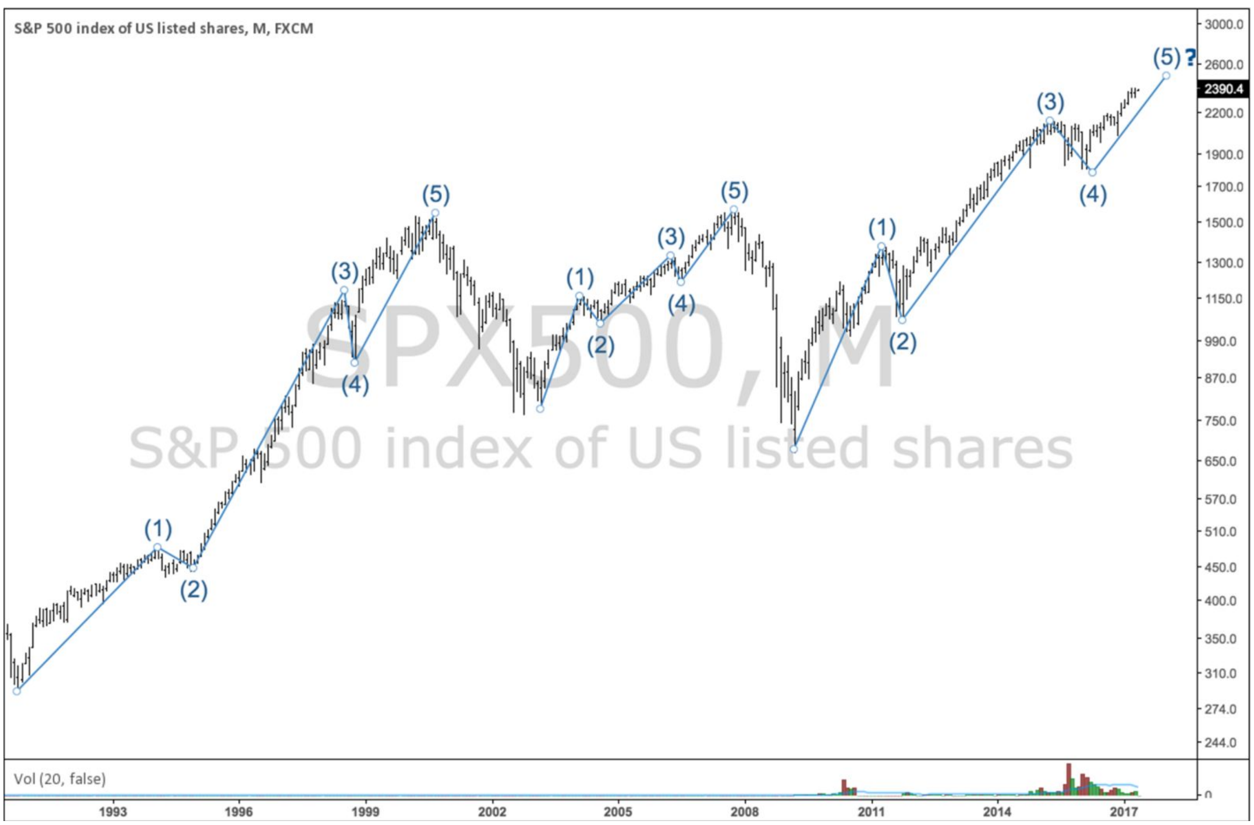
The 5 Stages Of A Bull Market

Bull markets progress in five stages: three up moves intermingled with two corrective moves.

Just to clarify, this isn't Elliott Wave Theory. To all you EWT practitioners… PLEASE don't email us saying we've labeled our 2 wave on the wrong pivot. We're purposefully rough in labelling these market stages. They aren't used for predictive purposes, but more so as an approximate rubric to help section and label different parts of a market advance.

Similar to how Bridgewater divides the long-term debt cycle into five different stages of sentiment and social mood, we've done the same, but with the short-term debt cycle.



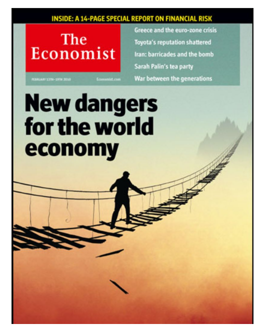
We call these the **Five Stages Of Disbelief**.

A bull market advances as bears convert to bulls. The greater the disbelief in the rally, the more fuel it has to keep running. It only ends when demand is exhausted… which happens after most of the bears turn bullish. All bull markets constantly climb this proverbial "wall of worry".

