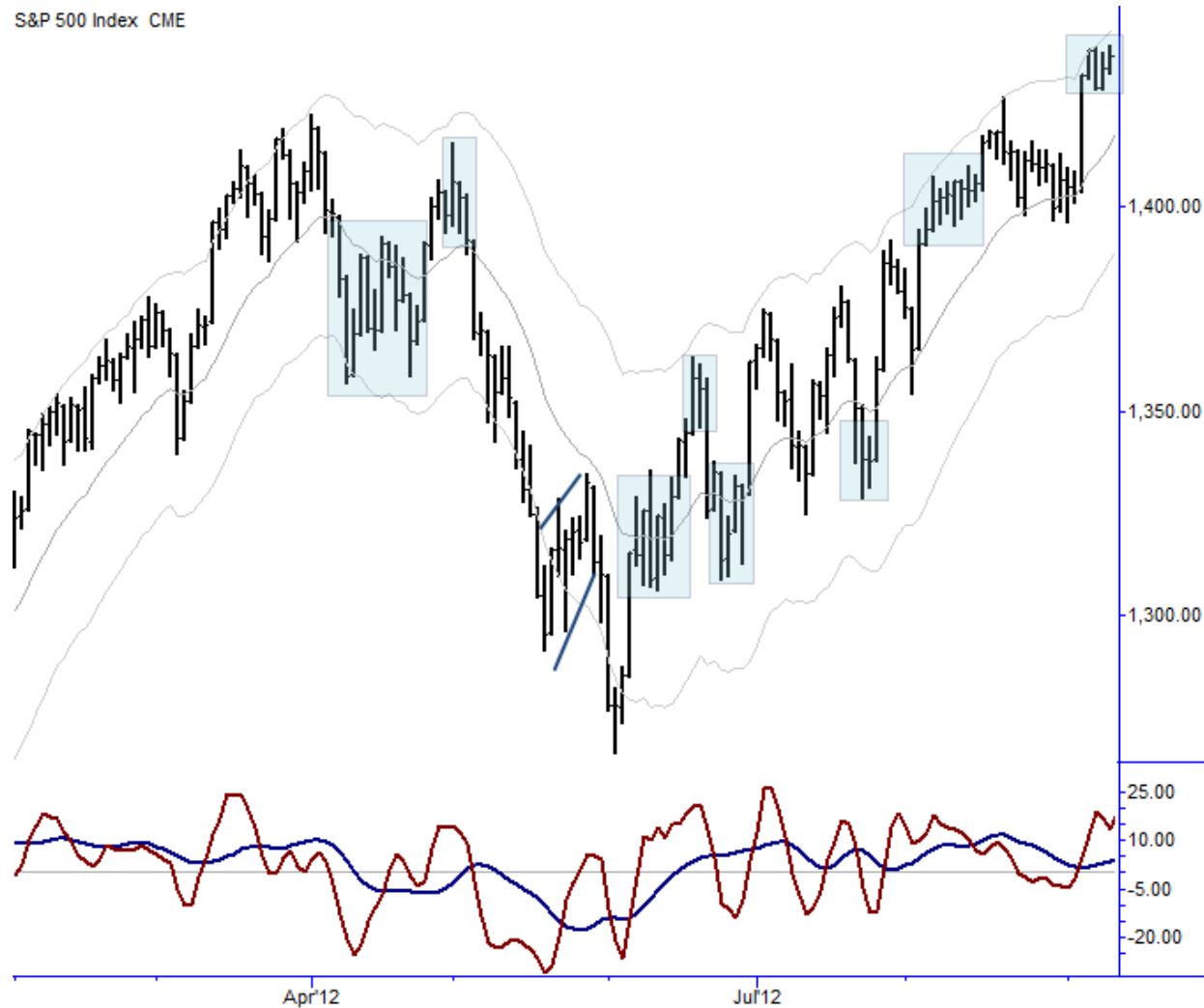


Trend



Trading Range

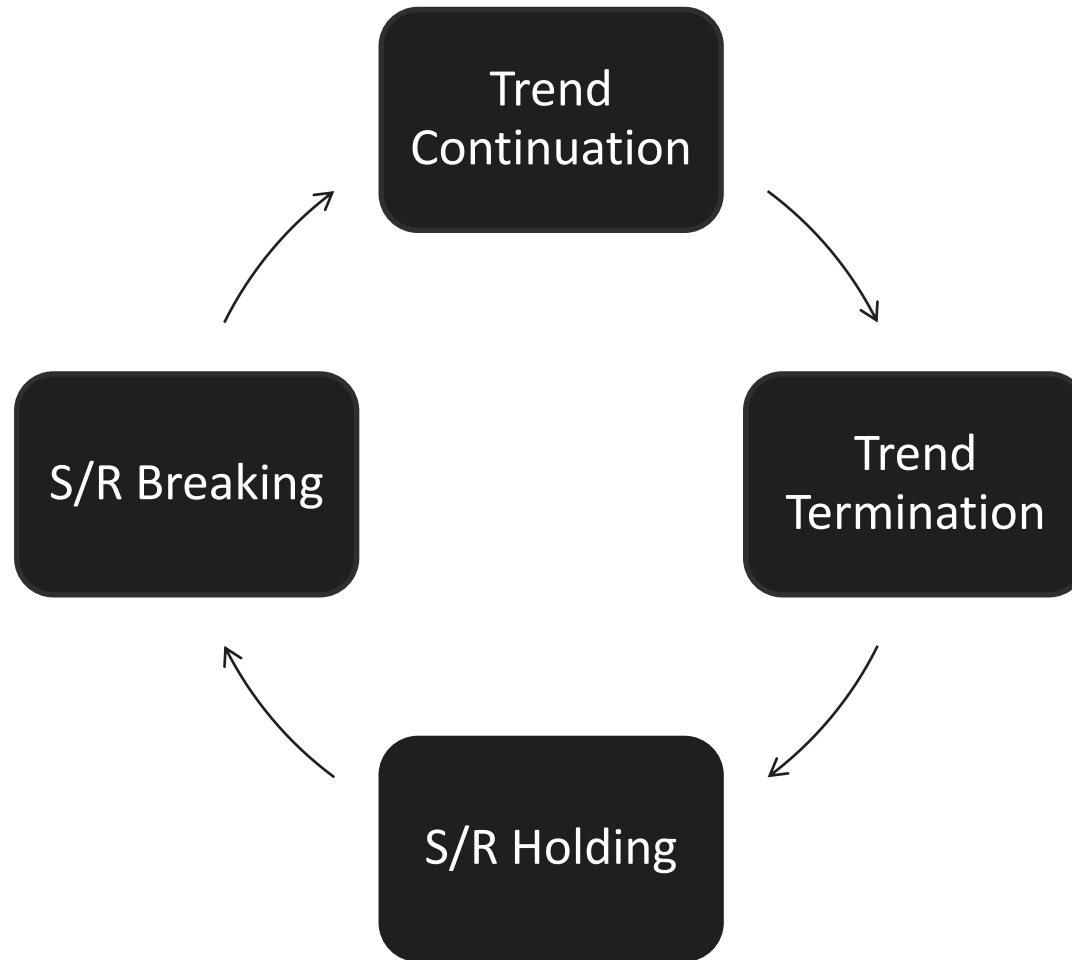
S&P 500 Index CME



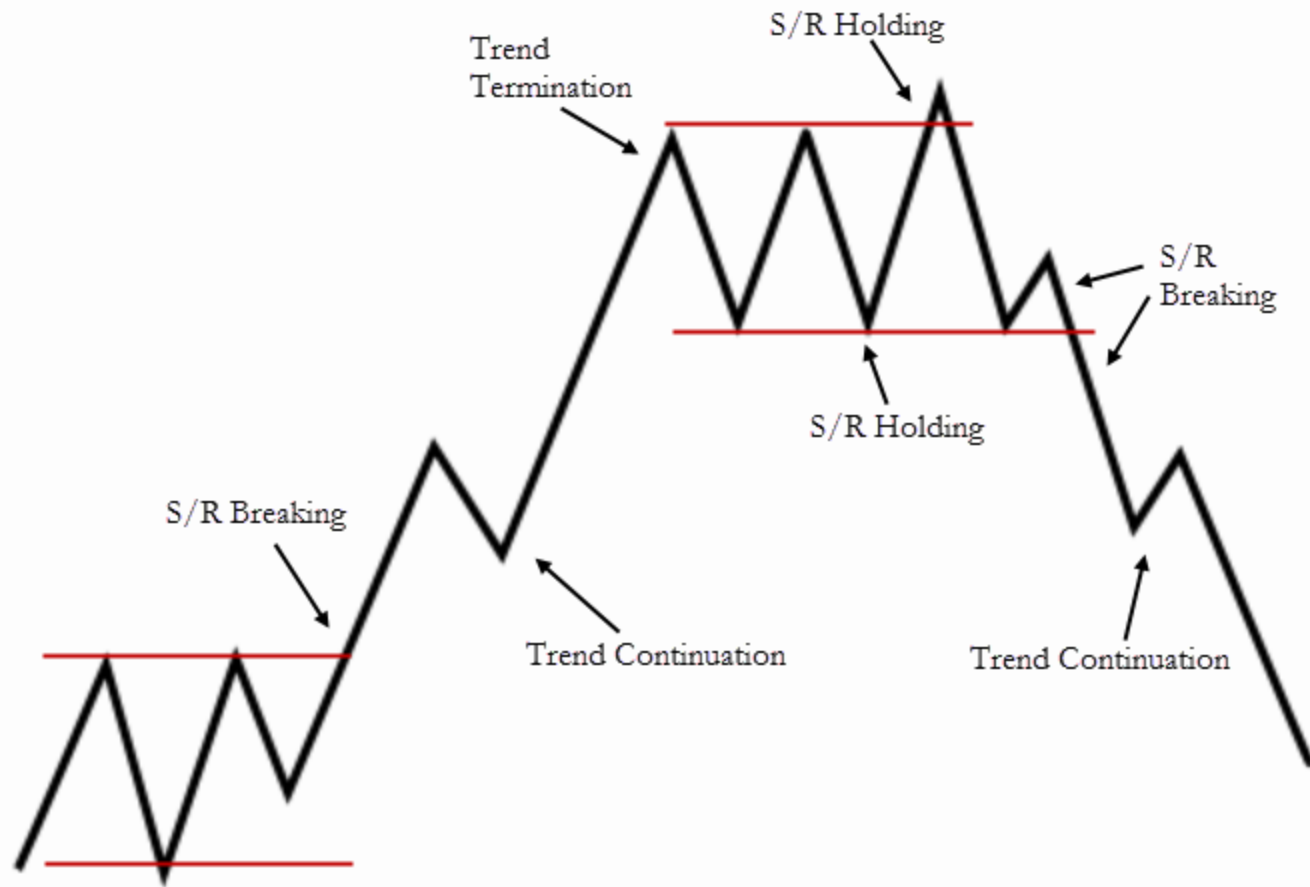
The Four Trade Types: Trading the Cycle

- **Trend Continuation**
 - Identify a trend and look to position with the trend
- **Trend Termination**
 - Identify a trend that may be ending and look to take a position against the trend
- **Support/Resistance Breaking**
 - Identify a range and look to trade breaks of the confines of the range
- **Support/Resistance Holding**
 - Identify a range and look to trade tests of the confines of the range

