Trade Financial Markets Like The Pros

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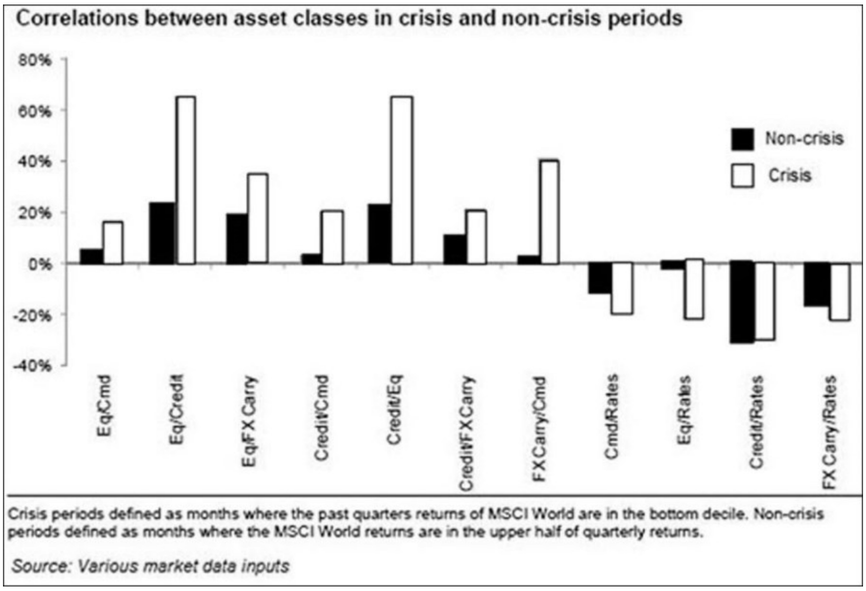
SAMPLE

Risk-On/Risk-Off And Other Correlations

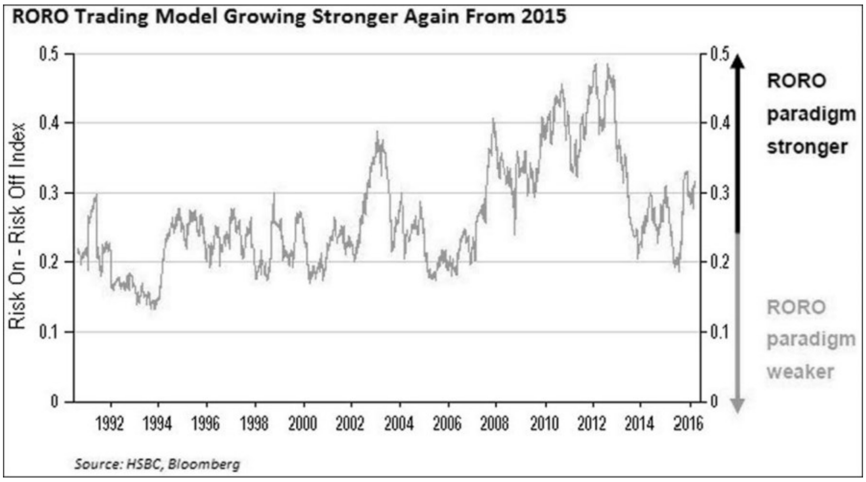
Even in a more 'normal' market environment – that is, one not torn in different directions by some major central banks continuing QE and some not, differing central bank emphasis on certain key economic data points rather than others and divergent inflation and interest rate paths for pivotal global economies – simply 'jobbing' in and out of an asset in isolation in search of a few pips here and there is almost certain to result in trading disaster. Indeed**, this style of dealing is the number one reason why 90% of retail traders lose all of their trading funds within 90 days of beginning to deal.** Not being one of these – and, rather, being one of those that makes life-changing serious money – requires self-discipline, knowledge of trading fundamentals (see later), a sound grasp of technical analysis and risk management (see later), extensive knowledge of risk management techniques (see later) and the ability to discern what patterns are in play across the global financial markets at any given point. This last point is what this section is about.

In general terms, the degree to which the price action of all major financial markets assets are correlated positively or negatively has varied since this phenomenon fully manifested itself after the collapse of Lehman Brothers in 2008. It is equally the case, though, that **these correlations, which are a function of the risk of systemic failure across the global financial system, remain a significant common price component of all assets in all regions across the world**.



