



When Will the Rally End? S&P Euphoria, French Frailty, and the Gambler's Fallacy

May 20, 2013, v3, n8

Betting Against the Trend

"On August 18, 1913, at the casino in Monte Carlo, black came up a record twenty-six times in succession [in roulette]. ... [There] was a near-panicky rush to bet on red, beginning about the time black had come up a phenomenal fifteen times. In application of the maturity [of chances] doctrine, players doubled and tripled their stakes, this doctrine leading them to believe after black came up the twentieth time that there was not a chance in a million of another repeat. In the end the unusual run enriched the Casino by some millions of francs."
~ [From FallacyFiles.com](#): Darrell Huff & Irving Geis, How to Take a Chance (1959), pp. 28-29.

A precious metals bullion dealer called me last year inquiring if I'd do an interview on his radio show about the psychology of precious metals prices. He explained that his customers are irrationally fearful of buying, and he was hoping I would soothe his listeners using something out of my psychological "bag o' tricks." (Note: before you email me that this is unethical, yes, I'm aware of that, and I don't do it).

The broker said he was extremely bullish on metals prices. When I asked *why* he was bullish, he explained, "Silver is at three-and-a-half year lows, it can't go any lower..." So I asked, "Why not?" and he barraged me with aggressive and profoundly confident assertions: "The U.S. Mint ran out! The demand is far greater than the ETF is holding - they own futures! Silver is an industrial metal and is not recyclable! Retail demand in India and China is just beginning!"

This was the same biased reasoning about silver (and gold)



Richard L. Peterson, M.D.
+1 (323) 389.1813
richard@marketpsychdata.com

Past Newsletters

[HashCrash – May 1](#)
[Gold – Apr 14](#)
[Bitcoin – Mar 31](#)
[Price Forecasts – Mar 2](#)
[World Risk Map – Feb 4](#)
[Global Equities – Jan 20](#)

Recent Press

[When to invest? When most are afraid to.](#) MarketWatch.com.
Chuck Jaffe. April 26, 2013.

[Thomson Reuters Wins Best Use Of Social Media At FStech Awards 2013.](#) Press Release. April 23, 2013.

[Positive Sentiment in Apple Points To Better Days Ahead.](#) Haydn Shaughnessy. Forbes.com. April 22, 2013.

[MarketPsych Data Mines Negative News For Good](#)

that I heard from others in 2011. When such projective statements are asserted aggressively and without self-consciousness, it is a sign the bubble hasn't fully deflated.

The broker expressed a number of cognitive biases in his thinking about precious metals. I'll discuss one here - the Gambler's Fallacy - since it is being uttered by true believers in many quarters currently: the U.S. stock market ("can't go any higher"), precious metals and Brazil ("can't go lower"), and the Euro ("can't break up") to name a few.

The [Gambler's Fallacy](#) is a bias in which investors underestimate the ability of a streak to continue, and as a result, they begin to forecast its reversal based on the length of price action in one direction alone. The reasoning of those embroiled in the Gambler's Fallacy sounds like, "It can't keep on going like this." It is a deeply ingrained bias, and as seen in the opening quote, enriches casinos in Roulette and other games such as Blackjack: "my losing *has to* turn around!"

On the market-level, the Gambler's Fallacy may influence group behavior, as evidenced by price action around series of events, such as [earnings surprises](#). The authors of [this experimental study](#) show how prevalent the Gambler's Fallacy is, and they differentiate it from the "Hot Hand Fallacy" in which streaks are expected to continue due to a talented human with a lucky "hot hand."

Today's newsletter examines how the Gambler's Fallacy permeates reasoning about current market activity in the U.S. stock market, Brazil, and the Euro.

Join us for a free webinar on Friday May 24th at 8am EST on Sentiment-Based Global Investing: "Inside the Global Brain: How sentiment trends in news and social media influence global equity and currency values." [Register here](#) (it's free).

[Buys](#). Trang Ho. Investors Business Daily. April 15, 2013.

[Cleaning up your financial portfolio](#). Interview by Barbara Bogaev. Marketplace Money for Friday, April 19, 2013.

