Lessons From The Trader Wizard

by Bill Cara

SAMPLE CHAPTER:

Part 3: TRADING STOCKS (ALSO CALLED EQUITIES)

To succeed at trading stocks, you need an investment plan complete with a range of trading strategies and tactics. I truly believe you need to learn very little about many things. A Jack or Jill of all trades if you will. Judging risk and sizing up opportunities for successful traders is based on macroeconomics, corporate fundamentals, corporate and peer group quantitative data studies and technical trend and cycle data studies. All of them.

For many years, I watched expert mathematicians, expert economists and expert accountants blow up their capital simply because they thought their specialized expertise was all they needed to succeed in the capital markets. In fact, you don't need to be an expert at any one thing, but you need a good working knowledge of many.

There are four basic knowledge elements that all traders must master before they can gain confidence to trade successfully. Start investigating a corporation whose stock you are interested in from the top down by looking at:

1. The macroeconomic and government regulatory environment that a corporation has to manage. Do this to assess the environment picture and operating conditions for business corporations.

2. The corporation itself and how it deals with its employees, suppliers and customers.

3. Industry peers and past-performance metrics compared with the results of (1) and (2).

4. The stock price to see where it's been, where it's likely to go (according to mathematical studies called Time Series Analysis), and how that theory compares with a sense of the underlying enterprise value and the share prices of a company's peer group, industry, sector and broad market.

1. Macroeconomics: Where public and private sectors meet

The first Friday of every month, the capital markets (stocks and bonds) are put through their biggest spin cycle of the month. It's called US Jobs Report Friday. Like "CPI", the number is almost meaningless because it is a wild estimate and will almost certainly be revised. What the Jobs data does, however, is to add grist to the sell-side mill. Just a lot more yada yada by smooth talking noggins, trying to convince Joe Public they are "experts" and you ought to be following their advice… I learned the patter too. I mean, if you want to survive in the securities industry in any capacity from chief investment strategist to mail runner, there are a few *things you must be prepared to utter when your lips start moving. The US Jobs Report data is at the top of the list. "CPI" is another. Why? Because all people have a vested interest in their jobs and in the cost of getting to the end of the month, hoping not to be a dollar short.* — from Bill's blog

Understanding economics, the Fed and the market

If a trader has a basic understanding of the subject, macro-economic data can be used to interpret and forecast trading conditions and make better-informed decisions. Business owners and executives do this and traders have to realize their business is managing the wealth under their control. Clearly, that is a business like any other.

The Internet offers traders free access to potentially valuable economic data. Where we go wrong is to overlook the data and focus on the "talking heads" who interpret the data in the broadcast media. These are well-educated, intelligent analysts and reporters, but they are either biased or paid to say what they say. Traders need better information.

When a US Government agency, like the Bureau of Labor Statistics (BLS) publishes data such as the Consumer Price Index number, the talking heads and Wall Street read the number like it is a sports report coming to you hot off the wire.

Economic data is made to seem as important as pulling a face card from the casino's blackjack dealer. The audience is advised to buy or sell because this number (an estimate in itself) is up or down a tenth of a percentage point from consensus expectation.

Now, isn't that an absolutely ludicrous approach to wealth management?

The fact is that economic data is just that — data. It is only an indicator of underlying conditions. Besides, the "CPI" data is materially incorrect and misleading. The US Bureau of Labor Statistics calculator states that the cost of living has increased by 7.56622 times in 50 years (June 1961-June 2012). That means $1,000 on all items of consumer expenditure in 2Q1962 would cost $7,656.93 today. Wrong.

Consider your typical consumer expenditure list today and compare them to what they would have cost in mid-1962. Here's a list of comparables:

- housing, property taxes, insurance
- auto costs, maintenance, insurance and repair bills
- mass transit
- hotel rooms
- food and beverages
- newspapers and magazines
- dental and hospital/medical care
- school tuition and books

A house bought 50 years ago for $16,000 is now selling at 25 times or more that cost. The soft drink I bought in my youth at the local service station vending machine now costs 15 times as much. The mass transit ticket I use has increased 20 times in price. Entire books have been published just on the issue of the flawed "CPI". (Source: http://data.bls.gov)

Economic data points do not strictly control stock prices. Conditions may set the framework, but players decide on the game. Economic data, like other data you receive, is carefully spun to you by vested interests. If those people want markets to go up, data, like the "CPI", is used to paint a positive picture. If they want it to go down, the same data is used to paint a negative picture.