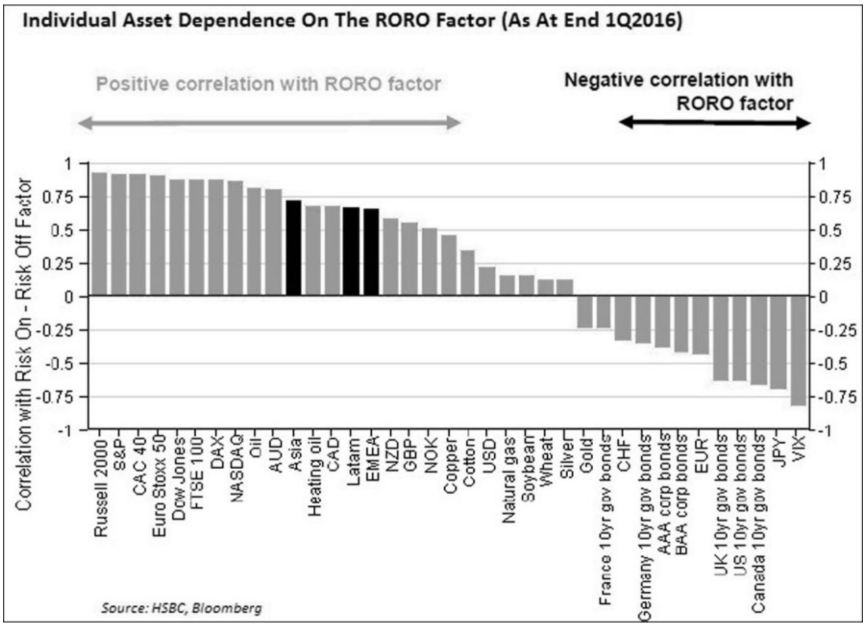
When the risk of this failure rises there is a shift towards less risk-exposed assets ('risk-off') and when it falls there is a move towards more risk-exposed assets ('risk-on'); both conditions together being acronymically termed 'RORO'.

As at the end of the first quarter of 2016, the RORO trading model was a dominant theme again (together with the more specific trading correlations mentioned earlier) as shown below.



The fact that the prices of apparently disparate individual assets move in tandem (either positively correlated or inversely correlated) means that **classical methods of maximising returns whilst minimising risk will remain sidelined for the foreseeable future, calling for shrewder and nimbler investment approaches going forward** (currently, the RORO matrix is as laid out in the chart below).

This is even truer in periods when these correlations change on a proverbial dime, as they have been doing for some time now, although there are much longer-term cycles of which a trader must be aware in order to understand the base point from which they are operating, and these are identified immediately below.



Long-Term Economic Patterns

There are broad-based long-term cycles that have important ramifications for overall portfolio structuring. They include the comparative weighting of different asset classes, the point of possible convergence of an economy from 'frontier' market status to 'emerging' and then to 'developed', and even for discerning very long-term patterns in technical analysis.

The Kondratieff Wave

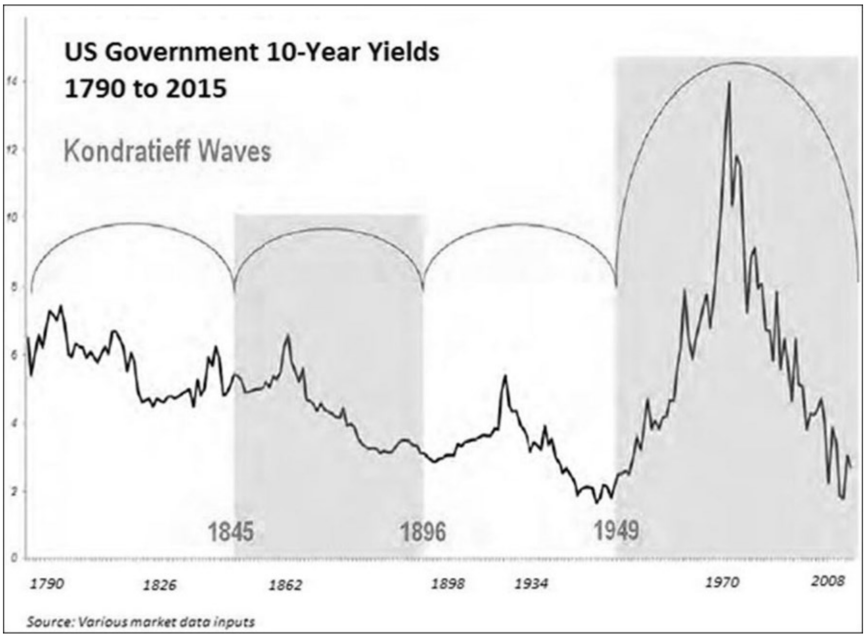
In global terms (we will get to the specifics for regions and asset classes in a moment) to kick off with, the trader needs to be aware of the Kondratieff Wave ('K-Wave') – named after a Russian economist active in the 1920s named Nikolai Kondratieff – which seeks to show that **there are long-term cycles in the entire global capitalist economy of between 45 and 60 years – and even much longer – each that are self-correcting and evolving and are defined by the emergence of new industries in ongoing technological revolutions.** As an adjunct of this, each major cycle involves the destruction of much of the past cycle and the concomitant evolution of new innovation.

