Session 31

Market Timing Approaches: Non-financial & Technical Indicators

Test

1. Assume that you are looking for a good market indicator to use in market timing. Which of the following would you want in the indicator?
    a. The indicator should provide a buy (sell) signal after stocks have gone up (down).
    b. The indicator should provide a buy (sell) signal as stocks are going up (down).
    c. The indicator should provide a buy (sell) signal before stocks go up (down).
    What type of statistical test would you use to capture this?
2. Which of the following statements best describes the January indicator for market timing?
    a. If January is a positive month for stocks, the returns in the remaining eleven months of the year are also likely to be positive.
    b. If January is a positive month for stocks, the returns in the remaining eleven months of the year are likely to be negative.
    c. If January is a positive month for stocks, the returns for the year are also likely to be positive.
    d. If January is a positive month for stocks, the returns for the year are likely to be negative.
    e. None of the above
    Explain the implications for using this indicator in investing.
3. Looking at annual returns on US stocks over very long time periods (1871-today), which of the following conclusions would you draw?
    a. Stocks are more likely to go up after a down year than after an up year.
    b. The returns on stocks are likely to be higher after a down year than after an up year.
    c. Stocks are more likely to go up after two up years than after two down years.
    d. The returns on stocks are likely to be higher after two up years than after two down years.
4. Trading volume is often used in conjunction with market price indicators to draw conclusions about future market direction. Which of the following is viewed as the most bullish combination?
    a. High trading volume with stocks prices going up
    b. Low trading volume with stocks prices going up
    c. High trading volume with declining stock prices
    d. Low trading volume with declining stock prices
5. Studies have looked at the relationship between market volatility (actual or implied) and stock returns. Which of the following conclusions have they drawn?

a. Stocks go up in the period when volatility increases and continue to go up in the subsequent period.
b. Stocks go up in the period when volatility increases but go down in the subsequent period.
c. Stocks go down in period when volatility increases but go up in the subsequent period.
d. Stocks go down in period when volatility increases and continue to go down in the subsequent period.

Solution

1. Assume that you are looking for a good market indicator to use in market timing. Which of the following would you want in the indicator?
    a. The indicator should provide a buy (sell) signal after stocks have gone up (down).
    b. The indicator should provide a buy (sell) signal as stocks are going up (down).
    c. The indicator should provide a buy (sell) signal before stocks go up (down).

Explanation: You want a market indicator that tells you ahead of time whether stocks will go up or down. If you get a contemporaneous or lagging indicator, you cannot invest based upon it.

2. Which of the following statements best describes the January indicator for market timing?
    a. If January is a positive month for stocks, the returns in the remaining eleven months of the year are also likely to be positive.
    b. If January is a positive month for stocks, the returns in the remaining eleven months of the year are likely to be negative.
    c. If January is a positive month for stocks, the returns for the year are also likely to be positive.
    d. If January is a positive month for stocks, the returns for the year are likely to be negative.
    e. None of the above
    Explain the implications for using this indicator in investing.

Explanation: Even if January is positive, the returns for the remaining eleven months are up in the air, but the positive January returns do push you into positive territory. Since you don't get to observe January returns until January is done, it is not useful as a market-timing device.

3. Looking at annual returns on US stocks over very long time periods (1871-today), which of the following conclusions seems to be backed by the data?
    a. Stocks are more likely to go up after a down year than after an up year.
    b. The returns on stocks are likely to be higher after a down year than after an up year.
    c. Stocks are more likely to go up after two up years than after two down years.
    d. The returns on stocks are likely to be higher after two up years than after two down years.

Explanation: The only statement that is backed up by the statistics is (b), but even that statement may not have any economic basis. The market is actually more likely to up after an up year than a down year, but the average return is higher after a down year than an up year.

4. Trading volume is often used in conjunction with market price indicators to draw conclusions about future market direction. Which of the following is viewed as the most bullish combination?
    a. **High trading volume with stocks prices going up**
    b. Low trading volume with stocks prices going up
    c. High trading volume with declining stock prices
    d. Low trading volume with declining stock prices

    Explanation: Momentum is strongest when higher stock prices are accompanied by higher trading volume.

5. Studies have looked at the relationship between market volatility (actual or implied) and stock returns. Which of the following conclusions have they drawn?
    a. Stocks go up in the period when volatility increases and continue to go up in the subsequent period.
    b. Stocks go up in the period when volatility increases but go down in the subsequent period.
    c. **Stocks go down in period when volatility increases but go up in the subsequent period.**
    d. Stocks go down in period when volatility increases and continue to go down in the subsequent period.

    Explanation: Historically, increases in volatility have been accompanied by lower stock prices in the period that the volatility increases, followed by positive stock returns in the period after.