MODULE:5

UNDERSTANDING BASIC ECONOMIC FACTORS AND STOCK VALUATION

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UNDERSTANDING BASIC ECONOMIC FACTORS AND STOCK VALUATION

Before you invest, you should familiarize yourself with basic economic factors that affect the markets. Is the economy expanding or contracting? Are interest rates due for an increase or a decrease? What about inventories and employment? All this data, while not perfect, helps provide an overview of the state of the economy. It can also help you determine what asset classes you should be focusing on.

Interest rate curve

The yield curve, also known as the "term structure of interest rates", is a graph that plots the yields of similar-quality bonds against their maturities, ranging from short- to long-term maturity.

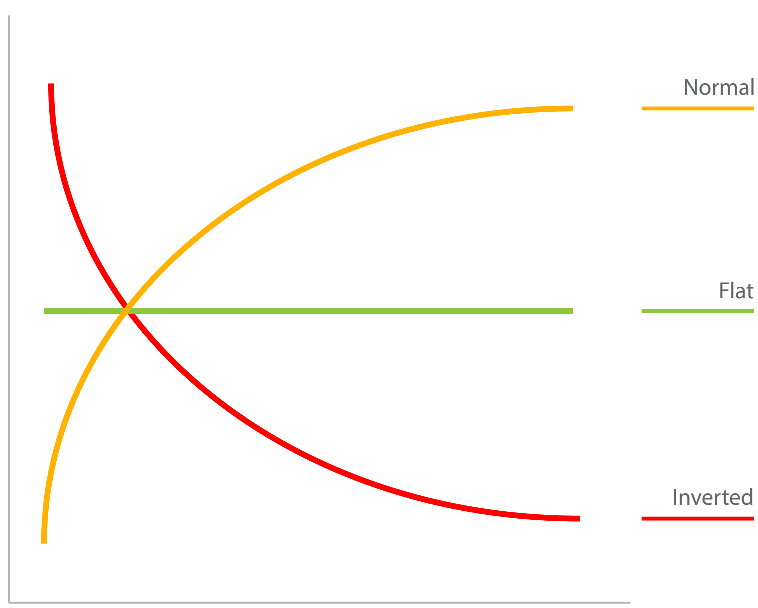
The yield curve can take three primary shapes:

- Normal
- Flat
- Inverted

If short-term yields are lower than long-term yields (the line is sloping upwards), then the curve is referred to as a positive (or "normal") yield curve. This means that the economy is growing and the expected rate of growth will be reflected in the steepness of the curve. In other words, a normal or upward-sloping yield curve indicates yields on longer-term bonds may continue to rise, responding to periods of economic expansion.

A flat yield curve may result from a normal or inverted yield curve, depending on changing economic conditions. When the economy is transitioning from expansion to slower development, and even recession, yields on longer-maturity bonds tend to fall and yields on shorter-term securities will likely rise, changing a normal yield curve into a flat yield curve.

An inverted or downward-sloping yield curve suggests yields on longer-term bonds are dropping, indicating a contraction. Rates may continue to fall, corresponding to periods of economic recession.



Other key economic indicators

GDP Growth Rate

The Real Economic Growth Rate is the rate at which a nation's Gross Domestic Product (GDP) changes or grows from one year to another. GDP is the market value of all the goods and services produced in a country during a particular time period. As an investor in company stocks, you want to see positive numbers. If growth is too high, you may want to ask yourself if the pace is sustainable.

Unemployment Rate

The unemployment rate is defined most essentially as the percentage of the total labour force that is unemployed but actively seeking employment and willing to work. Job creation is a sign of economic growth.

Employment Rate

The percentage of the labour force that is employed. One must also consider the quality of the jobs that are being created.

Inflation Rate

Inflation is the rate at which prices for goods and services are rising and, consequently, the purchasing power of currency is falling. Central banks attempt to limit inflation and avoid deflation in order to keep the economy running smoothly. A certain level of inflation is considered good and reflects economic growth while high inflation may mean you are paying too much for good and services compared to your household income.

Nonfarm Payroll

This is a monthly report generated by the U.S. Bureau of Labor Statistics. It is intended to represent the total number of paid U.S. workers of any business. Wage increase is another indicator of expansion as it indicates that households will have more money to lower their debt level or spend on goods and services.