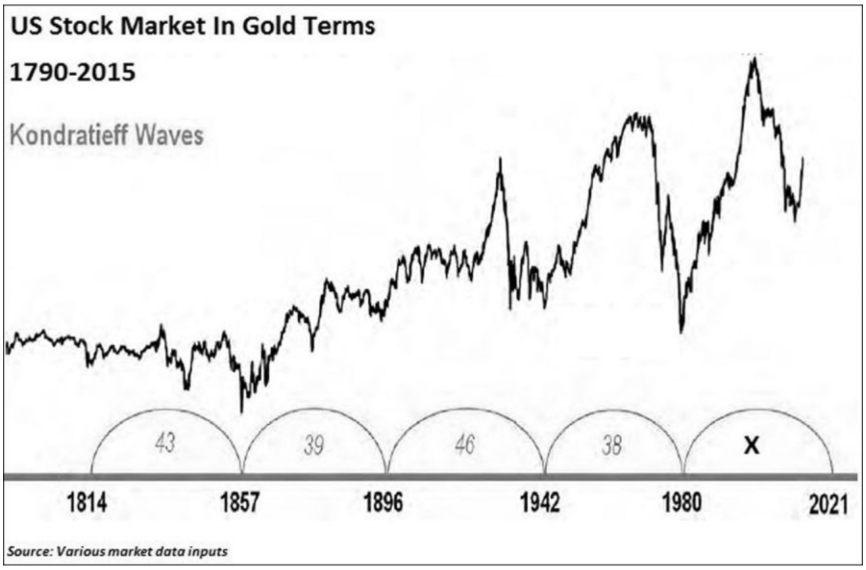
Kondratieff's theory has been refined/distorted – however you want to look at it – by various people since, but the consensus of the major examples over the past few hundred years would be:

- 1770s – the Industrial Revolution
- 1820s – the Steam and Railways age beginning
- 1870s – the Steel and Heavy Engineering move
- 1900s – the era of Oil, Electricity, Automobiles and Mass Production
- 1970s – the shift to the age of Information and Telecommunications.

It is interesting to note at this point that – arguably, although not much – the world's most successful stock investor ever, Warren Buffett, bases his investment strategy on such fundamental paradigmatic shifts; seeking to identify the onset of a new cycle (or 'wave'), buying shares in as many solid new cycle-related businesses as he can and just sitting on them.

In any event, the correlations between the K-Waves and key asset markets are evident from the charts below.





In broad terms, there are four stages to the cycle described by the K-Wave:

1. At the onset of a long-term economic cycle there is likely to be a lack of confidence and a fear of falling back into slump or depression, before inflation, interest rates and credit slowly start to rise as confidence in the new age increases.
2. As the economy expands (indicated in this instance by inflation) and interest rates increase as an adjunct to this, then so business and consumer confidence grows further and credit is extended more.

3. As we enter into the final up-phase of the move, confidence levels morph into over-exuberance and extraordinary loose 'bubble-like' credit conditions, with interest rates also declining.
4. Finally, rising concerns over loose credit, inflationary upward spiral and bad debt causes business and consumer reticence to embark on new projects (in business terms, expansion, and in consumer terms, new purchases), default rates increase, credit is squeezed, the economic outlook turns negative, unemployment rises, disinflation turns into deflation and we have a negative world view.