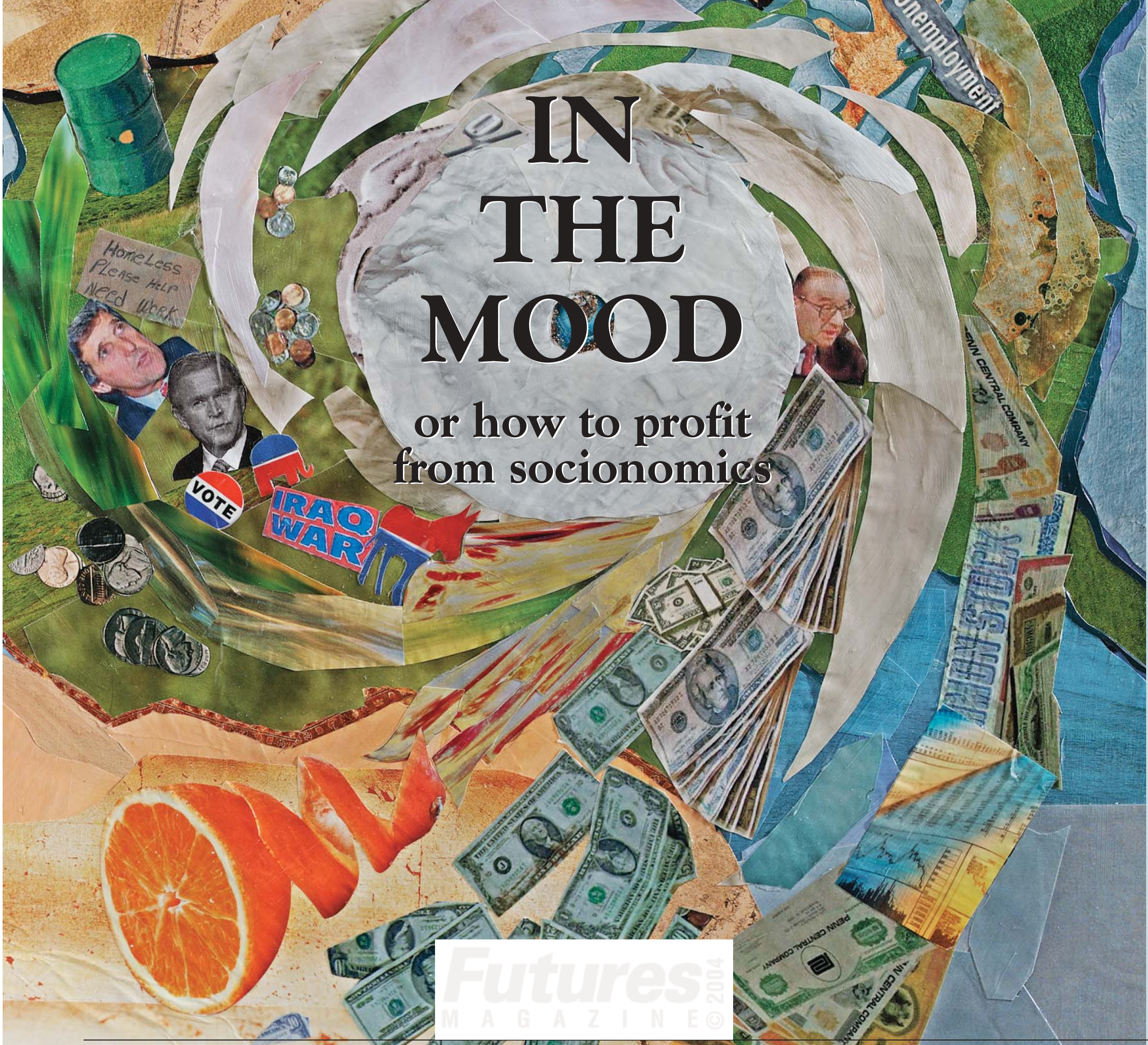
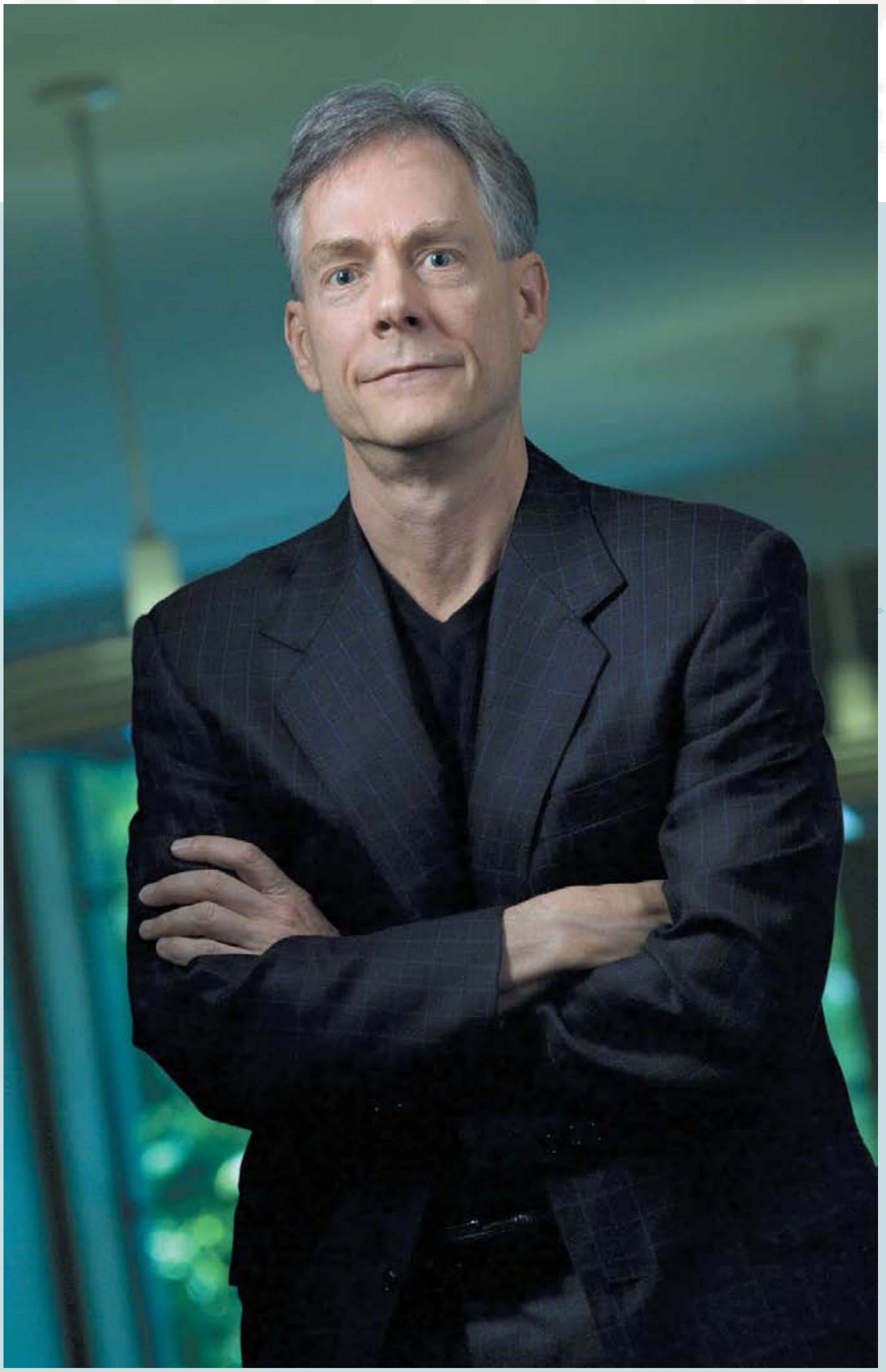
The madness of crowds often is examined in relation to cultural movements and stock market crashes. Robert R. Prechter, author and renowned interpreter of Elliott Wave, describes here how social moods are the cause, rather than the effect, of not only market moves but key events. Prepare yourself, we're in one bad mood.