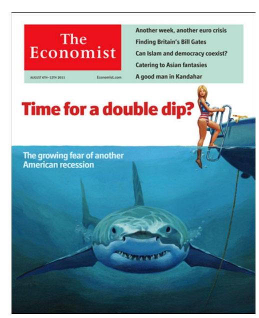
In his latest book, *The Socionomic Theory of Finance*, Robert Prechter notes that, "Because herds are ruled by the majority, financial market trends appear to be based on little more than investors' mood… "Social mood" we postulate, is the net mood of the populace, shared through the herding impulse." This "mood" can be traced through the progression of every market cycle.

Each stage in the Five Stages Of Disbelief is marked by a distinct sentiment and social mood. Understanding and tracking this helps you stand apart from the herd as you objectively watch these stages unfold.

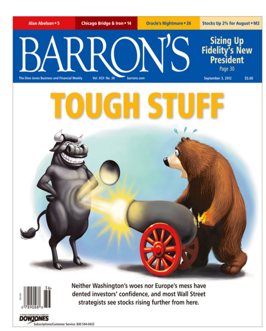
Let's break each one down:



1. **Stage 1 - Seller Exhaustion:** The bear market ends as selling exhausts itself. Fear is pervasive and dominates the news. Nearly all investors who stampeded for the exits are finally out. Most of the selling pressure is relieved. A new bull market now begins. Extremely depressed valuations create bargains as opportune buyers drive the market up swiftly. The advance is typically quick and marked by extreme disbelief. Social mood is pessimistic and the dominant narrative is filled with caution. Most believe the market still has further to fall. *(Each of the magazine covers to the right were published during each stage of the current cycle. You can see the clear progression of herd mentality and social mood.)*



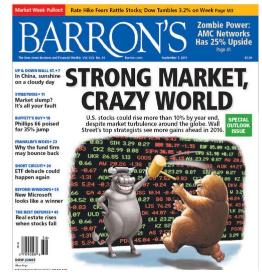
2. **Stage 2 - Bearish Vindication:** Stage two begins when those who bought into stage one become skittish after quick gains. Social mood is still extremely negative and buyers begin to take profits as short sellers hammer the market on expectations of another leg lower. Those who sold at or near the bottom of the last bear market feel vindicated and pat themselves on the back for their wise prudence. Things look bleak.



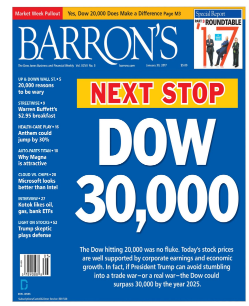
3. **Stage 3 - The Balance:** The third stage starts to the disbelief of the majority. Social mood still remains highly negative. The news is bearish and there's plenty of talk about false rallies. But as this stage progresses, more and more bears are driven back into the market. One of the most powerful market forces, the fear of missing out (FOMO), starts becoming a driver of investor participation. The third stage is often where the meat of a bull market's advance occurs. It's relentless march higher converts more and more disbelievers into buyers. Social mood tends to balance

out about half way through. There's still plenty of bearish talk, but there's also serious chatter about the economy improving.

4. **Stage 4 - Bears Last Stand:** Stage four begins as the remaining bears scream about a market top, exclaiming that this imprudent advance has gone on too long! Valuations are high and the Fed is raising rates. The market is *clearly* due to mean revert — or so the bears say. There's still a bit of negative news reporting, but on the whole, social mood has turned more positive than not. Stage four sees a minor correction, but this is widely viewed as a buying opportunity. Since most investors didn't get into the market until the later part of the third stage, after missing much of the move, they're certain to not make the same mistake twice.



5. **Stage 5 - Bearish Capitulation and Euphoria:** The market advances once again, sounding the death knell for bears. Most of them finally capitulate and buy into the market. The pain of FOMO becomes unbearable during this stage. Pullbacks are shallow and quickly bought. Retail investors pile into the market and margin debt explodes as they leverage up to buy more stock. News and social mood escalate from good to euphoric. Stage five is also when the economy runs the hottest, creating plenty of confirming evidence for buyers to validate their bias. This stage progresses until buyers literally exhaust themselves as the market becomes crowded into unsound and overvalued positions.



It's not easy standing apart from "social mood" and recognizing it for what it is. We're socially herding creatures. It's seared deep into our evolutionary wiring.

It's funny how nearly every investor claims to be a contrarian. Obviously that can't be so. The truth is that the vast majority of us fall into the herd.

To turn to Robert Prechter again, he notes that "investor thought is not conscious reason but unconscious impulsion. The herding impulse is an instrument designed, however improperly for some settings, to reduce risk… not straying from the group induces feelings of safety and well being. Therefore, investors in the aggregate — whether they are buying in uptrends or selling in downtrends — are always acting unconsciously to reduce risk, thanks to the emotionally satisfying impulse to herd."

He's essentially saying that investors' real fear isn't losing money, but being apart from the crowd and losing money. A loss is much easier to stomach if the herd is losing with you. It's an interesting take and one in which we mostly agree.