Maintaining a Weather Watch

Buy and hold forever is not likely to work well in the current environment because:

- Governments and central banks are highly active and activist. As a result we get cycles of weaker and stronger regulations and tighter and looser monetary policy impacting markets and making them more volatile
- Increased mobility of capital through reduced commissions and the availability of derivative assets such as ETFs based on commodities

On the other hand, trading on every twitch in the financial news is even more dangerous, as it increases the chances that you will be whipsawed.

The best approach is to keep an eye out for storm clouds revealed through pricing anomalies in the markets – what I call maintaining a weather watch.

There are more models for maintaining a watch on the markets than you could count. Having spent a good deal of time paying attention to economic indicators, world events, etc, I have come to the conclusion that the most reliable indicators are those embedded in actual market prices. Assuming that, like me, you are primarily interested in stock market risk, I keep my eye on two markets.

<u>Scour the Equity Markets for Signs of Valuation Risk</u>

I think the best measure of equity valuations is Robert Shiller`s rolling 10 year real P/E. I encourage you to read about this measure more fully in his book *Irrational Exuberance.* In a nutshell, Shiller argues that the normalized real earnings power of the market changes only very slowly even though earnings for a given year can vary quite a bit depending on the position in the economic cycle. To get an idea of the normalized earnings power, Shiller takes the average earnings (adjusted for inflation) for the prior 10 years and uses that along with the current index level to compute a normalized P/E for the index.

I also like to use a long-run Return on Equity (ROE) approach as a check on the Shiller P/E. Shiller recognizes that over long periods of time, the index earnings increase slowly. The long run ROE approach relies on the observation that this increase in earnings is a function of the accretion of book value and that the cyclically normalized ROE is fairly constant. The product of the long-run ROE and the current index book value results in the cyclically normalized index earnings which can be used to arrive at the current normalized P/E.

If these two valuation measures are historically rich, be aware that the stage is being set for a significant drop in stocks. Remember that these states of overvaluation can persist for years so you may not want to reduce risk right away. The most recent example of a bear market that was preceded by overvaluation was the crash of 2000.

Don't Lose Sight of the Bond Market

Even though equities may be your focus, pricing in the bond market contains much useful information. I find that bond investors are often more sensible and sensitive to emerging problems than stock analysts. This is not necessarily because they are smarter. More likely it is because the prime interest of bond investors is the return of their capital while equity investors are looking for a return on capital. As a result, bond managers spend much of their time focussing on risks while their counterparts in equities are looking for opportunities.

- Inverted yield curve. This happens when shorter dated bonds are trading for higher yields than longer dated ones. While this situation is fairly rare, it indicates the expectation that yields will decline which often implies a looming recession
- TED spread. This stands for the difference between the yield of Treasuries and Eurodollars. Eurodollars are effectively interbank lending while Treasuries are obligations of the US government. Usually the difference between these yields are quite small. However, when Eurodollars are yielding significantly more than Treasuries, this often indicates stresses in the banking system and signals that the banks no longer trust each other
- Corporate spreads. This is the difference between investment-grade corporate yields and treasury yields of the same maturity. It is not so much the absolute level of corporate spreads as their trend which is revealing. If corporate spreads are increasing (or widening in bond argot) at the same time as equity prices are increasing, that is a warning sign. Basically it is saying that the bond market sees a looming deterioration in the credit quality of companies while the equity market remains oblivious. More often than not, the bond market is right.

Conclusion

Developing your own framework for maintaining a weather watch is important. Make sure your approach is simple enough that you can actually update it on a regular basis but comprehensive enough to capture major risks. Remember that a weather watch is not the same thing as market timing. In the case of the weather watch, you are simply staying abreast of warning signs in the markets that will alert you to reduce your exposure to risky assets. Assume that when the storm clouds start to dissipate that you will be ready to move right back to your policy asset mix. Expect any tactical moves as a result of the weather watch to be years apart – not months or days. The goal is to ensure you have meaningful cash to deploy after a drop of 20% or more.