In 2007, when I wrote the original *Lessons* book, the US Federal Reserve Bank leadership had a Fed rate of ***4.75%.*** I asked if "The Fed" had set a rate of ***3.75% or 5.75%,*** would there have been any difference? I remarked that after a series of moves, there would still be a stable stock market, but that traders would then be worrying about if, and when, the next Fed rate would be set at ***4.00% or 6.00%.*** Today "The Fed" funds rate is near zero and traders are worrying about the implications of a move to higher levels.

Still, economic analysis is a truly important adjunct to securities analysis for serious traders. It is the change in the data that is important and how each change affects thinking, which has an impact on market prices. Back in November 2007, for instance, traders were hoping "The Fed" would cut "The Fed" rate to ***4.25% from 4.75, which had fallen from 5.25%*** in just a couple months, but I remarked at the time, "if that were to happen the reason would be problematic. Traders would initially think that the rate cut would be a positive factor, and would rally equity prices; then they would think about the underlying reasons for the rate cut and would start selling stocks unless there were a series of rate cuts. All through this period, the spin artists for the various sides would be pushing the public to move from one extreme to the other."

By focusing on a few key economic statistics, any trader should be able to acquire a reasonably full understanding of the real-world conditions in which corporations and professional traders operate. This is essential to drawing a link to future operations and financial strength of a company and its future share price.

Rather than thinking that any one data series is more important than others, consider the many interrelationships between underlying economic conditions and securities prices, and the fact that financial markets are dynamic. They constantly evolve due in part to changes in these economic conditions.

One caveat to new students of the market is that US data are only part of the economic picture. Traders, like corporate business managers, must increasingly deal with a global economy. Push and pull forces on stock prices — economic factors like interest rates, commodity and currency prices and so on — operate today in the international arena. Every Fed action or public speech must be put into the context of trying to stabilize interest rates and the US dollar in a global context. In any discussion of economics, start from the premise that "those with the money set the rules". Banks — and the most important bank, the US Federal Reserve Bank — are a good place to begin one's analysis. Commercial bank lending facilitates personal and business spending, and excessive spending generates "inflation". Since "The Fed" controls bank lending in the US, it thereby controls the pressures that would increase or diminish inflation in the United States.

Stock market indexes may run up or down in tandem with the economic cycle, or they may run counter to it. Both have a cycle. Stock prices are linked to the economic cycle, and the economic cycle is linked to conditions set by or permitted by "The Fed". Fed policy determines the actions of commercial banks, which happens to be the most important source of lending and, therefore, spending.

Bank lending is a key ingredient in the economic cycle — it drives the cyclic expansion of demand. Lending can't grow beyond the limits set by commercial bank reserves, so when "The Fed" wants to give the economy a boost it will encourage banks to lend more by increasing reserves at those banks. To do this, "The Fed" simply buys securities on the open market or directly from the commercial banks. The sellers (who are independent of the commercial banks) deposit some of the proceeds of the sale into their banks. Thus, the banking system reserves grow from both sources.

Increased commercial bank reserves directly increase the money supply — given that banks can find borrowers (and they always do). Banks create money through loans by crediting the deposit/ checking accounts of their borrowers when they make those loans.

Money is a commodity. All commodities have a market price and the interest rate you pay to borrow is the price of money. Its price fluctuates according to the laws of supply and demand, depending on its use. The use of money is what this discussion is all about.

If money is used to build armaments for warfare, that's probably inflationary. During wartime, wealth is destroyed. Historically, periods of war (over hundreds of years, affecting all markets) have been the only serious periods of inflation for otherwise stable economies. During peacetime, the economic cycle is typically disinflationary. This is the best time to invest in stocks and bonds — particularly those that are low interest rate beneficiaries, such as the banks and mortgage companies, REITs, and companies that "hold" several bonds and high debt as liabilities, like regulated telephone companies, other utilities and insurance companies.

During periods of economic expansion, which occur when the business cycle is disinflationary or inflationary, the demand for money increases and interest rates rise because consumers and businesses often need to finance increased spending.