BY GINGER SZALA AND JAMES T. HOLTER

IN THE MOOD

or how to profit from socionomics





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Robert Prechter is a well-known author, market analyst, publisher and as he says, the first socionomist, who is best known, at least in the markets arena, for his writings on Elliott Wave. As president of Elliott Wave International, Bob has interpreted and parsed the writings of R.N. Elliott to make Elliott Wave a popular tool and area of study for serious traders. Today, although he still stays involved in the markets and trades, Bob has grown more involved in the study of socionomics, which he discusses here. As an author of such books as *At the Crest of the Tidal Wave* and *Conquer the Crash*, he has a larger view of the markets than most do. In an interview, *Futures* editors asked him to discuss this study of socionomics and how traders can use it in today's markets.

FM: What's this we hear about someone filming a documentary on your social mood work?

Bob Prechter: A filmmaker in Atlanta got intrigued by socionomics, so he proposed doing a documentary, the kind you see on PBS but better. It has taken him two years of work, and it shows. It's an hour-long program that lays out the case for the idea that human herding produces patterns of mood, which in turn motivate social actions. He's got film clips, news footage, and a killer sequence showing how the mood of popular songs tracks the Dow. He also interviewed about a dozen PhDs in various fields and even gets into the pros and cons of the Wave Principle. It's more fun — to me, anyway — than reality TV. This is *real* reality TV. The Socionomics Foundation, which is nonprofit, is funding the project. Of course, he's got to get someone to air it, which is the next hurdle.

FM: Please discuss socionomics. In about two sentences, I mean.

BP: Socionomics is the study of social action that expresses social mood. Social mood arises endogenously from unconscious herding impulses inherited through evolution and is patterned according to the Wave Principle.

FM: Endogenously, meaning that nothing impacts social mood?

BP: Right. No outside forces change the trends and patterns of social mood. This idea is counter-intuitive, but our studies demonstrate time and again that even the most dramatic news events do not change the dynamics of stock pricing, which is our measure of social mood.

FM: Can you describe these studies?

BP: The best introduction to the evidence is a paper I wrote this year called "The Stock Market Is Not Physics." It demonstrates that even advance knowledge of the most shocking news events in history would not have helped anyone make money in the market.

FM: Then can you explain the palpable depressed mood of the crowd after 9/11? It seemed the event put a gloom over everyone, which is contrary to what you are saying. Was that an aberration?

BP: On the contrary, it is exactly in accordance with socionomics. What you say didn't happen. People had been getting gloomier for a full year and a half before the attack, not after. Six trading days after the attack, social mood improved non-stop for half a year to a far more optimistic level than it was at the time of the attack. The positive trend showed up in stock prices, consumer sentiment and measures of advisor and investor optimism. When the event occurred, people unconsciously latched onto it as an explanation for their waxing gloom. "Ah, there's a reason!" And they wrote articles about it in financial magazines. But if the attack really were the reason, then it should have occurred when optimism was strong and preceded a change toward pessimism. That's not what happened. The opposite happened. You can read our study on this in a book called *Pioneering Studies in Socionomics*. Another one in the book shows unequivocally that the Enron scandal did not upset investors. In fact, mood improved throughout the anthrax scares and the erupting Enron scandal, which were concurrent. And that was in the middle of a bear market! It should go without saying that scary news in a bull market has no negative effect.

FM: Then why do people believe that it does?