[Price Forecasts in the Media: a Lousy Way to Invest](#). Joyce Hanson, *AdvisorOne*. April 1, 2013.

[Following Your Bliss, Right off the Cliff](#). Kai Ryssdal and Megan Larson. *New York Times*. March 25, 2013.

Partial List of [Past Press](#).

[Join Our Mailing List!](#)

The S&P 500 "Can't Go Up More"

Articles like [this one](#) by Peter Schiff paint a vivid picture of Fed incompetence and an impending U.S. stock market train-wreck. And such commentary is correct to say that Fed stimulus has been fueling asset prices higher, where they may be wrong is in whether or not the Fed stimulus will turn into a dead weight on the economy when it is withdrawn. The goal of the Fed stimulus was both to raise asset prices and to raise economic sentiment. When economic sentiment rises, a positive feedback loop of risk taking and borrowing is created, and economic growth becomes self-sustaining.

Behind this rational analysis is the idea of "it can't keep going up, it's got to end" – the Gambler's Fallacy.

We currently see the S&P500 Bubbleometer— a.k.a. the MarketRisk index - as hitting highs in News media (but not social media). While the overall height of the index is worrisome for a year out, the divergence implies that the community of investors is still not entirely convinced of the rally, despite rapidly climbing prices.



Our S&P 500 Bubbleometer is inversely correlated with future 12-month equity prices, which means this rally may be in for a pause. For timing, sell when the short-term Bubbleometer drops dramatically. We've used this timing tool many times, including in these [June](#) and [July 2011](#) blog posts and this [NBR interview](#) with Dr. Frank Murtha preceding the summer 2011

selloff. In October 2011 [we called the subsequent rally](#) based on the extreme of Fear. The Bubbleometer is a useful timing tool if you wait to sell when a convincing reversal is in store (and that is not quite yet).

Before the current rally is susceptible to a correction, we need to hear much more “rah-rah” commentary like the below, which I agree with, by the way: *“Tepper, co-founder and owner of Appaloosa Management LP, said in an interview on CNBC that he is still bullish and the economy is getting better. Tepper, who led Institutional Investor’s ranking of the top earners in hedge funds last year with \$2.2 billion, said in January in a Bloomberg Television interview that the U.S. “is on the verge of an explosion of greatness.” ~ [Bloomberg](#).* This is true of the U.S. economy, but not necessarily of equity prices.

In the short-term positive economic momentum, and cash on the sidelines, will drive higher equity prices. According to [this article](#), the explanation for rising prices may be as simple as supply and demand – there are fewer shares, and more money flowing into stocks.

But WHY is that money flowing into stocks? Remember that emotions precede behaviors. I don’t buy stocks and then feel optimistic. That’s the wrong order. *First I feel optimistic, and then I buy stocks.* And as optimism rises, so follows buying. As optimism drops... And that’s when the Bubbleometer is useful. Most investors don’t sell fast enough when the bad news starts coming out.

When will this rally end? When optimism begins to drop. And that drop is not yet. But stay tuned, because it is coming soon. We’ll keep you posted when that day comes.

Euro Crack-Up to Come?

If you didn’t skip reading this section, then you’re not as tired of Euro news as I am. The past few years have been Euro-saturated. “It will crack!” “No it won’t!” “Yes it will!” Ireland, Greece, Portugal, Spain, Cyprus, Italy – all the usual suspects. Next to fall, and the lynchpin of the Euro, will be France.

