

The Buy Side

Market timing is only a sometime-thing



There are several risks to consider with the bond market in the coming year, including rising supply, a faltering economy and higher interest rates. A lot of companies issued new debt in 2009 and if the trend increases in 2010, some deals could collapse, which would drive up the yields and send down bond prices. Likewise, if the economic recovery stumbles, default rates could inch up and put upward pressure on yields. And when central banks finally start to push up government rates, expect bond prices to fall. iStockPhoto

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Can market timing work? The answer is no, and sometimes.

No, because if you rely on market timing exclusively, you are bound to lose money since you have no edge, no matter what you think. There are no rich market timers.

So why the sometimes? Because in true extremes, the market is often a clear buy or a clear sell, for example, when everyone panics since the world is obviously ending, such as in October, 1987; or conversely, when the market is on its way to the moon, as in March, 2000. But in other, normal periods, market timing is a mug's game. The problem is that even at such useful extremes, you are either too panicked or too euphoric to act – unless you use rigorous economic fundamentals to help you stay calm.

Yes, the economy has fundamentals, too, like stocks. And no, they don't always work, but at extremes they sort of point in the right direction. Like the old **Value Line** pages that list all stocks trading below net-net (cash less all obligations). An old rule was: When VL has only a handful of

these – as in August, 1987 – reduce your longs and favour shorts. But when there are pages and pages of net-nets – as in August, 1982 – you can safely buy the stocks you researched. Sort of like background music to sleuth stocks by.

As you may recall, on Feb. 28, 2009, this column told you the market was as close to a bottom as can be. (The Dow was then at 6,600.) The upside was about 50 per cent. This was based on what I called **the California Model** (popularized by Stephen Leeb) – the same model (plus some background fundamental music) which by March and April this year showed the market as stretched, and so the column recommended that you be hedged or short. Up to now it worked. Of course there's no guarantee this would continue to work. But just for fun, what do these background tunes say now? They are neither in clear "buy" nor "sell" territory (which is where they are 95 per cent of the time). Still, here's an interesting question: By looking at the model's economic fundamentals, can we estimate what's needed for the market to become a buy?

To remind you: **The main fundamentals** are **Real Interest Rates** (that's the corporate triple-A rate less the 12-month change in the producer price index), **commodity price inflation**, **yearly rate of change in U.S. unemployment insurance claims (UIC)**, **changes in the money supply (M1 and M2)**, **real price-to-earnings ratio** (trailing P/E plus consumer price inflation), extreme market rise or fall, and some other minor items. Again: **The model is right only in market extremes**, and even then, only about 75 to 80 per cent of the time. But with these caveats in mind, where does it stand now?

Real rates are minus-2 per cent – not as bad as the minus-4 per cent in March (or the minus-10 per cent in August, 2008); but they're still negative.

Commodity price inflation is lower, mainly due to energy prices, but it's still plus-6.8 per cent year-to-year.

UIC is terrible: it's down 32.5 per cent, on lower unemployment claims (mainly because of end of benefits) – which means the Fed is not ready to panic yet.

Real P/E is a middling 17 times, because CPI is low, and earnings didn't fall much.

And the stock market (e.g. the S&P 500) is 6 per cent above its level a year ago. Another middling sign: Only when the market has plunged is it primed for a rise.

So what would make the market a buy? **First** and foremost, **a healthy plunge in commodity prices**, like in 2009. If you give me \$60 (U.S.) oil, I'll give you a rising market. If you give me \$40 to \$50 oil, I'll give you a super bull: The U.S. bank bailout and Europe's debt are paid, the economy zooms, and the bad guys have less money for terrorism – ergo less risk premium for the market. How could lower oil be attained? Either through a second-dip recession (assuming no new oil gushers), or Gulf War III – which would also tank the market initially.

Second, high real rates. If you give me 5 per cent-ish triple-A and a minus-8 per cent Producer Price Index (PPI, which lower oil would bring), I'll give you a bull market. If it's a minus-10 per cent to minus-12 per cent PPI? A raging bull, like March to December, 2009.

Third, higher unemployment, which would panic the government and the Fed.

Fourth, M1 and M2 (which have been flat to negative last three month), should expand – which would happen if unemployment rises, the market falls, commodity prices plunge, rates rise a bit, and there's a Mideast scum. The Fed would then panic usefully and print money.

Fifth is a market lower by 15 per cent – say Dow 8,500, Nasdaq 1,850, and a \$15 price on the iShares S&P/TSX 60 Index Fund. This would cut the P/E and scare consumers, which would lower CPI and PPI, and push the Fed to act.

So: Stay hedged for now, but if you see higher U.S. unemployment, a Mideast kerfuffle, lower oil, a lower stock market and a panicked Fed, you can take the hedges off and add to your sleuthed longs – with the wind at your back for a change.

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