



How the Markets React if Bad News Comes at The Top

Editor: Alexander Nikolov

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This article briefly outlines what happens when some really bad news comes at the market place at a time when the stock market is right at or near its top.



I've discussed in our February article what kind of news one needs for a stock market to find a bottom. In a recent video that I made, I also discussed how the news influences the stock prices. In these two past issues I have mostly focused on how the market usually finds a bottom – with a panic sell-off amid some very bad news. In today's article, I am going to briefly outline what happens when some really bad news hits the newswire at a time when the stock market is right at a top.

What happens when there is negative news right at the market top?



Source: Meta Trader

I have marked three dates on the chart above. First, examine what happened at and after November 27th, 2009. On that day the market opened sharply lower and sold off hard amid news on the bankruptcy of the Dubai World investment fund. As you can see, this news came right at the top back then. What happened after the initial sell-off? Well, the initial sell-off lasted only one day and then the market rallied sharply to new highs within a few days.

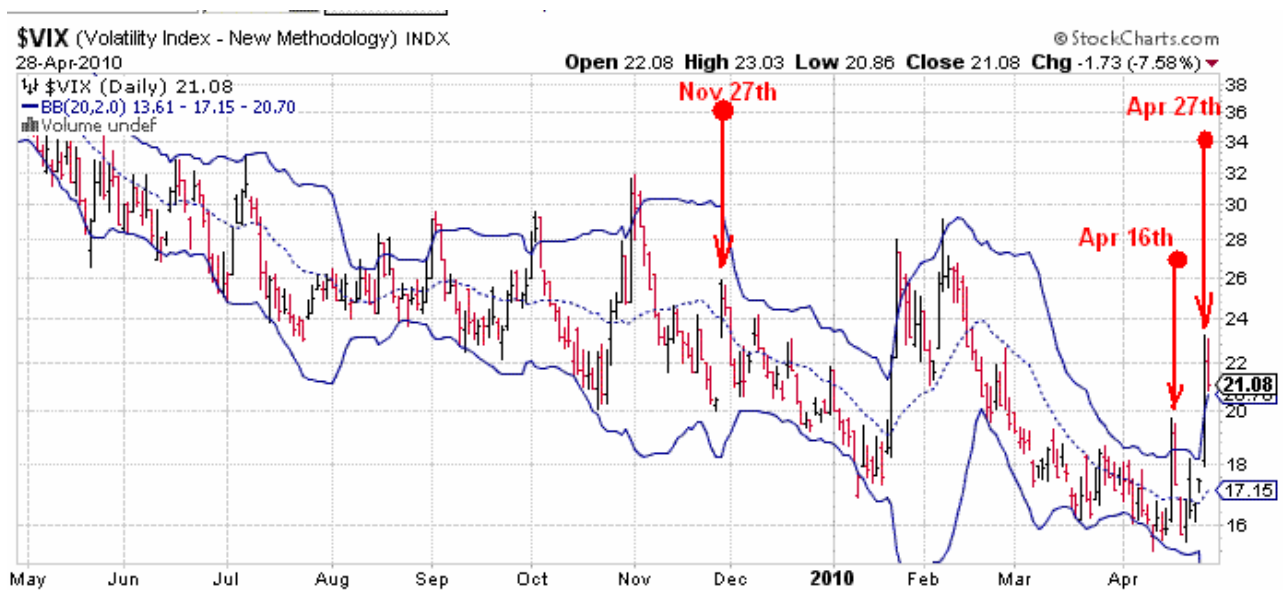
The next point I've marked on the chart, is April 16th 2010. As you can recall, that was the day when the SEC informed that it had been investigating Goldman Sachs on some fraud charges. The market sold-off immediately the same day and then continued on the downside on the next trading day. But it quickly bottomed on this next trading day and within few days it rallied to a new high for the uptrend.



And now we come to the most recent case: the news that S&P downgraded the credit ratings of Greece and Portugal. That came on April 27th, 2010. And on the next day, it downgraded the credit rating of Spain too. It remains to be seen if the market will now rally to new highs within a few days but it is clear the initial sell-off has found good support right at the 1182 level (previous important chart support and resistance level).

Also, take a look how on each of the above three occasions, the market was overbought, so the bad news actually was an excuse to sell a market that was due for a pullback anyway. And from the chart below, you can see how these one-day sell-offs provoked on bad news, lead to sharp spike in the VIX index (the volatility index) only for a day and then the volatility declined quickly again.

Volatility (VIX) spikes for a day and then turns lower again



Source: www.stockcharts.com

These three examples above are good illustration of what usually happens when the market is at or near a top and some bad news comes at the marketplace. If the news is really bad, it sparks a sharp but usually short-lived panic decline that simply brings the next buying opportunity for position traders. And this is exactly the opposite of what most people believe and that is the reason why they lose most of the time. To be successful you need to understand how the market works and to act accordingly.



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