Session 32

Market Timing Approaches: Mean Reversion & Macro Fundamentals

Test

1. You believe that the normal PE ratio (based on current earnings) for the market is 16. The market is currently trading at 1800, with current earnings at 100. If you expect earnings to go up 10% over the next year and the PE ratio to revert back to the normal level by the end of the year, what is your expected level for the market a year from now?
    a. 1600
    b. 1760
    c. 1800
    d. 1980
    e. None of the above
2. If you believe that interest rates have a normal range, which of the following implications emerge for asset allocation (assuming that you can invest only in stocks, bonds and cash)?
    a. If interest rates are high, relative to history, you will invest less of your money in bonds, more in stocks and hold less cash.
    b. If interest rates are high, relative to history, you will invest less of your money in bonds, less in stocks and hold more cash.
    c. If interest rates are high, relative to history, you will invest more of your money in bonds, less in stocks and hold more cash.
    d. If interest rates are high, relative to history, you will invest more of your money in bonds, less in stocks and hold less cash.
    e. If interest rates are high, relative to history, you will invest more of your money in bonds, more in stocks and hold less cash.
3. If short-term interest rates have come down this year, stocks are more likely to go up next year.
    a. True
    b. False
4. One commonly used market timing measure is to compare the earnings yield (Earnings/ Stock price) to the T.Bond rate. Which of the following combinations would be viewed as most bullish using this indicator?
    a. PE ratio =10, T.Bond rate = 10%
    b. PE ratio =10, T.Bond rate = 5%
    c. PE ratio = 20, T.Bond rate = 10%
    d. PE ratio = 20, T. Bond rate = 5%

    Which would be the most bearish combination?

5. If the economy is strong during a year, stocks should also do well during that year.
    a. True
    b. False

Solution

1. You believe that the normal PE ratio (based on current earnings) for the market is 16. The market is currently trading at 1800, with current earnings at 100. If you expect earnings to go up 10% over the next year and the PE ratio to revert back to the normal level by the end of the year, what is your expected level for the market a year from now?
    a. 1600
    b. 1760
    c. 1800
    d. 1980
    e. None of the above

Explanation: Earnings next year = 100 (1.10) = 110

Expected stock index level next year = 110*16 = 1760

2. If you believe that interest rates have a normal range, which of the following implications emerge for asset allocation (assuming that you can invest only in stocks, bonds and cash)?
    a. If interest rates are high, relative to history, you will invest less of your money in bonds, more in stocks and hold less cash.
    b. If interest rates are high, relative to history, you will invest less of your money in bonds, less in stocks and hold more cash.
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    d. If interest rates are high, relative to history, you will invest more of your money in bonds, less in stocks and hold less cash.
    e. If interest rates are high, relative to history, you will invest more of your money in bonds, more in stocks and hold less cash.

Explanation: if interest rates are high relative to history, they are more likely to go down than go up. Lower interest rates are good for bonds and even more so for stocks. Thus, you would hold more stocks and bonds and less cash.

3. If short-term interest rates have come down this year, stocks are more likely to go up next year.
    a. True
    b. False

Explanation: Historically, there is no basis for this statement. Stocks seem just as likely to go up in a year after short term interest rates go up as down.

4. One commonly used market timing measure is to compare the earnings yield (Earnings/ Stock price) to the T.Bond rate. Which of the following combinations would be viewed as most bullish using this indicator?
    a. PE ratio =10, T.Bond rate = 10%
    b. PE ratio =10, T.Bond rate = 5%

   c. PE ratio = 20, T.Bond rate = 10%
   d. PE ratio = 20, T. Bond rate = 5%

   Which would be the most bearish combination?

Explanation: The most bullish combination would the one where the E/P ratio is highest with low interest rates (With (b), E/P = 10% and T.Bond rate = 5%). The most bearish combination is the one with the lowest E/P ratio and and high T.Bond rate (With (c), E/P = 5% and T.Bond rate =10%)

5. If the economy is strong during a year, stocks should also do well during that year.
   a. True
   b. False

Explanation: It depends on expectations. If the market was expecting an even stronger economy, this would be a negative surprise, leading to lower stock prices.