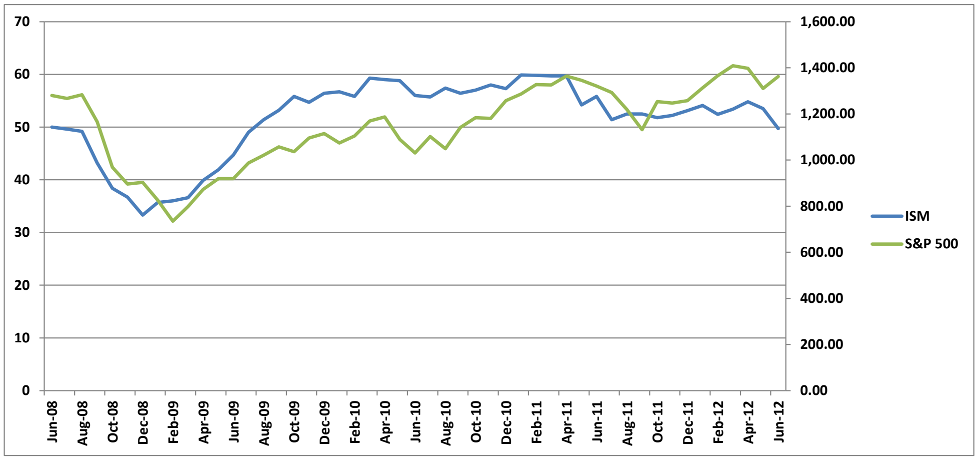
How to use indicators to invest in uncertain markets

Investors are constantly bombarded with economic data. Some of it is predictive, some of it is reactive, and much of it is irrelevant. In today's macro driven markets, indicators can play a key role in understanding where we are in a cycle and how to position portfolios to manage risk and optimize potential return. We use a variety of indicators to help manage our client's tactical portfolio allocations both to take advantage of specific opportunities and most importantly, to protect against the downside. Here are some examples of how we use indicators and why:

Leading Indicators – such as the ISM Manufacturing Index and housing starts help provide clues as to the direction and speed of the economic cycle which can be closely correlated to the equity markets. The challenge is they can be misleading and some revised significantly.



Data: The most recent reading of the ISM Manufacturing index (July) was 49.7. The index dipped below 50 for the first time since July 2009. A reading slightly below 50 indicates that the U.S. economy is still growing even though the manufacturing sector is contracting (below 43 indicates a recession). Housing starts rose 6.9% in June from May to a seasonally adjusted annual rate of 760,000. This is the highest number since October 2008. Additionally single-family housing starts rose for the fourth straight month.

Conclusions:

- *The ISM Index and the S&P 500 will likely begin to converge again after decoupling for the past two years due to Fed Policy. Housing starts show growing strength in real estate prices which is critical to a sustained US recovery.*
- *We are implementing a short-term treasury position (ETF: TLT) to hedge against additional softening in the US equity markets which we already have a significant overweight to over the past 18 months (S&P 500 up over 9% in 2012). We also added exposure to the US Dollar (ETF: UUP) as global manufacturing continues to slow and BRIC countries add stimulus which devalues their currency on a relative basis.*

Lagging Indicators – such as the Unemployment and Jobs number provide a "look back" and reaffirm key assumptions made by the markets in pricing in risk and return especially in understanding longer-term cycles or themes.

Data: The most recent reading on unemployment shows 80,000 jobs in June, with the unemployment rate staying at 8.2%. The economy added on average just 75,000 jobs per month in the 2nd Quarter which is one third less than the 226,000 per month created in the first quarter.

Conclusions:

- *Consumption is key to the U.S. Economy as it makes up over 71% of GDP. The key factors to keeping the recovery going are the consumer as well as employment. These two factors will determine our fate. Another round of additional Quantitative Easing (QE) is possibly on the table if the economic data continues to deteriorate, but the actual impact on the economy will likely be minimal, and the resulting equity market response will be more muted as well this time around.*
- *Over the past two years, central banks have given investors the equivalent of free put options, however we feel this time it's best to have exposure to more defensive sectors, and that is why we are adding exposure to health care (ETF: XLV) and utilities (ETF: XLU). As the saying goes "a good defense is sometimes the best offense."*

Coincident Indicators – such as the Real Gross Domestic Product or retail sales numbers provide additional real-time data points to understand what is happening right now in the global economy. They are used to re-price risk across asset classes and identify shorter term trends.

Data: Real Gross Domestic Product increased at an annual rate of 1.9% in the first quarter of 2012. Retail sales dropped 0.5% in June versus the 0.2% rise that economists were expecting. Retail sales have not fallen for three straight months since the fall of 2008, at the height of the financial crisis. It should be noted that retail sales do not include spending on services, which represent a larger part of the economy.

Conclusions:

- *Concerns over the continuing Euro Zone crisis along with uncertainty at home with the fiscal cliff have led to a slowing global economy although with a somewhat healthier backdrop compared to last year.*
- *We are continuing to add selective risk exposure sparingly from excess cash but remain cautious as trading volumes are light. There is likely additional volatility on the horizon as we approach the election and the increasing probability of some form of Fed action in the fall.*

Please feel free to contact us with any questions.

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