Understanding Market Cycles - the Key to Successful Investing

By: Stan Harley | **Posted:** Sep 19, 2008

How many times have you bought a stock, bond, or mutual fund – just when the fundamentals sounded great – only to see that investment go into a protracted decline? The key to any successful strategy is buy low and sell high. But a successful implementation of that strategy requires an in-depth understanding of market cycles. "The knowledge and exploitation of cycles embodies one of the most powerful analytical tools available for identifying trends and forecasting their reversals" notes Stan Harley, editor/publisher of *The Harley Market Letter*. "I have long recognized that the study of market cycles is the key factor in understanding how markets move" observes Harley. Cycles provide the essential algorithm in predicting how long a trend should run and when to expect reversals. Studying the chart history of a stock or index will reveal that there are, indeed, rhythmical beats that define the up and down market movements. But, like any stream of data comprising a solution set, the time period between cyclical occurrences will vary from beat to beat. At times a high occurs where a low is expected. And not every projected cyclical turn results in a market reversal of importance. At other times, the larger, more-dominant trend will be so strong that the shorter-term cycles will seemingly disappear or skip a beat. A 50 percent phase shift either forward or backward is not uncommon at times either. All of these peculiarities present frustration to many traders and investors looking for the "holy-grail." Investors should recognize that these windows of times are ones to monitor for the potential – but not the certainty – for a cyclical trend change to occur.

Cyclical analysis is a top-down approach Harley advises. Identify the longest dominant cycle, then work down to the smallest cycle affecting price activity. Most cycles have subcycles embedded within them, usually two or three, which Harley refers to as the alpha, bravo, and charlie components. When a particular cycle is nearing its trough, it will tend to dominate the shorter cycles which comprise it, causing them to contract or expand beyond their usual frequency schedule.

Harley defines three essential elements required in cyclical analysis. The first element requires an awareness of the numerology underlying the derivation in market cycles. Most market cycles have their roots grounded in fibonacci numerology Harley has found. The second element requires that the analyst employ statistical analysis to verify the numerology premise and provide mathematical organization (computation of the central tendency and its variation) to the data under study. The third element involves the development of properly designed tracking tools that can measure the cyclical function under study and recognize its turn in as close to real time as possible.

Long-term readers of *The Harley Market Letter* are aware that in performing cyclical analysis of the financial markets, it will often be found that the time period taken for one complete cyclical rhythm will vary from beat to beat. To ascertain the central tendency of the data, Harley performs a statistical analysis of the data. From this analysis, he uses both the mean and the median of the data to project the window of time for the next reversal point. Experience has taught him that even though a cycle has had a history of market lows, it may not necessarily produce another low at the next occurrence. One has to be ready for a low or a high to occur. However, it is little more than academic to know that a cycle has occurred in the past – as a trader, investor, and newsletter author, it is critical to know that a cycle high or low is occurring in the present – necessitating the need for mathematical tools than can track a cycle in real time. One of the tools Harley employs involves the calculation of the rate of change in price – the slope at which a stock or commodity moves up or down. So called "market momentum" is really no momentum at all, for those with a background in physics or engineering will recognize that any measurement of price over time is correctly called price velocity. For a price velocity indicator to be valid, it must be based on cycle length. If it is, the indicator will correctly measure the rate of change of prices with a cycle and turn up or down as the cycle itself turns up or down.

The other calculation the analyst should perform involves determining trend through measurement of price range. Any range-based measurement – stochastic, percentage range, or relative strength indicator – will do. The important point is to employ the calculations over multiple time periods (no less than three). A trade-execution signal will be generated when both sets of indicators – price velocity and price range – turn together in the desired trading direction.

Cyclical turns can be reflected in a number of ways. Sometimes they mark the exact low or high of the move. Sometimes they mark a retest point. At other times they are marked by the apex of a sideways pattern that results in an expansion to the upside or to the downside. It's not always possible to know in advance which of the aforementioned will define the cyclical structure until after the fact. One form or a multiplicity of forms may occur. Harley defines the cyclical turn as the point at which price velocity balloons in the direction opposite of the trend that preceded it. In a bottoming evolution, for example, the time point that immediately precedes the point at which price velocity suddenly expands to the upside is the cycle low point in his definition.

One final characteristic of cyclical behavior involves the concept of translation. In bull markets, there is the tendency for the cycle high (crest) to occur to the right of the midpoint of the cycle. This is known as right translation, with prices rising for a greater amount of time to the high than it takes to decline to its next low, and is characteristic of bull market cyclical structure. In bear markets, the same cyclical schedule from low-to-low is retained, but there is the tendency for the cycle high to occur to the left of the midpoint of the cycle. This is known as left translation, with prices rising for a shorter amount of time to the high than it takes to decline to it next low, and is characteristic of bear market cyclical structure.

Knowing when to buy and when to sell is the cardinal axiom for successful investing. The knowledge and exploitation of market cycles embodies one of the most powerful analytical tools available for identifying trends and forecasting their reversals. But market cycles do not present the investor with a magical formula that will time a market upturn to the precise moment. What they do afford, in objective fashion, is a means to quantify the timing of your investment decisions.

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