Lesson # 13

ECONOMY AND MARKET ANALYSIS

INVESTMENT RATIOS:

1. Dividend per Share:

The DPS ratio is very similar to the EPS: EPS shows what shareholders earned by way of profit for a period whereas DPS shows how much the shareholders were actually paid by way of dividends. The DPS formula is:

\[ \text{DPS} = \frac{\text{Dividends paid to Shareholders}}{\text{Average common shares outstanding}} \]

2. Dividend Yield:

The dividend yield ratio allows investors to compare the latest dividend they received with the current market value of the share as an indicator of the return they are earning on their shares. Note, though, that the current market share price may bear little resemblance to the price that an investor paid for their shares. Take a look at the history of a business's share price over the last year or two and you will see that today's share price might be a lot higher or a lot lower than it was a year ago, two years ago and so on.

We clearly need the latest share price for this ratio and we can get that from newspapers such as the Financial Times, The Times, The Guardian and the Daily Telegraph. We can also find the share prices on the Internet. The formula for the dividend yield is:

\[ \text{Dividend Yield} = \frac{\text{Annual Dividends}}{\text{Current Market Share Price}} \]

3. Price Earning Ratio:

The P/E ratio is a vital ratio for investors. Basically, it gives us an indication of the confidence that investors have in the future prosperity of the business. A P/E ratio of 1 shows very little confidence in that business whereas a P/E ratio of 20 expresses a great deal of optimism about the future of a business. Here's the formula:

\[ \text{P/E} = \frac{\text{Current Market Share Price}}{\text{EPS}} \]

The Business Cycle:

The business cycle reflects the movements in economic activity as a whole, which comprises many diverse parts. The diversity of the parts ensures that business cycles are virtually unique, with no two parts being identical. However, cycles do have a common framework, with a beginning, a peak, and an ending. Thus economic activity starts in depressed conditions, builds up in the expansionary phase, and in the ends in a downturn, only to start again. The word trough is used to indicate when the economy has hit bottom.

The National Bureau of Economic Research (NBER), a private nonprofit organization, measures business cycles and officially decided on the economic “turning points”. The NBER's Business Cycles Dating Committee determines the turning points of the business cycle, which are the dates at which the economy goes from an expansion mode to a contraction mode and vice versa. These turning points typically are determined well after
the fact, so that observers do not know on a current basis, at least officially, when a peak or trough has been reached.

It is possible to identify those components of economic activity that move at different times from each other. Such variables can serve as indicators of the economy in general.

Standard practice is to identify the leading, coincident and lagging **Composite Economic Indexes**. The leading indicators consist of variables such as stock prices, index of consumer expectation, money supply, and interest rates spread. The coincident indicators consist of four variables such as industrial production and manufacturing and trade sales, and the lagging indicators consist of seven variables such as duration of unemployment and commercial and industrial loans outstanding.

The composite indexes are used to indicate peaks and troughs in the business cycle. The intent of using all three is to summarize and reveal turning points patterns in economic data better. Note that a change in direction in a composite index does not automatically indicate a cyclical turning point. The movement must be of sufficient size, duration and scope.

**The Stock Market and the Business Cycle:**

The stock market is, of course, a significant and vital part of the overall economy. Clearly, a strong relationship exists between the two. If the economy is doing badly, most companies will also be performing poorly, as will the stock market. Conversely, if the economy is prospering, most companies will also be doing well, and the stock market will reflect this economic strength.

The relationship between the economy and the stock market is interesting; stock prices generally lead the economy. Historically it is the most sensitive indicator of the business cycle. Therefore, we must take into account this leading relationship when we are using the economy’s condition to evaluate the market. The market and the economy are closely related, but the stock prices typically turn before the economy.

How reliable is this relationship between the stock market and the business cycle? Although it is generally considered to be reliable, it is widely known that the market has given false signals about future economic activity, particularly with regard to recessions. The old joke goes something like this “the market has predicted nine out of the last five recessions.”

**Forecasts the Economy:**

Good economic forecasts are of obvious significant value to investors. Since the economy and the market are closely related, good forecasts of macroeconomics variables would be very useful. How good are such forecasts which are widely available?

McNees concluded that forecasts made by the prominent forecasters are similar and that differences in accuracy are very small, suggesting that investors can use any of a number of such forecasts. Obviously, not all forecasters are equally accurate, and all forecasters make errors. The only good news is that forecast accuracy apparently has increased over time.

Because of its vital role in the economy, monetary policy traditionally has been assumed to have an important effect on the economy, stock prices and interest rate. Almost all theories of the macroeconomy postulate a relationship between money and future economic activity with the relationship depending on whether changes in money stock can be attributed to
shifts in money supply or money demand. For example, increases in money supply tend to increase economic activity whereas increases in money demand tend to reduce economic activity.

**Insights for the Yield Curve:**

The yield curve depicts the relationship between bond yields and time, holding the issuer constant, and in effect shows how interest rates vary across time on any given day. It should contain valuable information, because it reflects bond traders’ views about the future of the economy. Several studies suggest that the yield curve is very useful in making economic forecasts. The professionals use the yield curve as an indicator of how the Fed is managing the economy.

It has long been recognized that the shape of the yield curve is related to the stage of the business cycle. In the early stages of an expansion, yield curves tend to be low and upward sloping and as the peak of the cycle approaches, yield curves tend to be high and downward sloping. More specifically:

A steepening yield curve suggests that the economy is accelerating in terms of activity as monetary policy stimulates the economy.

When the yield curve becomes more flat, it suggests that economic activity is slowing down.

An inverted yield curve, however, carries an ominous message-----expectations of an economic slowdown. Every recession since World War II has been preceded by a downward-sloping yield curve.

**Understanding the Stock Market:**

**What Do We Mean By The Market?**

When most investors refer to the “market”, they mean the stock market in general as poxied by some market index or indicator. Because the “market” is simply the aggregate of all security prices, it is most conveniently measured by some index or average of stock prices.

Most market indexes are designed to measure a particular market segment, such as blue-chip New York Exchange (NYSE) stocks, all stocks on the NYSE, the NASDAQ market and foreign stocks. When discussing the market, it is possible to use a broad market index, such as the Wilshire 500 index. Typically, however, most investor’s today, when they refer to the market, use as their indicator of the market either the Dow Jones Industrial Average or the S & P 500 composite index. Therefore, when we discuss the market, we are referring to the market as measured by one of these two market indexes.

**Uses of the Market Measures:**

Market measures tell investors how all stocks in general are doing at any time or given them a “feel” for the market. Many investors are encouraged to invest if stocks are moving upward, whereas downward trends may encourage some to liquidate their holdings and invest in money market assets or funds.

The historical records of market measures are useful for gauging where the market is in particular cycle and possibly for shedding light on what will happen. Assume, for example,
that the market has never fallen more than X percent, as measured by some index, in a six-month period. Although this information is no guarantee that such a decline will not occur, this type of knowledge aids investors in evaluating their potential downside risk over some period of time.

Market measures are useful to investors in quickly judging their overall portfolio performance. Because stocks tend to move up or down together, the rising or falling of the market will generally indicate to the investor how he or she is likely to do. Of course, to determine the exact performance, each investor’s portfolio must be measured individually.

Technical analysts need to know the historical record of the market when they are seeking out patterns from the past that may repeat in the future. Detection of such patterns is the basis for forecasting the future direction of the market using technical analysis.