WELCOME!

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NAVIGATING THE MARKETS

THE LESSONS OF HISTORY

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The Peter Dag Portfolio

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THE PETER DAG PORTFOLIO

- TWICE A MONTH – 17-20 PAGES
- MARKET UPDATE (weekly)
THE QUESTION I ASKED MYSELF

WHAT ARE THE MOST IMPORTANT LESSONS I LEARNED IN THE PAST 30+ YEARS OF MANAGING MONEY?
DOES
“LONG-TERM” MEAN ANYTHING?

- THE ANSWER DRIVES MY STRATEGY
- BUSINESS CYCLE GIVES A SENSE OF “LONG TERM”
- PERFORMANCE OF ASSET CLASSES AND TIMING
FLEXIBILITY AND THE IMPORTANCE TO KEEP ASKING “WHAT IF”
THE FOCUS OF MY RESEARCH IN THE PAST 30+ YEARS

- RELATIONSHIPS BETWEEN ECONOMIC AND FINANCIAL TRENDS AND INVESTMENT STRATEGY
- MINIMIZE THE VOLATILITY OF RETURNS
THE OBJECTIVE

TO ESTABLISH GUIDELINES ON

♦ WHEN TO BUY
♦ WHEN TO SELL
♦ HOW MUCH
MAIN APPROACH

THE BUSINESS CYCLE DRIVES ALL ASSET PRICES
BUSINESS CYCLE
(DRIVEN BY BUSINESS DECISIONS)

ABOVE AVERAGE GROWTH OR BELOW AVERAGE GROWTH DRIVE ASSET PRICES (COMMODITIES, HARD ASSETS, INTEREST RATES, STOCK PRICES, PROFITS, CURRENCIES)
THE IMPORTANCE OF FEEDBACK

The Business Cycle: The Force Driving Asset Prices

Growth Potential

Growth Cycle
MAJOR HISTORICAL PATTERNS
WHAT HAPPENED
1969-1982

- WAR
- GREAT SOCIETY
- EASY MONEY
- LOW REAL INT. RATES
- COMMODITIES – INFLATION
- INTEREST RATES
WHAT HAPPENED
1982-1998

- LOWER INFLATION
- LOWER INTEREST RATES
- HIGH REAL INT. RATES
- BABY BOOMERS
WHAT HAPPENED
1998-2011

- TECH AND HOUSING BUBBLES
- AGING OF BABY BOOMERS
- LOW INTEREST RATES
- LOW REAL INT. RATES
- BOOMING COMMODITIES
DEMOGRAPHICS

- THEY COULD DO NO WRONG.
- THE BIG SPENDERS (45-50 Y/O) WERE GROWING RAPIDLY, PROPELLING THE ECONOMY.
DEMOGRAPHICS
(Source: HS Dent)
S&P 500: “LONG-TERM”
THE REAL WORLD: 20 UP 23 FLAT
.... AND NOW

THE TACTICAL

FACTS
THE MOST IMPORTANT INDICATOR: SHORT-TERM INT. RATES

- I AM GOING TO DISCUSS THEIR MEANING
- WHAT DRIVES THEM
- HOW TO USE THEM TO DEVELOP AN INVESTMENT STRATEGY TO WITHSTAND MOST MARKET CONDITIONS
S-T INTEREST RATES

- INTEREST RATES ARE THE FEVER CHART OF ANY ECONOMY
- 5% IS THE GOLDEN MEAN
SHORT-TERM INTEREST RATES

THE MOST IMPORTANT INDICATOR

BECAUSE THEY TELL YOU ABOUT RISK AND WHICH ASSETS YOU SHOULD USE TO MAKE MONEY
INTEREST RATES

3-Month Treasury Bill: Secondary Market Rate (DTB3), 10-Year Treasury Constant Maturity Rate (GS10), 20-Year Treasury Constant Maturity Rate (GS20), 30-Year Treasury Constant Maturity Rate (GS30), 5-Year Treasury Constant Maturity Rate (GS5)

Shaded areas indicate US recessions.
2010 research.stlouisfed.org
COMPARE SHORT-TERM INTEREST RATES TO …

- … BUSINESS CYCLE
- … INFLATION
- … BONDS
- … COMMODITIES
- … EARNINGS
- … STOCKS
BUSINESS CYCLE

The Business Cycle: The Force Driving Asset Prices

Growth Potential

Growth Cycle

2 3

4 1
SHORT-TERM INTEREST RATES AND THE BUSINESS CYCLE

3-Month Treasury Bill: Secondary Market Rate (TB3MS)
Source: Board of Governors of the Federal Reserve System