These indicators can help you choose the markets and the sectors to invest in.

Sectors

Consumer Discretionary

This is the term given to goods and services that are considered non-essential by consumers, but desirable if their available income is sufficient to purchase them. Consumer discretionary goods include durable goods, apparel, entertainment and leisure, and automobiles.

Consumer Staples

These are goods that people are unable or unwilling to cut out of their budgets regardless of their financial situation. Consumer staples are considered to be non-cyclical, meaning that they are always in demand no matter how well the economy is performing. Food is the best example of a consumer staple.

Information Technology

Stocks relating to the research, development and/or distribution of technologically based goods and services. The world is going digital and we are changing our consumption habits. While always improving on technology and capability, companies such as Apple and Amazon also fall into the Consumer Discretionary sector.

Financial

The financial sector is a category of stocks containing firms that provide financial services to commercial and retail customers including banks, investment funds, insurance companies and real estate.

Health Care

Stocks relating to medical and health care goods or services. The healthcare sector includes hospital management firms, health maintenance organizations (HMOs), biotechnology and a variety of medical products.

Industrial

Stocks that relate to producing goods used in construction and manufacturing. This sector includes companies involved with aerospace and defense, industrial machinery, tools, lumber production, construction, waste management, manufactured housing, cement and metal fabrication.

Energy

This is a category of stocks that relate to producing or supplying energy. This sector includes companies involved in the exploration and development of oil or gas reserves, oil and gas drilling, or integrated power firms. It also includes electricity and alternative energy such as solar or wind.

Materials

This sector includes the mining and refining of metals, chemical producers, and forestry products, and includes companies involved in the discovery, development, and processing of raw materials.

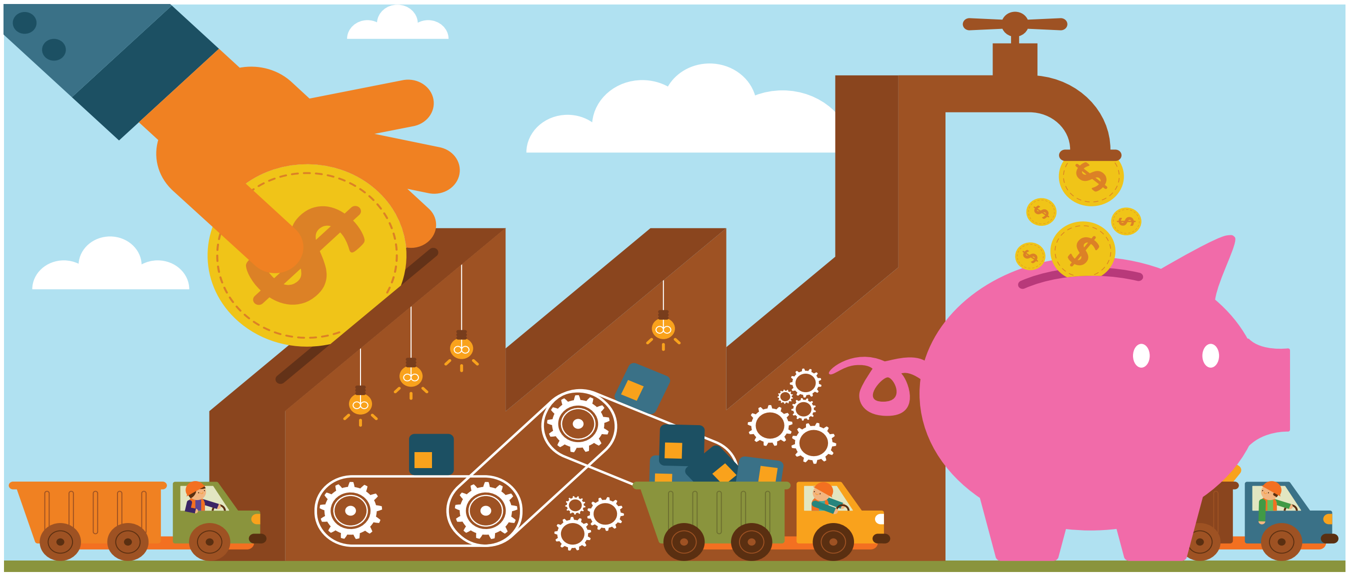
Telecommunication

Companies that make communication possible on a global scale whether through the phone or Internet. These companies created the infrastructure that allows data to be sent anywhere in the world. Currently the largest companies in the sector are wireless operators, satellite companies, cable companies and internet service providers.

