

Thought for the Week: Monday, September 27th, 2010

Ten Factors you should Follow – Part II

5. The Dollar

A falling Dollar makes our exports more competitive and should therefore increase GDP (for example, German GDP rapidly dramatically increased when the Euro devalued in the Spring).

Unfortunately, a weak dollar increases the cost of imports, which puts pressure on prices and interest rates. One way to increase the value of a currency is to increase interest rates as increasing interest rates generally attracts more yield investors to a currency.

A rising Dollar makes imports cheaper, thereby helping to keep inflation low, but it reduces the competitiveness of exports which will no doubt reduce GDP. As commodities are usually priced in dollars, the effects described above are felt worldwide.

DIAS management believes that those companies with 40% or more of their revenues coming from overseas are companies that we feel may experience attractive growth. **For these companies, a change in the value of the dollar isn't such a big factor** as a great deal of their revenues are denominated in non-dollar currencies.

6. Federal Open Market Committee (FOMC)

Eight times a year **the FOMC holds regular meetings to review economic and financial conditions**, determine the appropriate stance of monetary policy, and assesses the risks to its long-term goals of price stability and sustainable economic growth. Following each meeting the minutes are published.

These minutes provide **valuable insights into how the economy is really performing** and the future direction of a number of important factors including interest rates, inflation and GDP growth.

We say “insights” because the minutes can sometimes be cryptic; the FOMC might not wish to make explicit predictions, but markets are regularly moved by the expectations and actual content of these meetings. **We wonder if the first signs of interest rate rises might emanate from FOMC minutes.**

7. Investment Dollar Flows

The **short-term prices of most securities are dictated, in part, by the principles of Supply and Demand** - basically, the greater the demand, the higher the price. **Long-term prices depend more on fundamentals** – growth prospects, balance sheets strength, etc.

Quite often, **demand for a security can cause its price to get well ahead of the fundamentals** supporting it. Obviously, the fair price of an item is what a buyer is willing to pay a seller; however, when sentiment changes and demand falls, the willing buyer gets stuck with a loss.

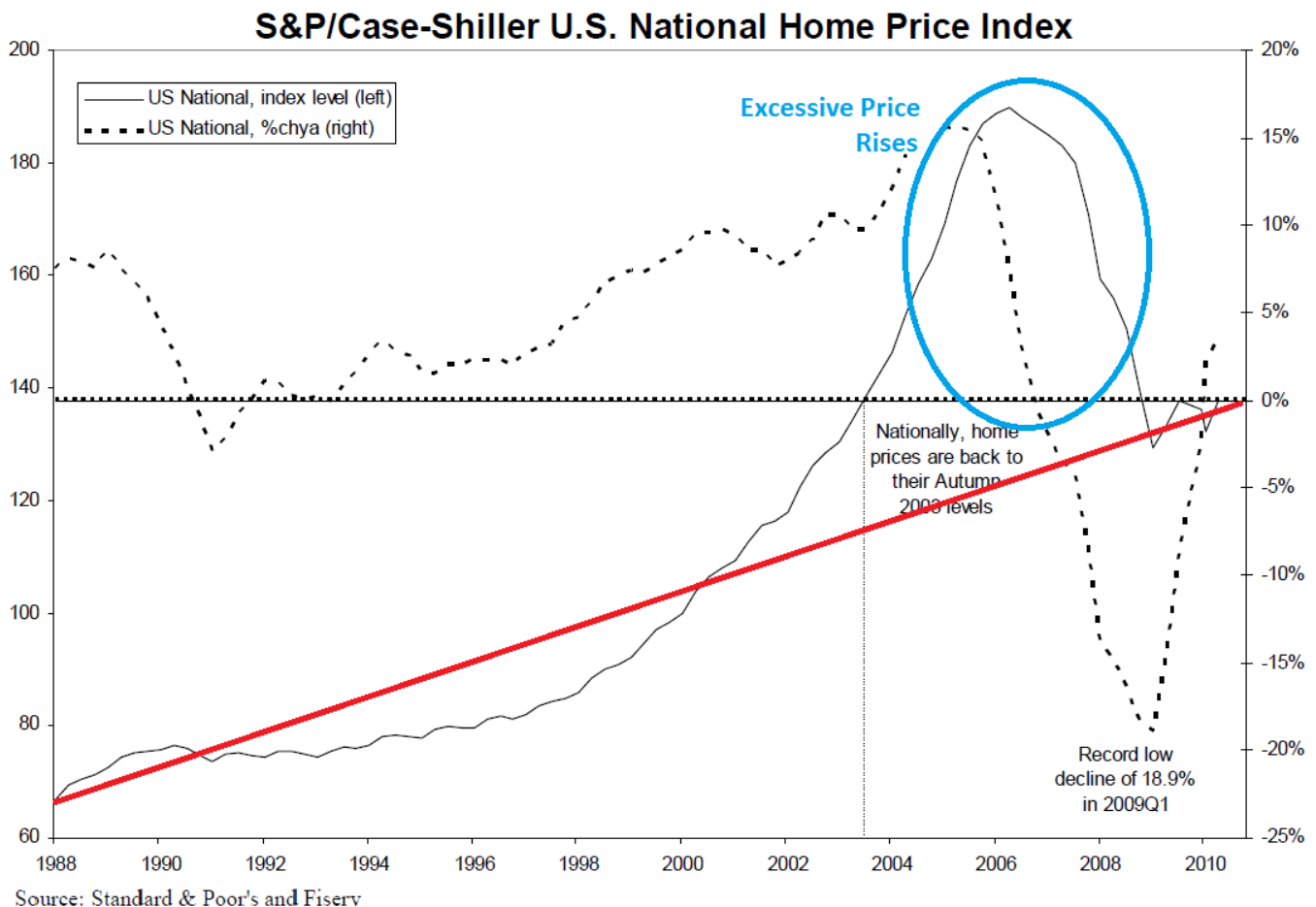
When you see excessive growth in the cash flowing into one asset class an over-valuation may be occurring. For example, at the time of writing, billions of dollars were moving into most areas of the bond market at the expense of the stock market. The volatility and valuations of stocks may justify some lack of

