

What Drives the Markets?

By Richard A. Weiss
Chief Investment Officer, City National Bank

A disciplined and strategic approach to portfolio management can require some serious multi-tasking – and the monitoring capabilities of a supercomputer. Here are a just few of the numerous factors investors need to keep an eye on:

Macroeconomic Factors

Economic indicators such as interest rates, inflation rates, trade balance and currency movements help determine where we are in the economic cycle and where we may be headed in the market cycle.

For example, at the present time, the U.S. economy continues to grow at a healthy rate, both in nominal and real (inflation-adjusted) terms. However, there is accumulating evidence that our economy is beginning to slow down, leading to a deceleration in corporate earnings, while inflation and interest rates continue to rise.

Accordingly, equities, on the whole, may only produce modest returns for the foreseeable future. In the fixed-income markets, it may be better to consider higher-quality, shorter-term issues in this environment, and to wait until rates have risen before extending your average maturity and credit-risk profile.

Fundamental Market Valuation

Key to these measures is the comparison of the price of a security to the earnings or underlying value of the company the security represents. These ratios help investors gauge whether the markets are expensive or inexpensive relative to historical averages and trends.

Right now, for example, the price-earnings ratio of the domestic stock market (which is trading at about 17 times earnings) is roughly equal to historical norms over the last 10 years. In fact, when measured against a 70-year history, a P/E ratio of 17 is actually a little overvalued or “pricey.”

Bottom line: from a market valuation perspective, equities appear to be fairly valued – that is, neither a screaming buy nor a sell.

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Investor Sentiment or Psychology

The markets, especially stocks, can drift far from both the current economic and fundamental valuation pictures. Fear and greed are two significant forces that can drive stock and bond prices to extremes.

From the tulip bulb mania in the late 1880s to the tech bubble of the 1990s, investors can drive the markets beyond reasonable values. Thus, it is relevant to measure indicators that help determine where and to what extent investors are optimistic or pessimistic.

When investor confidence is low, there is a lot of money on the sidelines. This is actually a very bullish indicator for stocks in general because sentiment is a contra and lagging indicator. When do you want to buy stocks? When everyone else seems to be focused mainly on the negatives.

Of course, the opposite is also true. You want to sell stocks when most others are bullish and are only focusing on the positives.

Richard A. Weiss is executive vice president and chief investment officer for City National Asset Management, the investment management arm of City National Bank. In this capacity, he oversees the management of more than \$8.7 billion in client assets. For more information, please call (800) 708-8881.

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