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Stocks: Late-Show Chills and Thrills

During these wild times on Wall Street, the last hour of trading has been marked by rapid plunges—and sudden rallies. What gives?

by Ben Steverman

For one of the best signs of how the stock market is handling this time of deep fear and uncertainty, look at how stocks perform late in the day.

In the morning and early afternoon, indexes might swing wildly between "things aren't so bad" to near-panic selling. But as the closing bell approaches, traders know they'll be stuck with their decisions overnight.

As fear of a global credit crunch spread earlier this week, traders have spent the late afternoon flooding the market with sell orders. That's fear, plain and simple, market experts and traders say.

"No one knows who to trust," says market veteran Arthur Cashin, UBS Financial Services' (UBS) director of floor operations at the New York Stock Exchange (NYX). They don't want to be exposed to risk overnight when things could turn from bad to even worse.

But on Thursday, the market bounced back late in the day. Is that a sign investors' panic is easing a bit?

Night Moves

Late-session moves are a function of what Chris Johnson of Johnson Research calls "news-cycle risk." The latest bad news could come from a French bank, a Wall Street brokerage house, or a California mortgage bank, and such news usually hits between the 4 p.m. ET closing bell and the 9:30 a.m. ET opening bell. Rumors spread online and through trading rooms about who might next get hit by credit issues. Indexes took a turn for the worse at about 2 p.m. ET on Monday, Tuesday, and Wednesday.

It wasn't always this way. Until this summer, the opposite was the case. The market often rallied at the end of the week—"you could almost count on it," Johnson says—in anticipation of big merger-and-acquisition deals being announced late Sunday and early Monday. No one wanted to miss out on a big move.

But as the market fell day after day in the last week, no one wanted to get stuck in a market that gaps lower at the opening.

Traditionally, market pundits say, the last hour of trading is when the professional traders make their moves, while the first hour is for the more emotional, amateur investors. Of course, it's not that simple: In a market with thousands of participants making billions of trades, the reality is complex and often hard to quantify.

But it's true that stock markets have seen a rash of late-session sell-offs lately.

Off-the-Map Volatility

It's been tough for individual investors and especially day traders trying to time the wild market movements, says Ray Johns, senior market editor at DayTraders.com. "So many people have been conditioned over the last five years to play a market that is overall bullish," Johns says. "People tend to get conditioned to buy on the dips." But buying on dips or late in the day hasn't been working, he adds.

Birinyi Associates keeps track of market indexes during the first hour and last hour of trading. In the year to date, the S&P 500 is up 1.3% in the first hour and down 0.9% in the last hour. But those numbers have shifted from earlier in the year: From January to Apr. 20, the S&P 500 was down 2.2% in the first hour and up 1.5% in the last hour.

Cleveland Rueckert, a research analyst at Birinyi, is cautious on whether you can read anything into such figures. "It's very difficult market conditions just in general," Rueckert says.

Volatility, a gauge of fear and uncertainty in the market, is at an all-time high. The Chicago Board Options Exchange's volatility equity index was at a sky-high 30.7 at the end of Thursday's session.

That index reflects big and unpredictable swings in stock prices throughout the day and overnight, as buyers and sellers disagree from moment to moment about which way this market is moving.

Programmed to Sell… and Buy

Some market experts believe electronic trading is causing some of the volatility.

Nearly all the big institutions trust their minute-by-minute trading, if not their overall investment decisions, to computers. Trading programs can move in and out of the market quickly and decide exactly the right millisecond to sell shares.

Institutional investors may have made decisions to unload stocks, either because they've been forced to sell or because they are betting on a falling market, says Bill Cline of Acai Solutions, a capital markets consulting firm. But big investors can't sell their shares all at once or risk affecting prices. So their trading programs wait for the market to show signs of strength and then unload lots of shares. "We're seeing professional traders, who believe there are more fundamental changes in the market, taking advantage of momentum," he says. The fact that so many programs are looking for these buying or selling opportunities at once can lead to big swings in momentum.

That happened Thursday, when stocks made up nearly all of a massive decline earlier in the day. The Dow Jones industrial average was off 340 points at one point before ending the day down just 15.69.

It may be a sign of optimism that traders were willing to buy up stocks late in the day and stick with them overnight, a reversal of the recent trend.

Richard Sparks, of Schaeffer's Investment Research, believes the market fell Thursday until it hit some key technical barriers that strategists were watching, especially the 20-month and 200-day moving averages of the Standard & Poor's 500. The fact that markets finally saw some late-day buying "is somewhat encouraging," Sparks says, but he says he would be hesitant to attach much significance to one afternoon's move.

Wild and Crazy Market

The worries in the market are still quite real: A credit crisis started by rising defaults on subprime mortgages, but soon spread to other kinds of debt. Many worry the liquidity and credit problems could ultimately affect economic growth.

Much of these moves boil down to many investors running away from risk—in stocks, debt, and other assets. "It's a fear of what news might come up after you go home for dinner," says Avery Shenfeld, senior economist at CIBC World Markets (CM).

A key question might be what happens on Friday. Will trading desks, fund managers, and individual investors feel comfortable going away for the weekend exposed to a wild and crazy stock market? If stocks show strength before the closing bell, that would be a sign that many investors believe the worst is behind us. If stocks head south, investors may be expecting more bad news over the weekend.

Of course, the best sign for stocks would be a return to rising prices. Despite Thursday's recovery from earlier lows, several major indexes ended the day in the red. John Wilson of Morgan Keegan says that until you see the market up 1.5% to 2% on heavy volume, "it's going to be difficult to buy."