Shaded areas indicate US recessions.
2011 research.stlouisfed.org
S-T INTEREST RATES AND INFLATION

- Interest rates/inflation rise after a period of stronger economic growth.
- Interest rates/inflation decline after a period of slower economic growth.
- Low real interest rates are inflationary.
SHORT-TERM INTEREST RATES AND INFLATION

![Graph showing short-term interest rates and inflation.](2011 research.stlouisfed.org)
REAL INTEREST RATES

HIGH INFLATION RELATIVE TO S-T INTEREST RATES IS A SIGN OF CHEAP MONEY AND INFLATIONARY
SHORT-TERM INTEREST RATES AND COMMODITIES

- Commodities rise after a long decline in interest rates.
- A long rise in interest rates anticipate a peak in commodities.

Assumption: Commodities respond to levels and trend of S-T interest rates.
SHORT-TERM INTEREST RATES AND COMMODITIES

CRB FUTURES AND TREASURY BILLS

IMPORTANT: Commodities decline following an increase of interest rates of more than 12 months.

Since 2009 commodities are rising because short-term interest rates too low. Borrow at 0% interest rates and stockpile commodities.
REAL INTEREST RATES AND COMMODITIES

TB3MS/CPIAUCSL
Spot Oil Price: West Texas Intermediate (OILPRICE)

Shaded areas indicate US recessions.
2011 research.stlouisfed.org

(Dollars per Barrel)

(%) Chg. from Yr. Ago)
BONDS

YOU BUY BONDS FOR CAPITAL APPRECIATION NOT FOR INCOME
BONDS

THIS IS HOW IT WORKS

- INTEREST RATES: 2.5%
- $100 BOND HAS TO HAVE COUPON OF $2.5
- INTEREST RATES DECLINE TO 2.0%
- NEW BOND PRICE: $125 ($2.5/$125=2.0%)
- GAIN: 25% + COMPOUNDING INTEREST OF BOND
SHORT-TERM INTEREST RATES AND BOND YIELDS

- Bond yields rise when S.T. interest rates rise
- Bond yields decline when S.T. interest rates decline

PS. BONDS RETURNS CHANGE WITH DURATION, QUALITY, AND LIQUIDITY (CHAPTER 9 MY BOOK)
SHORT-TERM INTEREST RATES AND TREASURIES

3-Month Treasury Bill: Secondary Market Rate (DTB3)
10-Year Treasury Constant Maturity Rate (DGS10)

Shaded areas indicate US recessions.
2011 research.stlouisfed.org
SHORT-TERM INTEREST RATES AND CORPORATE BOND YIELDS
SHORT-TERM INTEREST RATES AND CORPORATE BOND YIELDS

- FROM 1983 TO 2010 AAA YIELDS DROPPED FROM 12.5% TO 5.0%.

- NEW BOND PRICE: $250 (ASSUME PRICE OF $100 IN 1983)

- ADD COMPOUNDING INTEREST FOR 27 YEARS
EARNINGS PER SHARE ARE CLOSELY RELATED TO ...

- BUSINESS CYCLE
- S-T INTEREST RATES
- COMMODITIES
- ... AND STOCK PRICES
EARNINGS PER SHARE AND BUSINESS CYCLE

- E/S RISE FASTER WHEN THE ECONOMY STRENGTHENS
- E/S SLOW DOWN WHEN THE ECONOMY SLOWS DOWN
S-T INT. RATES AND E/S

T BILLS AND EARNINGS PER SHARE ($)

T BILLS

E/S
E/S AND COMMODITIES

[Graph showing the relationship between CRB (Commodity Research Bureau) and Earnings Per Share (E/S)].
E/S AND STOCK PRICES

S&P 500 AND EARNINGS PER SHARE ($)

SP500

E/S
SHORT-TERM INTEREST RATES AND STOCK PRICES
SHORT-TERM INTEREST RATES AND STOCK PRICES

- STOCKS PEAK FOLLOWING A RISE IN S-T INTEREST RATES
- STOCKS BOTTOM FOLLOWING A DECLINE IN S-T INTEREST RATES
INTERESTING BUSINESS CYCLES, SHORT-TERM INTEREST RATES, BOND PRICES, COMMODITIES, STOCKS ARE ALL TIED TOGETHER
THE PROCESS

