Philequity Corner (October 24, 2011)
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Short Squeeze, Dead Cat Bounce and Other Stock Market Jargons

After last week's Q&A column, a number of our readers have sent us more questions regarding a number of terms used in the past. We have also been asked to clarify other words being tossed around in the news. While we have shed light on the reasons behind the market's rollercoaster ride last week, today we will clarify some stock market jargons and economic terms. Below are some of the questions from our readers:

What is a short squeeze?

There has been a persistent opinion that the market rally the past two weeks was due to a short squeeze. So while it may sound like a funny handshake or a way of squeezing someone's neck, what we are actually talking about is a much-discussed stock market phenomenon. A short squeeze happens when short sellers are forced to buy back their stock when the price rises despite the heavy selling of short sellers. The strength of the stock price despite massive short sales may be a result of corporate buybacks or purchases by mutual funds, long term investors, hedge funds, and insiders. Normally, short selling is used to profit from a drop in the stock's price. But sometimes events, like the European pronouncement of a possible solution to its debt crisis, force them to cover their shorts at a loss. Once short sellers start buying, more traders pile in, sparking a stock market rally, like what we have seen recently. A short squeeze is normally seen as a temporary rally, but it can actually start a change in pattern.

What is a rally?

We are not talking about the Occupy Wall Street movement or the Greek rallies opposing the government's austerity measures, but a rally in the stock market. A rally happens when a stock moves up after a sustained downward move. Stock prices do not go down in a straight line. Despite all the bad news, stocks tend to bounce back, because of temporary good news, renewed optimism or oversold conditions. For instance, stocks rallied because of an impending solution to the European region's problems. However, if the various leaders do not agree on a solution, then what we saw was merely a technical rally.

What is a relief rally?

If the market rebounds because of oversold conditions, then what we are seeing is only a relief rally. By the word relief alone, it means the market is just trying to ease selling pressure. It is a just temporary upwave or pause before the resumption of a downtrend.

What is a dead cat bounce?

The market has been really volatile the past few months. Both drops and rallies have been quite large, confusing both bulls and bears. However, rallies can also be brief and limited. A feeble rebound which signifies that a rally is short-lived is called a dead cat bounce. When a dead cat is thrown from a building, it only bounces a little bit upon hitting the pavement before eventually touching the ground again. Traders who got stuck and want to exit the market usually wait for a large rally to get out. If the rebound is not sizeable, they will not be able to sell and the rally is considered to be a dead cat bounce. So before PETA thinks this article supports violence against animals, we would like to clarify that we are referring to a term used by equity traders.

What is a breakout?
We are not referring to a jail escape, but rather a price movement through a resistance level. When this price barrier is significantly surpassed to the upside, it is usually followed by more buying on high volume. If a support level is breached and prices fall on heavy volume, it is called a breakdown. If and when the European leaders come up with a solution to their debt crisis, we may see a breakout from current resistance levels. The resumption of the bull trend may then continue for the PSE index.

What is a head and shoulders?
If one is left scratching his head while trying to figure out how to navigate volatility and the price swings of the market, then maybe it will help to look for a head and shoulders. No, we are not prescribing a shampoo to stop a person from scratching his head or to solve his dandruff problems. Rather, we suggest that, in addition to trying to understand what is going on with the European crisis, a trader can try to fathom what happened by looking at chart patterns, like a head and shoulders. This pattern is so named because the chart formation resembles the head and shoulders of a person. The highest peak is the “head” while the smaller peaks occurring before and after the “head” are the left and right “shoulders.” Head and shoulder formations are usually reversal formations, meaning that once completed, it marks a change in trend. It is also considered to be a distribution pattern, which also suggests that the major trend may be changing. Whereas the completion of a head and shoulders pattern is bearish, the reverse head and shoulders pattern is considered to be a bullish signal.

What are macroeconomic headwinds?
In aviation and seafaring, you have headwinds and tailwinds. If you have a tailwind, it means that the wind travels in the same direction as the ship, which makes travelling much quicker. Unfortunately for a traveller though, if his plane is experiencing a headwind or that which blows directly against the plane’s course, he can expect a long and choppy ride. What we are experiencing now are macroeconomic headwinds coming from Europe, the US and other countries. Much like the wind that blows directly against the course of a ship or airplane, macroeconomic headwinds are factors that are not supportive of economic growth. Examples are slowing industrial production, dropping labor productivity, high unemployment, falling exports, lack of fiscal discipline, sovereign debt issues and the need for stimulus packages. As mentioned above, since these are signs that an economy is slowing down or collapsing, it also weighs on stock prices. This has brought about a sense of urgency among Europe’s leaders who are now scrambling to put together a roadmap out of this crisis.

What does “buy on dips” mean?
Although fear has swept the market, Europe’s quest for a solution has triggered long term investors and professional fund managers to buy on dips. Buying on dips means that one takes market corrections as opportunities to buy since he considers the uptrend is intact. One may also buy on support. This is an especially profitable exercise if the market is in the middle of a bottoming-out process. Assuming that the Europeans are able to come up with a resolution to their crisis, then this might well be the case. However, if they do not find a solution to this crisis, then the downward move may resume, thus plunging us once again into a bear market. That said, the ball is in the European court.

What is a double dip?
Having two scoops of ice cream is a very wonderful thing, especially during the summer, but when you are talking about the US economy, it paints a sordid picture. Much like a dead cat bounce, this refers to a recession followed by a short period of positive GDP growth, followed by another recession. To be strict about it, a country will be technically declared to be in recession if it experiences two consecutive quarters of negative GDP growth. Thus, by the time the official announcement is out, the country would

actually already be knee-deep in a recession. What makes a double-dip recession much more dreadful is the realization that the recovery was merely temporary and that the economic picture is much worse than expected. This tends to negatively impact stock prices since earnings would naturally decrease in line with a slowing economy. There are persistent fears that Europe and the US are at risk of going through a double dip recession.

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