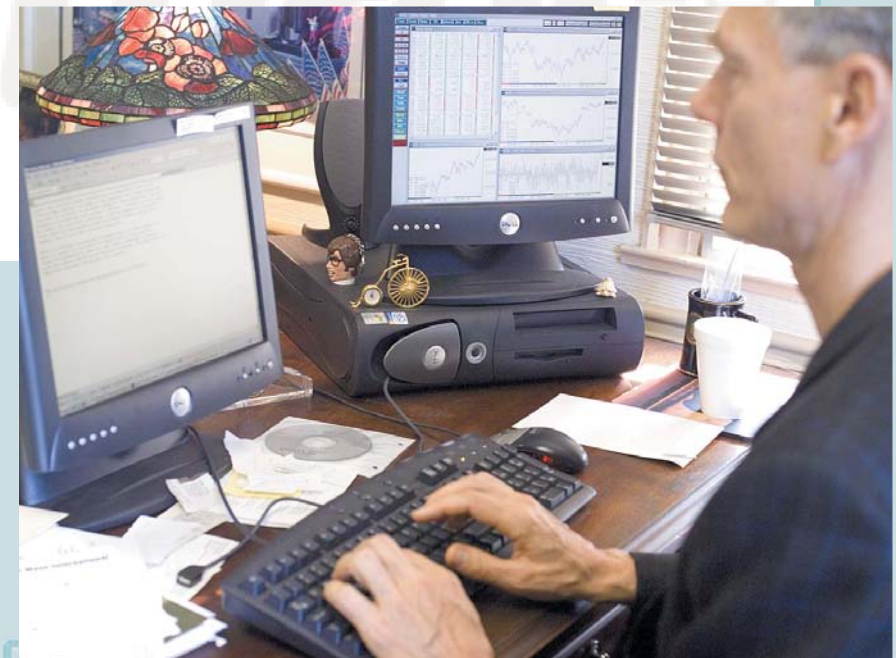
BP: Because people's brains naturally default to mechanics when they think about social events. A knowledge of mechanics has helped keep the species alive. We know that an object in motion will continue in motion unless acted upon by a force. So we duck when a rock is thrown at us and we swerve out of the way of a drunk driver who is drifting across the median. So people assume, with deep conviction, that any change in the stock market's direction must have been caused by some outside force. If they can't find one, they make one up. That's what the newspaper writers do every day after the market closes. But the stock market is not an object in motion, and outside forces are not required to change its trajectory. Unlike rocks, people have minds, and they can change them. In fact, they do change them, all the time, in accord with the impulse to herd. That is what moves markets. It's also what makes markets patterned. Herding is not rational, but neither is it random. It trends and reverses by its own dynamics.

FM: As the Chinese might say, these certainly are interesting times, with Iraq, rise in terrorism, economic issues, the coming of age of China and India, etc. Are the effects of crowd psychology more pointed when we find ourselves in a more turbulent and critical era?

BP: Crowd psychology creates peaceful eras and turbulent eras. After the mood has trended positively for a long time, peace reigns, as it did in the 1920s, from the mid-'50s to the mid-'60s, and during the 1990s. After the mood has trended negatively for a long time, turbulence reigns, as it did in the 1930s, the 1970s and since the peak in 2000. Social mood induces social actions, which express that mood. If you really want to get down to what I'm talking about, the eruption of scandals did not cause a negative social mood; a negative social mood caused the eruption of scandals. In fact, we predicted that it would.

FM: Discuss cause and effect a bit. You say that notable social events follow, rather than precede, corresponding stock market waves (hence socionomics). Does the market cause changes in mass psychology or does mass psychology drive market prices?

BP: Mass psychology drives markets. But it also drives other things. Changes in social mood cause people



Contrasting models of finance

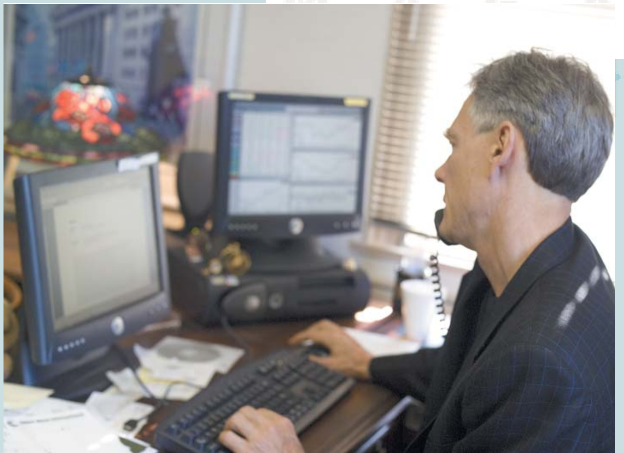
ECONOMIC MODEL

1. Objective, conscious, rational decisions to maximize utility determine financial values
2. Financial markets are random.
3. Financial markets are unpredictable.
4. Financial markets "tend toward equilibrium" and "revert to the mean."
5. Investors' decisions are based on knowledge and certainty.
6. Changing events presage changes in the values of associated financial instruments.
7. Economic principles govern finance.