- SLOWDOWN
- LOWER IN. RATES, COMMODITIES, INFLATION, PROFITS
- PROFITS, PURCHASING POWER IMPROVE
- SPENDING, INT. RATE, COMMODITIES, STABILIZES
- ECONOMY STRENGTHENS
- RISING INTEREST RATES, COMMODITIES, INFLATION
- DECLINING PURCHASING POWER, PROFITS .......... SLOWDOWN
THE BUSINESS CYCLE TIES THESE IDEAS TOGETHER (WITH LEAD/LAGS)

- **STRONGER ECONOMY:** RISING INTEREST RATES, COMMODITIES, E/S, INFLATION, ...

- **WEAKER ECONOMY:** DECLINING INTEREST RATES, COMMODITIES, E/S, INFLATION....
SECTORS FOR A WEAK ECONOMY AND BEATING THE S&P 500

- HEALTH SERVICES
- INSURANCE
- BANKS, REGIONALS
- BROKERS
- REAL ESTATE/REITs/TRUSTS
- PRIVATE EQUITY
- DEFENSE
SECTORS FOR A STRONG ECONOMY AND BEATING THE S&P 500

- METALS AND MINING
- ENERGY
- MACHINERY
- ELECTRONICS, INTERNET
- COMPUTER SOFTWARE & SERVICES
- CONGLOMERATES
ETF SECTORS

- **FINANCIALS** (WEAK ECONOMY)
  -- XLF, KRE, IYR, KIE, PSP, PPA, JNK, LQD

- **CYCLICALS** (STRONG ECONOMY)
  -- XLI, XME, XLB, XLE, XLK, GLD
WHY MOMENTUM WORKS

- MOMENTUM REFLECTS CHANGES IN THE ECONOMY, MANAGEMENT, MARKET.
- THESE CHANGES LAST FOR A LONG TIME
- BUT YOU HAVE TO WATCH FOR THE LOSS OF MOMENTUM
- HORSE RACE
THE FOLLOWING THOUGHTS ARE PROBABLY THE MOST IMPORTANT LESSONS I LEARNED IN 30+ YEARS IN THIS BUSINESS
THOUGHTS #1

- IS YOUR PORTFOLIO INCREASING IN VALUE?
- IS YOUR CHOICE OF SECTORS THE CORRECT ONE?
- NO? START REDUCING EXPOSURE TO WORST PERFORMING POSITIONS AND ADD TO THE BEST PERFORMING ONES
- USE FAN CHARTS AND 40-WEEK M.A. TO COMPARE PERFORMANCE/SELLING
THOUGHTS #2

- AVOID ASSET CLASSES NOT IN TUNE WITH THE BUSINESS CYCLE
- DIVERSIFICATION = INDEXATION = AVERAGEAGING DOWN = LONG-TERM = NONSENSE
- ONCE YOU LOSE, YOUR MONEY IS GONE. CONCENTRATE ON WHAT TO DO NEXT.
THOUGHTS #3

- USE TIMING TOOLS TO KEEP FOCUSED
- MANAGE THE MARKET VALUE OF YOUR PORTFOLIO, NOT EACH POSITION
- MOMENTUM WORKS - SELL WEAK & BUY STRONG POSITIONS (GRADUALLY)
- USE HEDGING TECHNIQUES (“SH” INSTEAD OF CASH)
NOONE KNOWS THE OUTCOME OF POLITICAL, SOCIAL, ECONOMIC DECISIONS.

HISTORY IS RANDOM – THIS IS THE REASON WE SEEM TO REPEAT THE SAME MISTAKES.

GOVERNMENTS SHOULD SET THE RULES OF THE GAME AND NOT BE A PLAYER.
THOUGHTS #5

- ALL THE PHDs, NOBEL PRIZES, AND SO CALLED EXPERTS IN WASHINGTON---YET THIS CENTURY HAS BEEN PLASTERED WITH DEPRESSIONS (1930s), RECESSION & INFLATIONARY PERIODS (1970s), WARS (1910-2010), AND BUBBLES OF ALL TYPES (2000s). WHY DO WE NEED THEM?

- RELY ONLY IN YOURSELF
THOUGHTS #6

POWER AND WEALTH ARE THE ULTIMATE OBJECTIVE OF THE GAME
THANK YOU!

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