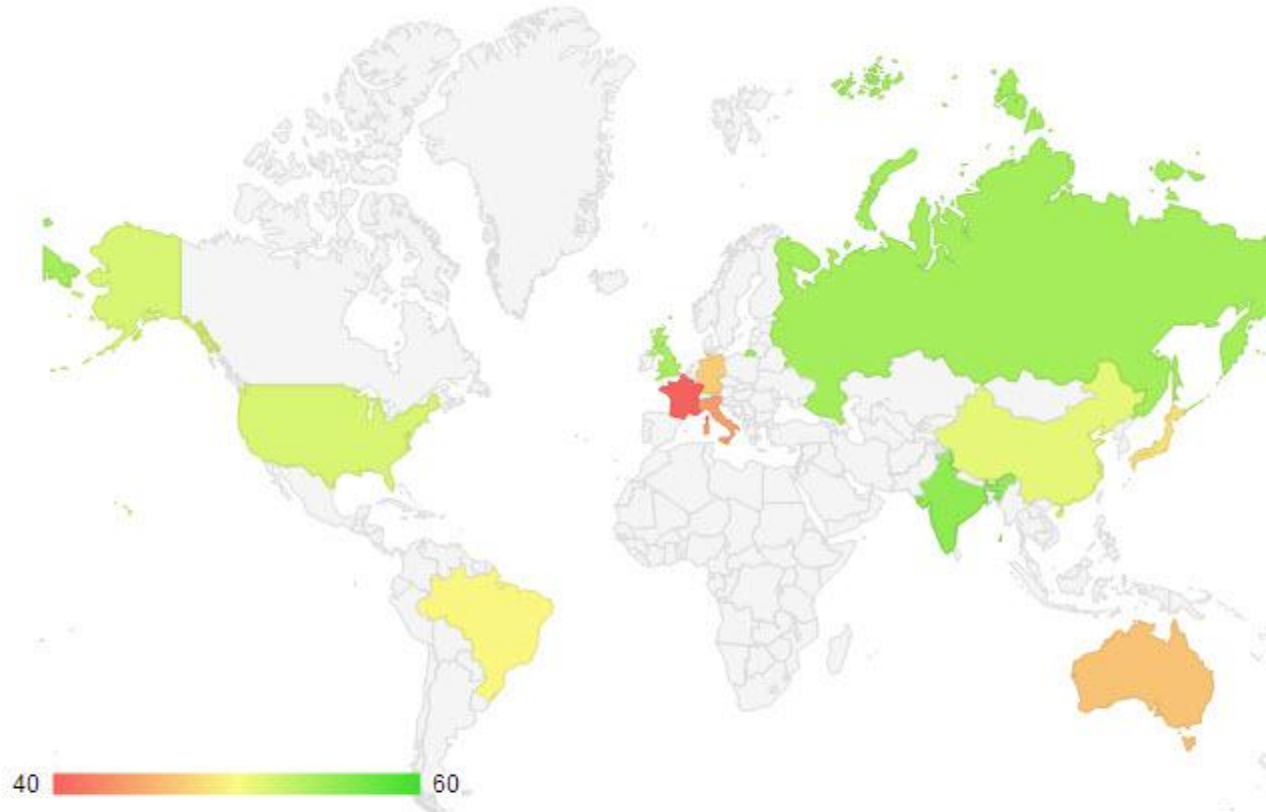
Why France? For the past 2 weeks our real-time metrics of French economic activity have been screaming “*Sortez!*” at investors.

As we pointed out in [this newsletter](#), French optimism in the midst of crisis is dangerous. Optimistic (proud?) voters are not willing to face difficult realities. Our predictions are being borne out in the slowing economic activity of France, which we believe will lead to more French political unrest and the ultimate break-up of the Euro.

Our resident genius and chief data scientist Aleksander Fafula developed daily-updating economic models based on global economic activity and national sentiment reported in the news flow.

One can see a comparison of current global economic estimates in the real-time monitoring tool he developed below. Note the abysmal and declining French economic activity numbers (boxed in red at the bottom of the list):

DAILY-UPDATED MANUFACTURING FORECASTS FOR THE TOP 12 ECONOMIES:



MPMI MarketPsych Manufacturing Index	Today's MPMI greater than 50 is expanding, less than 50 is contracting	Change from prior week		Change from prior month	
United States (US)	51.83	↑	0.04	↓	-0.54
Eurozone (EZC)	40.83	↓	-0.22	↓	-2.92
Brazil (BR)	49.79	↑	0.16	↓	-1.49

Australia (AU)	46.39	↑	0.06	↑	2.00
China (CN)	51.05	↑	0.19	↓	-1.35
India (IN)	55.63	↑	0.03	↓	-0.30
United Kingdom (GB)	54.07	↑	0.48	↑	1.33
Russia (RU)	54.53	↑	0.57	↑	2.43
Japan (JP)	48.33	↑	0.11	↓	-1.33
Italy (IT)	44.00	↓	-0.80	↓	-1.00
Germany (DE)	47.05	↑	0.84	↓	-0.59
France (FR)	37.05	↓	-2.77	↓	-6.75