SOCIONOMIC MODEL

1. Subjective, unconscious, pre-rational impulses to herd determine financial values.
2. Financial markets are patterned.
3. Financial markets are probabilistically predictable.
4. Financial markets are dynamic and do not revert to anything.
5. Investors in financial markets typically use information to rationalize emotional imperatives.
6. Investors' decisions are fraught with ignorance and uncertainty.
7. Changing values of financial instruments presage changes in associated events.
8. Socionomic principles govern finance.

Source: Robert R. Prechter Jr., The Socionomics Institute



to take certain types of actions. A positive mood induces people to expand businesses, dress with flair, buy happy music, make peace with others and buy stocks. A negative mood induces people to contract businesses, dress conservatively, buy morose music, fight with others and sell stocks. So social mood moves not only the stock market but other measures of social action as well.

FM: Isn't crowd or mass psychology just another way of referring to supply and demand? If not, how is this approach different than traditional economic analysis?

BP: It is definitely not the same as supply and demand, at least not in the sense that economists talk about it. I've written a paper called "The Financial/Economic Dichotomy" on the stark difference between the Law of Supply and Demand, which causes equilibrium in prices for utilitarian goods and services, and the Law of Patterned Herding, which causes dynamism in prices for financial instruments. In economics, higher prices deter buying; in finance, higher prices seem to attract buying. Think about how dichotomous that is. The first law operates in situations of substantial certainty in an economic context, and the second in situations of substantial uncertainty in a financial context or arbitrariness in a broader social context, such as with fads and fashions. Supply has almost nothing to do with these things. They are regulated by demand, which is regulated by patterns of herding.

FM: Are people listening to these ideas?

BP: They're starting to. I gave a two-hour presentation to graduate students at MIT and another at the London School of Economics. In December, I'm going to speak at an academic/professional conference, the First International Workshop on Intelligent Finance, in Melbourne, Australia. One academic is working on a new institute to conduct studies on these ideas. Another has done a socionomic study and written a paper about it. Some have been speaking about it at conferences. So it's starting to get exciting.

FM: I'm sure all traders really want to know is where the stock market is going. So please discuss today's stock market and where you see it headed, and how that plays out with socionomics.

BP: I am aggressively bearish on stock prices. The stock market has been topping out since 1998, when the Value Line geometric average peaked. Two years later, the major averages topped, and this year the Value Line arithmetic index is topping. People think we had a bear market in 2000-02, but we didn't; it was just the first wave down. Psychology never changed sufficiently, and that is key to understanding the market environment. Now that low interest rates have finished reflating the credit bubble, real estate is topping out. And that's the last area of credit demand. The risk for all financial markets — stocks, real estate, commodities and most bonds — is huge. A return to the bear market is inevitable, and the disconnect between stock values and everything else is so great that we also have substantial risk of a crash. I wrote a book called *Conquer the Crash* about how to get yourself safe before it happens.

FM: What about gold? Are you bearish in the metals markets too?

BP: Gold is the only real money. Paper money is nothing but credit, and unbacked paper money is nothing but a mental image. That being said, gold — or more properly, paper money — goes through bull and bear markets. Gold was in a bear market from 1980 to 2001. I issued a bullish report right at the low when everybody hated gold. Mining companies were selling it forward, and the gold bugs were just gone, retired or something. In fact, that's why I put out the report. Then I turned bearish in 2003, after a lot of people jumped on the bandwagon. But I'm wondering if that was the right move.

