The Standard Chartered Private Bank

The Standard Chartered Private Bank – The Journey

Cause & Effect in Financial Markets

As we contemplate the investment outlook for global markets in 2010, it pays to look back and remember that financial markets have an incredible capacity for reacting to news and economic developments in a way that confounds market professionals and casual observers alike – the only difference being the latter will admit to being confused, while the former will quickly come up with a few dusty rationalisations.

Economist John Maynard Keynes put it best when he wrote: *"A rational investment policy doesn't work in an irrational world"*. In the long run, true value is always revealed but in the short term the market and individual stocks and bonds get pushed and pulled by a variety of forces – portfolio re-balancing, rumours, news, investing fads, seasonal tendencies - that have nothing to do with fundamentals. Keynes also remarked that: *“In the long run we are all dead and in the short-run you get a margin call”.* Some of you might truly appreciate this statement, most however do not.

Monitoring economic reports is a very important but often overlooked area of trading and investing.

Nowhere are the advantages and drawbacks of instantaneous electronic communications more evident than in the financial markets. A long-term price trend might seem obvious or inevitable in retrospect, but in the short-term, markets are pulled and pushed by a never-ending stream of "News" – economic reports, statistics, earnings, etc.

As the speed and range of market news has increased, so has the challenge of interpreting it; or more accurately, managing the market's reaction to it.

When deciphering economic indicators and market news, it is important to understand that in the *Alice in Wonderland* world of global financial markets, bad news can be good news and good news can be bad news. The economic context in which a news report is released is the key to resolving these paradoxes.

Correctly anticipating the impact of such news, rather than the news itself, is one of the most useful skills of the accomplished investor. In financial markets, the impact of the data is not always what it should be (or what we think it should be).

What initially appears to be a "bad number" is sometimes followed by a rally of steady buying. Similarly, a report that seemingly underscores economic strength may be met by frantic selling.

Investors who learned to survive and prosper in the markets use this flow of information to form intelligent expectations about the market's chances /

probabilities of trading up, down or sideways. The macroeconomic flow also plays a key role in determining individual sector trends: Is it time to rotate out of bank stocks into transport stocks?

Having said that, when it comes to macroeconomic news reports that rock the market, the most important thing to understand is that it is not the number itself which counts but rather what expectation has been built in and how the market reacts to that number.

When contemplating how an economic report may affect the market, there are three crucial points to keep in mind. First, all indicators are not created equal; second, the news is not always what it seems; and the third, context is king.

To better understand the often confusing reactions to economic data, remember the three key points:

- Sometimes bad news can be very good news
- First impressions don't always last
- Only deviations from expectations truly move the market

Investment Management is an art, more than a science. The broader point is that assessing the market's reaction is much more a complicated game of chess than simple checkers. The picture is always changing. Every day some pieces get taken away and others get thrown in.

It comes into play when expectations about the future have a bearing on present behaviour – which is the case in financial markets. Some mechanism must be triggered for the participant's bias to affect not only market prices but also the so-called fundamentals, which are supposed to determine market prices. Fundamentals you may read about are typically useless, as the market has already discounted the price. Sometimes they are called “funny-mentals”. However, if you catch them early on and before the others, then you might have valuable “surprise-a-mentals”!

When it comes to investing, Albert Einstein’s immortal words of: *“Imagination is ten times more powerful then knowledge”* holds very true. A good investor can’t be rigid. If you can find someone who is really open to seeing anything, then you have found the raw ingredient of a good investor and/or investment advisor.

The best investments are the ones in which you have all three things going for you: fundamentals, technicals and market tone. First the fundamentals should suggest that there is an imbalance of supply and demand, which could result in a major move. Second, the chart must show that the market is moving in the direction that the fundamentals suggest. Third, when news comes out, the market should act in a way that reflects the right psychological tone.

Technical analysis gives an investor valuable information, fundamentals give an investor valuable news.

A lot of people who comment and/or offer advice on financial markets actually do not put their own money on the line. The Spanish sum it up nicely in a proverb: *"It's not the same to talk of bulls as being in the bull ring"*. Always consider the advice of economists, analysts and investment advisors if you are sure that they invest their own funds in the markets they offer advice on.

Fundamental analysis creates what might be called a *"*reality gap*"* between what should be and what is. The past is fixed and easy to analyse. The future is fluid and uncertain. You have to base your decisions on probabilities in an atmosphere of uncertainty.

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