Trading the Cycle



Trading the Cycle

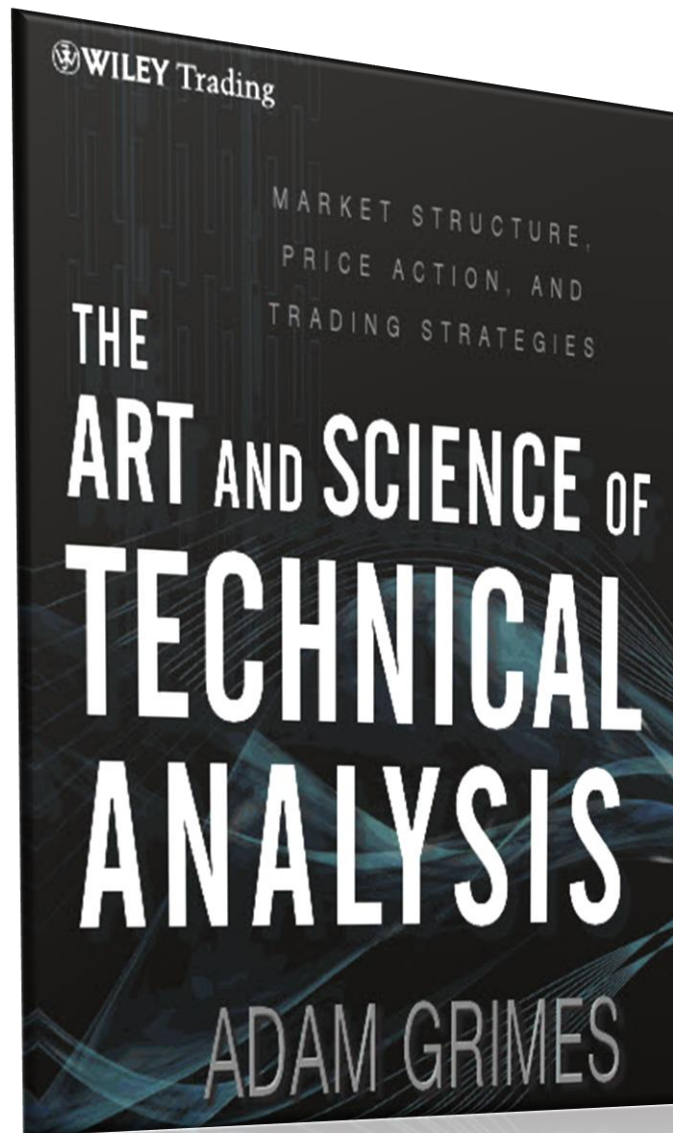


Review

- The Wyckoff Cycle
- Behavioral and Psychological Cycles
- Cycles in Prices and Volatility
- Trend/Trading Range
- The Four Trade Types
 - Trend Continuation
 - Trend Termination
 - S/R Holding
 - S/R Breaking

Waverly Advisors' Research

- Tactical commentary highlighting potential extremes
- Specific trade entries in climaxes
- Using climaxes as a filter to avoid lower-probability with-trend trades
- Specific stock screens published daily:
 - Consecutive closes
 - Extremes
 - Big Movers
 - Historical Big Movers (published weekly)



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My Blog

<http://adamhgrimes.com>

ADAM H GRIMES

financial markets, risk, and life

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MarketLife Ep 28 – So you want to be a trader? Here's what you can do next.

Sep 8, 2015

This week's podcast picks up where we left off last week, and looks at how to apply the lessons and ideas to your own development as a trader. These two podcasts are targeted at developing traders, or perhaps longer-term investors who want to learn to trade more...

[read more](#)

One, two, three steps to shorting stocks

Sep 2, 2015

I want to share a quick short setup in the S&P 500 index today. This is a repeatable pattern, and draws on many elements I have discussed here on my blog, and also in my book, The

Waverly Advisors, LLC: Research Products

- Tactical Playbook – Available on Interactive Brokers
 - Written for the active trader on the daily/weekly timeframes
 - Bigger-picture overview of all liquid asset classes.
- Tactical Portfolio Outlook – Contact Waverly Directly
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 - Focus on Equities, Equity Sectors, and other asset classes



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