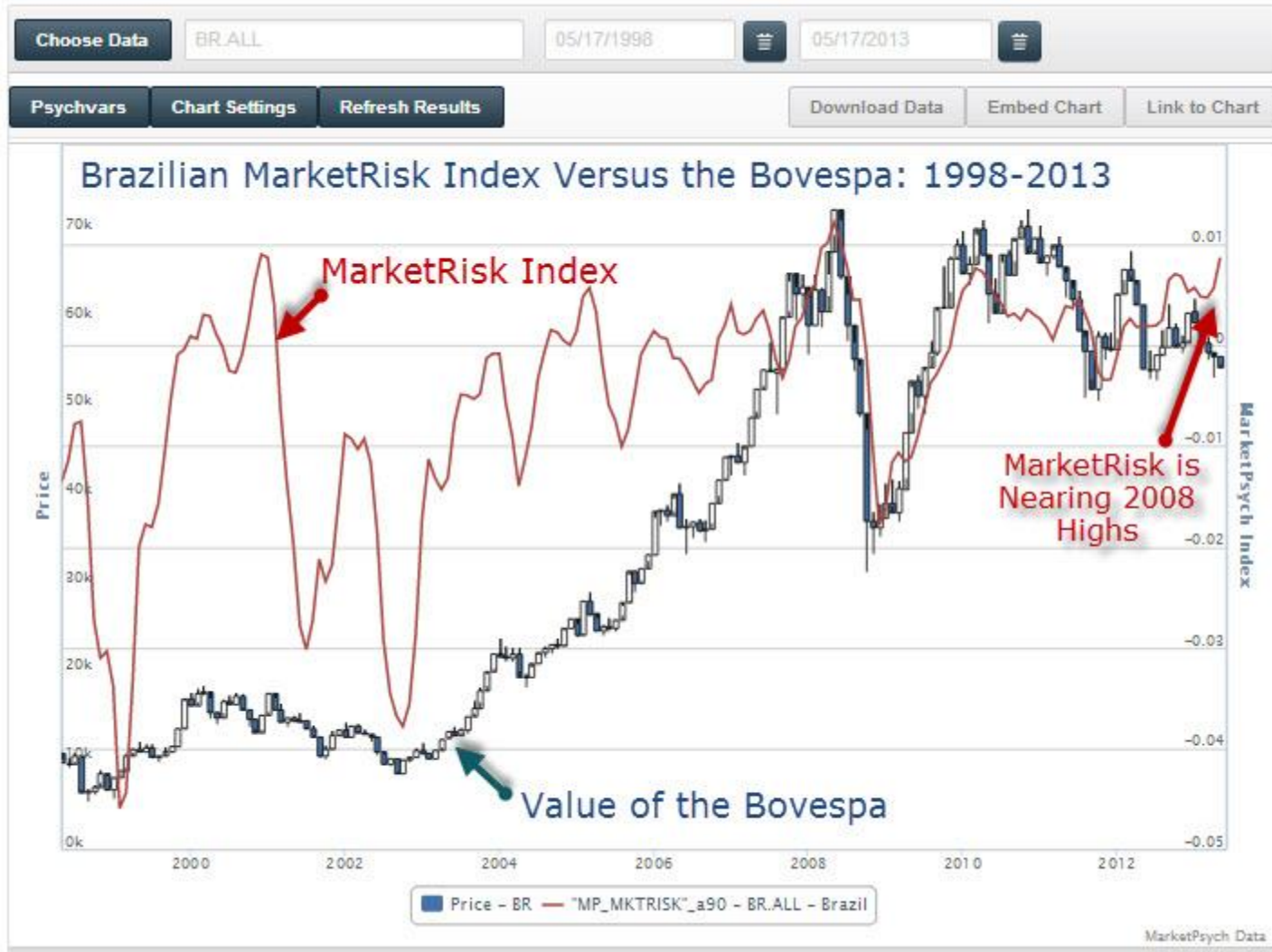
Based on extraction of real-time manufacturing and sentiment data from news and social media articles, MarketPsych has created daily-updating top 12 economies.