Utilities

Companies operating utilities such as gas and power. The sector includes electric, gas and water firms, and integrated providers.

Now that you know the different sectors you can choose which ones to invest in depending on the current economic outlook. You can diversify your portfolio by investing in each sector.



Looking at a specific stock

Earnings per Share

This is the portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability.

P/E Ratio

Stands for price/earnings per share. This metric measures a company's current share price relative to its per-share earnings and is expressed as a multiple such as "15x". The multiple should be in line with the expected earnings growth. Look for a lower ratio when you use value investing and a high ratio when you are using a momentum strategy.

Price to Cash Flow

This is a stock's price compared to its cash flow per share. Ratios in the low single digits may indicate the stock is undervalued or a good buy.

Price Earnings to Growth

Also called the PEG ratio, this indicator gives a more complete picture of stock valuation than simply viewing the price-earnings (P/E) ratio. It takes into account the projected growth of earnings. The rate at which a company will grow its earnings going forward is one of the largest factors in determining a stock's intrinsic value. If the price-earnings (P/E) ratio is in line with its potential earnings, 10X and 10% expected growth, the PEG ratio would be one, thus the stock is rightly valued. If the P/E multiple is higher than earnings growth, the stock may be fully valued. If it is smaller, the stock would be a buy. Now, why would the P/E ratio be higher? Is it because the company offers a good dividend in a low interest rate environment?

A good way to start your own analysis is to compare the metrics for a particular stock to the sector average or a basket of similar stocks. Remember to compare apples to apples and use the same numbers for each company. These steps might seem long at first but the numbers are widely available on the internet.

Finally, never forget that cash is king and that net income can be manipulated by companies in a number of ways. All these metrics have strengths and weaknesses. You can look at cash flow per share and earnings per share, and if there is a big difference, you should wait before investing and do further analysis.

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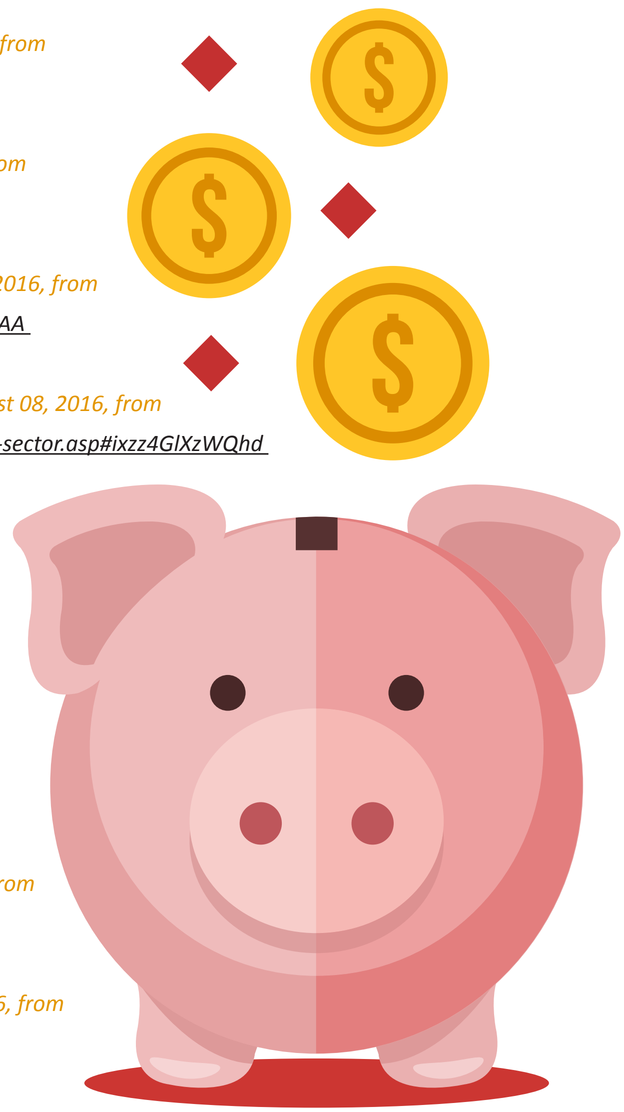

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