Spending is financed by savings, by sales of assets, or, most importantly, by borrowing from banks. Every few years the price of things, including money, gets too high to finance spending from bank borrowings or diminished savings levels, so personal and business spending cannot keep up with the supply of available goods and services. Then, inventories build, business investment slows and the economy goes into a recession.

Recession and "disinflation" are quite different. Recession is bad. Low inflation and periods of "disinflation" are good.

As a recessive economy recovers, savings start to rebuild, financial assets accumulate and debts are paid down. Cash becomes plentiful again. Interest rates fall as the supply of funds exceeds demand for funds at current rates. This was the economic picture leading up to 3Q98, for instance.

With cash available to lend because of higher reserves, and with a low enough interest rate to attract borrowers, bank lending increases. This leads to higher spending, which leads to increased total demand and economic expansion. Internationally, the US economy took the lead in 1998 (it doesn't always) and by late 1999, there were signs that other major industrialized nations were beginning to follow.

Excessive bank lending then leads to inflation when the higher demand for goods and services reaches a level exceeding supply. At that point, "The Fed" — all other considerations aside — steps in to reverse the cycle.

That process began in the US in 1999, and "The Fed" raised its rates to commercial banks several times until a recession ensued.

If "The Fed" abandons their responsibility to keep inflation in check, the trade-weighted US dollar falls in price, and the cost of imported goods — to a nation that is a heavy net importer like the US — rises, causing inflation to spiral higher.

Because the US is a debtor nation, "The Fed" often has to perform a balancing act between interest rates and the foreign exchange rate and their combined impact on US jobs.

If US interest rates rise too much, the dollar becomes too strong, causing businesses to stop spending on capital programs locally and start importing more from foreign vendors. Jobs are lost. If rates fall too quickly, the dollar weakens, causing imports to become needlessly expensive and inflation returns.

By 2003, additional spending by both business and consumers was needed to boost the US economy, so to ramp up jobs and avoid the potential for "deflation", interest rates were forced down by "The Fed" to 1%. As we subsequently learned, that rate was well below a reasonable point and had been the intention of "The Fed" to help their precious banks generate earnings and restore capital. As a consequence, the price of the US dollar collapsed. Following the financial system failures in 2008, "The Fed" rate was dropped to near zero, where it remains today to the discomfort of even some of "The Fed" governors who worry that it is yet another subsidy for large banks and a tool for redistributing wealth from savers to debtors.

A long-term balance between the supply and demand for money is needed and "The Fed" has for many years played a controversial role in moving too far in one direction or the other. Its critics wonder why the banks can borrow from "The Fed" at rates of 0.25% or lower and use that money, not to make loans to corporations and individuals, where cheap money is required to grow the economy, but to invest in Treasury bonds that yield 3%, strictly for the benefit of the shareholders of these banks.

For political reasons (as in pressure from the White House and Congress) the job is not an easy one. Sometimes when the economy is running hot on all cylinders, like kids in the schoolyard preferring an extended recess, there are many traders and politicians as well who never want "The Fed" to tighten the money supply and borrowing conditions. Then when the economy has cooled out, the same people want "The Fed" to be aggressive with accommodative policies.

Many schools of economic thought exist today, from the Keynesian/monetarist/demand-siders to the Kudlow-Laffer/supply-siders. All believe different factors in this equation (the business and economic cyclic process) have varying degrees of importance. The basic equation for the cycle remains the same.

The world is as rife with economic statistics as with sports stats listed in our daily news. Some are more important than others. Consumer and business spending aggregates are important economic numbers and must be routinely monitored by traders who use the big picture, top-down analytical approach.

The most important consumer spending statistics are auto sales, consumer credit and new permits/housing starts. For business spending, the most important data are capital expenditures and inventories.

The effects on the capital markets of changes in data related to retail sales, employment and personal income are difficult to analyze. This data is sometimes helpful when analyzing individual stock groups, such as specialty retailers, recreation and leisure stocks, and the like.

All this data is reported on by a free service called Econoday, which is available through the NASDAQ website.

The world is strewn with economists, statistics, economic analysis and reports. I frankly don't see the value of most of it and I certainly don't believe much of what I hear and read. I need to frame my trading analysis and opinions in my sense of the economy, so I constantly seek meaningful information in this area.

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