France is leading the world lower. And in the case of the United States, European stresses may again lead to a stock market downturn (the Bubbleometer is high, so we are vulnerable this summer to more Eurozone shenanigans).

Trouble in Brazil

We're seeing a bit of a slowdown in Brazil as well, with some evidence of the Gambler's Fallacy. Brazil is interesting because it grew quickly under Lula through the 2000s, but now there are struggles as expectations are reset and gains consolidated.

What we see here is that the declines from the Bovespa peak are not completed. We see optimism that the market will recover – mirroring the Gambler's Fallacy – an indication of more stock market investor pain to come.



This is somewhat counterintuitive to me, and I'm generally quite positive on Brazil. But that's why we produce this data – what we want to believe is easy. What is likely to happen in markets tends to be more painful than we expect.

Trading Recap

As we pointed out in [our newsletter on Gold](#) a few weeks ago, precious metals are in a collapsing bubble. But that doesn't mean they don't bounce occasionally.

As we stated in our Gold newsletter, after the one week rally in April, gold would roll-over. We're in the midst of the rolling, punctuated with another one-week bounce. To those who may be influenced by the Gambler's Fallacy and say, "Gold has to recover, the currency wars are in full swing with Japanese devaluation, etc..." I ask, "How often do markets do what they 'have to'"? Beware gold for more than trading based on psychology. It is in dangerous long-term unwinding territory with lots of volatility to come.

Our systems are this morning showing one-week buys on gold miners including junior miners (GDJ), Iam Gold (IAG), and Silver Wheaton (SLW). The rally is already underway today, so

be cautious and see the DISCLAIMER at the end. We're also seeing a five-day short on Tesla (TSLA), everyone's favorite car company including me. Being a favorite that already underwent a massive short-squeeze is why we're seeing a short idea.

You can see our collected research on www.marketpsychinvest.com. Users receive currency, equity, and screening models. If you're a value investor, we can help you follow Ben Graham's advice to buy from pessimists and sell to optimists (easier said than done, of course). Please respond to this email for a **free trial**.

The big question is, where is the next bubble likely to emerge? It may be somewhere obvious – robotics, biotech, 3-D manufacturing, housing, aqua-culture, crypto-currency and alternative banking, and natural gas infrastructure are all places where bubbles could re-emerge over time. There are also emerging markets that remain interesting and bubble-prone, such as Pakistan (we've had a buy on Pakistan, to good effect, for quite a while) and sub-Saharan Africa.

Housekeeping and Closing

If you desire healing,

let yourself fall ill

let yourself fall ill.

~ Rumi

As in the Rumi quote above, truth is here before us. If only we summon the courage to allow ourselves to think differently. Consider the next time you are arguing for a trend because "it has always been like that." That is not seeing the future but clinging to the past. To heal, to break out of the Gambler's Fallacy, we must abandon comfortable habit and walk face-first into the unknown.

We love to chat with our readers about their experience with psychology in the markets and with behavioral economics! Please also send us feedback on what you'd like to hear more about in this area.

Please contact us if you'd like to see into the mind of the market using our [Thomson Reuters MarketPsych Indices](#) to monitor market psychology for 30 currencies, 50 commodities, 120 countries, and 40 equity sectors and industries in social and news media. This data is used by top global hedge funds to improve their investment returns.

Join us for a free webinar on our latest research on Friday May 24th at 8am EST on Sentiment-Based Global Investing: "Inside the Global Brain: How sentiment trends in news and social media influence global equity and currency values." [Register here](#) (it's free!).

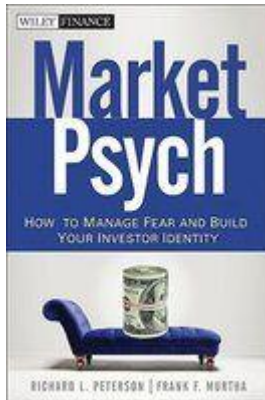
We have upcoming 2013 speaking engagements in New York, Orlando, London, and Chicago – we look forward to seeing our friends in those cities! Please contact Derek Sweeney at the [Sweeney Agency](#) to book us: Derek@thesweeneyagency.com, +1-866-727-7555.