demand from the retail stock investing investor herd, but we are not sure bonds deserve such high interest. **When the money flowing into bonds starts to drop, prices may fall accordingly.**

8. Housing

When house prices rise, massive amounts of wealth are created within U.S. households. When they fall, home owners lose tangible net worth and also feel less wealthy.

According to Standard & Poor's Case-Shiller Home Price Indices, pretty much THE historical data for house prices, **we are currently somewhere near the long-term trend for steadily rising house prices.** The excessive price rises of the last decade have been unwound. This does not bode well for those who expect house prices to spring back to "*what we paid for our house five years ago*". For the foreseeable future, current house price levels might be "about right".



The red line shown on the chart above is an approximate long-term house price trend.

The existing overhang of foreclosures, those now on the market and those waiting to come to the market, will probably keep housing where it is for some years to come. However, **expect any change in the direction of house prices to create favorable movements in the stock market.**

9. Gold

Probably the easiest factor here, when investors at the extreme end of the 'Fear Scale' start thinking the sky may fall in, demand for Gold increases causing the price to also rise. When economic order is resumed, the price of gold generally falls. This cycle seems to repeat every decade or so.

When you see the price of Gold fall, expect stocks to rise and U.S. Treasuries to fall.

Unfortunately, all that's gold doesn't glitter in the same way. Buying an ETF such as GLD is a simple, liquid means to invest in gold prices. Buying coins and other gold-based investments, such as those heavily marketed in the popular media, can dull the appeal of the shiny metal. **These investments can be unregulated and incur significant buying and selling commissions. Caveat Emptor!**

10. The VIX

The Chicago Board Options Exchange (CBOE) publishes **an index (VIX) which reflects the bets being placed by options traders**. A simplified explanation of the VIX is when options traders fear the market may drop, they buy short positions which moves the VIX upwards. The more they fear a market drop, the higher the VIX moves. For this reason, it is called the "Fear Index."

The VIX Index is not flawless, but keep an eye on it to see what probability options traders place on an imminent downward stock market movement.

Footnote: For those who haven't yet visited our offices, **the 'steam machine'** on page one of last week's Thought does exist but does not figure in our investment process!