

Market Forecasting: A Fresh Perspective

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An Exciting Start

There were so much volatility and action in the first weeks of 2008, it seems like we have lived through one full year. We witnessed almost a complete 'market cycle' in the space of a few trading days - thanks partly to Federal Reserve which has been influencing the markets with its actions and whose actions were in turn influenced by the markets. One plausible theory is the markets concertedly fell so much so fast to force Fed to cut rates by 75bps, the most aggressive in its history of intervention.

Suffice to say, the outlook now is so uncertain, any prediction or forecast of any kind risks being very wrong by the end of the year.

An interesting Odd

You toss a coin. Head. Toss again. Head. Assuming you did this 5 times in a row with Head every time. What do you 'feel' will be the result of the next toss? Statistically, it is exactly 50%. But the odds of getting 6 Heads in a row is very small. The Dow Jones has been up for a consecutive 5 years and looking back to its long history, there have been only a few rare occasions, when the Index is up more than 5 years (beware, the probability of an 'up' year is not 50%). That is, the probability of the Index closing higher this year is slim, by historical standards.

If we were to pick just one prediction for 2008 – it is that the Dow (and the STI too) will close lower for the year. I had a simple plan. On the last trading day of 2007, short the Index. But, what if it moved up instead during the year and only declined to end lower at the end of 2008, and we suffered too much losses in between that we had to quit the position? So, strictly, we need an instrument with an exact tenor of 1 year (end 2007 to end 2008), give us the right but not the obligation to exercise only on the last trading day of 2008, and we levered the position up. If this trade does not turn out right for 2008, we will repeat the same trade for another year at the end of 2008, with an even higher probability of success.

This seems like a good strategy now given that many markets are down 10-15% for the year. But, we never know till we reach the year end. And our risk is the Index only goes down slightly such that our profits cannot cover the cost of the transaction.

Watch out for downward movements which exceed 20%, which is a yardstick used to define a bear market. So far, a few markets including STI, Hang Seng have breached that. The US indices in general have not. To put things in perspective. Since 1926, the average bear market in the US has lasted 1.3 years and stock prices come down about 30%. Only 2 of the last 15 bear markets have ended in less than 6 months. More than half the bear markets have ended in less than a year.

An Alternative Perspective

Have we ever wondered why we are often fixated by what will happen over a year? I recall advising a friend in 2002-2003, a period of general gloom, to take a longer-term view of the property market. The perspective is simple – take a rolling 10-year window of the Singapore property prices in the last 40 years, and you will not find a window where the price level at the

end of the window is lower than at the beginning. For instance, the last peak was 1996 and 10 years later, which is about now, we are almost at a higher peak.

It is forecasted that, despite all the uncertainties, there is a good chance that the general property price index will breach the previous high. Philosophically, it is a question of time and definition of the segments. We are now into 10-11th year from 1996 peak, so the probability of a higher peak in the next 1-2 years is high. If this does not happen, it implies structural changes in the demand and supply of the housing markets in Singapore that have not been witnessed in the previous 40-50 years. Or, technically, the high-end condo market had breached the previous high this time while the overall property price index has not.

Another Few Predictions

Name of the Rose

When we look at the history of market cycles, there is a trigger or a 'Name' for each market downturn, the most recent being the dotcom bust in 2001-2002 where valuations of dotcom companies were irrationally high; in the late 1980s to early 1990s, it was the Savings and Loans (S&L) crisis. Now we have the schizophrenic monster named 'Subprime'. Subprime in itself may not have been a problem as this loan segment constitutes less than 15% of mortgages in the US; it was the much maligned financial engineering (securitization or CDO suffice for now) that created the domino. The other less publicised accomplice is the movement in the late 1990s where there were many real estate gurus who advocated 'No Money Down' for everyone to buy as many properties as they can with little or no down payments! The plan was simple: buy your first house, as property price continues to go up, capitalise on the increased equity in the existing house(s) and buy the next. I was sharing with a friend in 2003 that this would in time give rise to serious society-wide problem in a few years when the property prices reversed its trend and caused a domino. This will affect not just the investors who have little holding power but equally the others who are just over-stretched. The problem is still panning out in the US and Europe. So far, we have seen in excess of \$100 billions of bank CDO and mortgage-related write-downs.