Happy Investing!

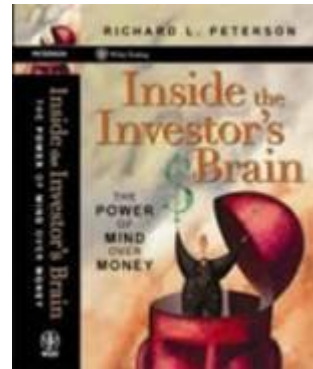
Richard L. Peterson, M.D. and The MarketPsych Team

Books

Both books named "Top Financial Books of the Year" by *Kiplingers*.



[MarketPsych: How to Manage Fear and Build Your Investor Identity](#)



[Inside the Investor's Brain: The Power of Mind Over Money \(Wiley Trading\)](#)

Who We Are

MARKETPSYCH DATA
179 POST RD W, WESTPORT, CT 06880
www.marketpsychdata.com

- Linguistic analysis paired with behavioral economics opens a new dimension for financial products and trainings.
- MarketPsych Data provides granular quantitative sentiment data from streaming social and news media through Thomson Reuters. Please contact us for data access and more information.
- Optimized to identify value over two+ years of real-time trading.
- The MarketPsych Data feed includes minutely macro indices tracking reported price action, supply and demand dynamics, media expectations, and other concepts for all major countries, commodities, currencies, ETFs, and equities (over 6,000).

Contact:

Richard Peterson
+1 (323) 389-1813
richard@marketpsychdata.com

Disclaimer

This material is not intended as and does not constitute an offer to sell any securities or a solicitation of any offer to purchase any securities.

The information of the MarketPsych Report is presented free of charge. It is no substitute for the services of a professional investment advisor. Investments recommended may not be appropriate for all investors. Recommendations are made without consideration of your financial sophistication, financial situation, investing time horizon, or risk tolerance. Readers are urged to consult with their own independent financial advisers with respect to any investment.

Past performance is no guarantee of future results. Screen and model signals and related analysis are for informational and entertainment purposes only and should not be construed as an offer to sell or the solicitation of an offer to buy securities. Most financial instruments (stocks, bonds, funds) carry risk to principal and are not insured by the government. Anyone using this newsletter for investment purposes does so at his or her own risk.

Data accuracy cannot be guaranteed. Opinions and analyses included herein are based on sources believed to be reliable and written in good faith, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness, timeliness, or correctness. We are not liable for any errors or inaccuracies, regardless of cause, or for the lack of timeliness of, or for any delay or interruptions in, the transmission thereof to the users.

As a matter of policy, we DO NOT act upon the investment information that this newsletter provides prior to making it available to the public. We currently DO NOT have an actively trading investment fund. However, it is possible that investment recommendations will be made concerning investments already present in our personal portfolios. These are not intentional. We do not actively discuss or post investment recommendations on social media in such a way as would influence our trading and investment signals. We do not accept compensation of any kind from any companies mentioned herein.

MarketPsych is not responsible for any special, indirect, incidental, or consequential damages that may result from the use of, or the inability to use, the Information contained on this newsletter whether the Information is provided or otherwise supplied by MarketPsych or anyone else. Notwithstanding the foregoing, in no event shall MarketPsych total liability to you for any and all claims, damages, losses, and causes of action (whether in contract or tort or otherwise) exceed the amount paid by you, if any, for accessing this newsletter.

MarketPsych expressly disclaims all warranties and conditions with regard to the Web sites, their Content, and the Information, including, without limitation, all implied warranties and conditions of merchantability, fitness for a particular purpose, title, and non-infringement. By using the Web site, Content, and Information, I assume all of the risks associated with their use, and I release and agree to indemnify and hold harmless MarketPsych from any and all liability, claims for damages, and losses arising from or connected with such risks.

IF YOU DO NOT AGREE WITH ANY OF THESE TERMS AND CONDITIONS OR FIND ANY OF THEM TO BE UNACCEPTABLE, SIMPLY UNSUBSCRIBE FROM THE EMAIL LIST. If you understand and accept these caveats, feel free to read the newsletter.