I'll be bullish again; it's just a question of the level. Besides, I don't do the daily forecasting at Elliott Wave International any more. I've got 80 people at this firm now, including about two dozen analysts. We cover every major market worldwide. We have an online timing service devoted entirely to gold and silver, and it's growing because my guy is good at it. And I don't tell him what to say.

FM: Let's cover application. Understanding the role of mass psychology in markets is one thing. Trading off that understanding is another. How does someone approach trading with that understanding?

BP: No question about it. Novices think that decent market analysis and making money are synonymous, but they aren't. Again, the key is psychology, but this time it's your own. Fear and euphoria are all-natural ingredients, but they can kill you financially. There are also mechanical things to deal with, not to men-

tion life, which gets in the way sometimes. I wrote a piece once called "What a Trader Really Needs To Be Successful" that has my ideas in it.

FM: To get specific, what tools — mental or physical as in software, charts, etc. — do traders need?

BP: They need a method, discipline and experience. They need charts, because there is no other way to read the market. I don't use commercial analytical programs because they are typically pretty useless, either the millionth variation on momentum oscillators or sort of mystical applications of Gann or Fibonacci. But if your method uses a program, that's fine. Just make sure you have done the research and know that it works well enough to give you an advantage. We are working on a computer program to recognize and forecast Elliott waves, so I may use some software yet.

FM: How can expert analysis — either directly or in terms of fading it — be integrated into someone's personal approach? Or, should it be ignored altogether and, if so, why?

BP: Boy, you've been around, haven't you? Fading it! Well, that's really the best thing to do. When I started at Merrill Lynch back in the '70s, there was a long-time technician there who used to be a broker. He said his dream indicator would be a direct line to 50 brokers who would report to him every move their clients made. When he saw a consensus action — not just an opinion but an action — he would just do the opposite. We try to emulate that model by following sentiment indicators, and many of them are based on the opinions of experts. Experts can often be right, but they are rarely right when they form a substantial majority. But to interpret sentiment indicators properly, you have to understand degrees of trend, which is the province of Elliott waves. On the largest trends, you often hear that sentiment indicators "don't work," when in fact they are giving the biggest signals in their history.

FM: Are these sentiment indicators what you all call sociometers (progressive and polar)? Could you describe these and how traders can use them in measuring social moods?

BP: Wow, you're getting technical here. In a nutshell, any record of social actions that express social mood is a sociometer. The measures that have endless trending potential, such as the stock market, are the "progressive" type, and the ones that oscillate between extremes are the "polar" type. Most standard sentiment indicators are polar, such as the put/call ratio, the percentage of bullish advisors, and so on.

The key to the utility of a sociometer is how quickly it responds to mood changes. The stock market moves almost instantaneously with the social mood, while the economy and politics take longer to respond. That's because it takes time to implement the long-range plans that people make when their moods change. That's why the stock market is a great tool for predicting the trend of the economy and the climate for peace or war. So sociometers are for people who want to predict the tenor of important news. But traders have to be able to predict where the leading sociometer is going, and that's a whole other ball game. The best way to do that is with Elliott wave analysis.

FM: Elliott wave analysis generally is placed in the context of technical trading. However, exploiting mass psychology in your trading seems almost fundamental. Does this mean that Elliot wave analysis acts as a bridge between the fundamentals and technical worlds?

BP: Yes! And the connection is very subtle. First, the Wave Principle is not just another technical tool. It is the foundation for all technical analysis. The market's fractal pattern is the reason that technical analysis works, and mass psychology is the driver of the pattern. The Wave Principle is not just fundamental; it is the fundamental. Now let's look at what other people call "fundamentals," the economy, politics and so forth. When we started this discussion, I said that social events such as economic and political trends are the result of social mood trends. If that is so, then these so-called fundamental causes are nothing but results. Being results, social events lag markets, which is why they are of no value in forecasting. But there's your bridge: The technical world of mass psychology creates the so-called fundamental world of economics, politics, fashion and culture.

FM: Can a trader expect to achieve an intuitive understanding of Elliott wave application? What I mean by that is, should a trader expect to always have to approach Elliott wave analysis with a calculator and ruler in hand, or can he expect to be able to trade with the naked eye?