It has been forecasted that the whole saga may take till end of 2008 or beyond with estimated total bank write-downs of up to \$400 billions! The peak of these will likely come in the next 2 quarters with many banks wanting to start on a clean slate, what with many new CEOs taking over the helm. There is a trick to testing when this will peak: when almost everybody knows and can grasp what this subprime issue is. I recall deciding whether Microsoft would be a good investment in the 1990s. It was not cheap then, in fact it was trading at about US\$500bil market cap but analysts were calling for it to cross the magical US\$1 Trillion soon. As part of the investment process, I spoke to my parents and friends in my small hometown in Malaysia. They all knew Microsoft (at least the computer software), that Bill Gate was the richest man on earth. I realised then that the company is likely at its peak, mature, with no meaningful further upside.

Now, forecasting the big picture. The beneficiaries of this credit crunch are likely the sovereign funds which cannot otherwise acquire substantial stakes in the top international banks. We have heard so much about the rising East, in particularly China and India. This is now going to be hastened by the changing equilibrium of world powers in the boardrooms of MNCs. The likely losers are the existing shareholders who see their stakes in the companies diluted; but they cannot complain too much since without the capital injection, the problem could be worse. US consumers in general are also worse off, with their economy teetering on inflation, and their Purchasing Power eroded by the weakening dollar.

The Cost of Money

The Fed had started cutting rates since Sep 2007 and had so far cut 225bps to 3.00% in the space of just 4 months, the last 225bps in just 1 week! Now, it is interesting that our financial markets have grown so sophisticated that market participants can vote with their money how much they want certain things to happen. So, we have the futures markets now pricing in rate as low as 2.0-2.5% by End 2008 with a certain confidence level.

With the cost of money tumbling to negative or near negative, it has been forecasted that the US dollar will continue to face downward pressure vis-à-vis the world currencies, including SGD.

From historical perspective (you will have noticed that history is our best companion to understand the financial markets, but history never repeats itself in the EXACT manner), the equity market had performed well over the next 3 to 12 months after the first rate cut. This translates into Jan-Sep 2008 from the first rate cut in Sep 2007. Watch this window. Also recall I forecast that the key stock indices are not likely to end 2008 higher than the 2007 close?

Riding the Millennium Wave

It is safely forecasted that if you ride on the big waves, the mega trends, you will not go wrong (at least in the medium to longer term). We have all heard about investment themes on agribusiness, global warming, climate change and infrastructure, and commodity secular bull, the rise of China and India. The key is diversification. Spread your investments among these themes, across industries and countries. You do not want to bet all your money on a company about to produce a break through product that can capture 60% of the market share. Sounds familiar?

The Invisible Hands

The market dynamics have changed - a function of the evolving market participants, their increased sophistication and resources.

If there is one market player that exerts the biggest influence on the markets, it has to be the Fed. With interest rate policy at its disposal, it has almost single-handedly turned the financial markets on its head.

However, what is not obvious is the invisible market participants, notably hedge funds that together create a market that is so swash with cash as well as being able to punish the markets in a matter of hours, so much so that the Fed and other central banks can be forced to react the way they want it.

This has created a seamless global financial market that tends to swing wildly and overshoot in both directions. A 20% swing to the negative territory in today's markets may not mean an onset of a bear market, but a mere unnatural market momentum that temporarily overshoots one way to quickly adjust back to the other extreme or to the mean. What we have seen recently.

Flight to Quality and Defensive Strategies

It is forecasted that defensive strategies will ride out the volatility better. In terms of stock selection, go for those with high dividend yields, low Price/Book rather than low PE ratio. Why? There is a probability that earnings may come under pressure in less favorable economic environment, hence making projected PEs misleading. The efficient market normally knows something that individual investors don't.

Diversification, asset allocation and portfolio re-balancing will help you ride through the market cycles, not just the current one.

Pulling the Strands Together

Personally, I read forecasts and reports with an aim to distill them into a few key underlying themes. Next, from this top-down process, we develop a strategy. In terms of tactical allocation to the underlying stocks, focus on familiar companies. Lastly, be disciplined, contrarian where it makes sense and employ money management customised to your situation.

Aim: “退可攻，进可守”。

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