IFF

TURNING POINTS

By Andrew Street

One of the oldest homilies in the world of markets is that “the trend is your friend”, usually followed closely by, “…but your friend is not a trend”. We have seen a sustained trend in Bond markets upwards for almost thirty years (with yields falling inversely, along with inflation) along with a major stock market recovery which has been strong for over two years. So, when is it all going to end? When do we get a turning point?

Human beings like linearity, straight lines, they like to get onto a trend and this can become self forefiling by generating its own momentum. It’s the bigger fool theory, I don’t buy on fundamentals, I buy because my (and others) price action will raise prices and I can then sell on to the “bigger fool”. Sometimes, if you get your timing wrong, you are the bigger fool.

So how do we spot turning points in markets? I am not going to say its is easy, it is not, but what indicators can we look at?

Clearly valuation plays a key role. In stock markets PE ratios, particularly CAPE, give good indications of longer term value and cheap / dear conditions. However, they are not so good for market timing, markets can stay rich for years before turning. US stock markets for example (about 50% of the worlds equity by value) have been very expensive by these measures for several years.

Looking at Bond yields critical indicators are the “real yield”, i.e. the return after adjusting for inflation and also “credit spread” adjusted for expect loss, which gives us a handle on the risk premium in corporate bonds. Again, historically these indicators have been very low and compressed. To some extent the equity market has represent the “only trade in town” or “there is no alternative” (“TINA”) and as such has received capital by default forcing prices higher along PE multiples, so investors pay more for the same earnings.

But things are now changing, real yields are rising and stock earnings yields remain extremely low, volatility is also returning to the market, suggesting that investors are adjusting positions, some money is being taken out of the momentum trade and now bonds can offer some real returns after inflation. The is an alternative, especially in the US.

Clearly the market depends on investor confidence, earnings are growing, particularly in the US and until very recently inflation seemed well controlled. However now the market fears that both inflation and / or the FED’s rate intervention will get out of control causing investors to question their confidence in the stock markets in particular.

Indicators we can monitor include the VIX index, 200 day moving average, real yields, credit premium, earnings growth and many others. But which will give us the key indicator of the turn? Probably no one indicator can do this, but prudent risk management would dictate that this is the time to scale back risk exposure to the crucial markets and consider a detailed plan of action for when the market finally turns with all the associated issues of liquidity and funding. Time to do the risk management.

ENQUIRIES

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