BP: The naked eye is often enough, but you need a ruler, a proportional divider and a calculator — or the computer equivalents — to get the

PERCEPTION VS. REALITY

To get a feel for how a socionomist understands social causality in a variety of areas, consider the following list of examples:

STANDARD VIEW (exogenous cause)	SOCIONOMIC HYPOTHESIS (endogenous cause)
Social events determine the tenor of social mood.	Social mood determines the tenor of social events.
Examples:	Examples:
• Recession causes businessmen to be cautious.	• Cautious businessmen cause recession.
• Talented leaders make the population happy.	• A happy population makes leaders appear talented.
• Epidemics cause people to be fearful and depressed.	• Depressed and fearful people are susceptible to epidemics.
• A rising stock market makes people increasingly optimistic.	• Increasingly optimistic people make the stock market rise.
• Scandals make people outraged.	• Outraged people seek out scandals.
• The availability of derivatives fosters a desire to speculate.	• A desire to speculate fosters the availability of derivatives.
• War makes people fearful and angry.	• Fearful and angry people make war.
• Happy music makes people smile.	• People who want to smile choose happy music.
• Nuclear bomb testing makes people nervous.	• Nervous people test nuclear bombs.

Source: The Elliott Wave Theorist (Sept. 17, 2004)

most out of it. Oh, and an eraser when you screw up, preferably one that can be used to go back in time and edit something that you published last month.

FM: What is the single most important rule of Elliott wave identification? What one relationship has to be true before anything else can fall into place?

BP: The one with your significant other. After that, the most important thing is, don't break rules. That's why we call them rules. They're all in *Elliott Wave Principle*, which Frost and I wrote in 1978. Guidelines are another matter; I learn small new things about Elliott waves every year. The impetus is usually some painful experience, all done so the next generation of readers can live pain-free. In the new edition, I'm including a clear list of rules and guidelines for each and every wave formation. It should be off press by year-end.

FM: You've said, "Beating the market requires a transcendence of emotional involvement." That statement sounds like it's getting at something a lot more complex than just "take your emotions out of trading." Explain the role emotions play in trading and how traders can use their emotions to their advantage.

BP: You can take some of the emotion out, for example by trading a very small portion of your capital. But you're right; that's not what I was talking about. I was talking about harnessing your emotions, not eliminating them. Because of the herding impulse, most people's emotions fluctuate as if it were true that rising prices increase the chances for rising prices and vice versa. But of course the opposite is true. You need to act in accordance with reality. To do that best, you need to have your emotions fit the proper actions. In other words, when you start out, recognize when you get bullish in a rally or bearish in a decline. That's the signal to think about doing the opposite of what your emotions are telling you to do. But it's hard. It's like forcing yourself not to duck when a rock is hurtling toward your head. If you can handle that, you have transcended your emotions and mastered them for a useful purpose.

After doing market analysis for a number of years, my emotions with respect to the market became inverted. I get bullish emotionally during declines and bearish emotionally during rallies. So my intellect and emotions are usually in gear. They are not always right, but they're in gear. When I first met a trader who acted that way, I thought he was a fluke of nature. Now I know that it's a change that comes with experience. And I mean experience with real money, not hypothetical paper-trading. Every successful trader fails at first. So does every loser. The difference between them is method, discipline and experience.

FM: OK, Bob, final question: Where do you see the S&P 500 being in June 2005 based on your Elliott Wave analysis in the first week of October 2004?

BP: I'll be surprised if it's not a lot lower. But markets have surprised me before. The main point is that I wouldn't touch the stock market with an 11-foot pole while wearing a nuclear radiation suit. It's toxic waste on steroids. I don't care if it does squeeze out one more rally. The next decent bottom is a long way away in both price and time, and you should never expose yourself to such risk. I guarantee, if I live long enough to be as super-bullish as I was in the late 1970s and early 1980s, most people will be too afraid to buy a share. |FM

Note: If you are interested in downloading any of the papers or studies mentioned in this article, please go to: www.elliottwave.com/futuresmagazine.