



Rules are made to be broken

By CK Wong 2006.06.29

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Introduction

On June 29, the Federal Open Market Committee (FOMC) announced to raise the rate by a quarter point to 5.25% at 2:00 p.m. Immediately, the spot gold price shot up 13 dollar by the end of the day. The Dow went up more than 200 points. If you speculate the gold price would go down along with the stock market like the previous Fed rate increase, you are caught by the market action. There is no fixed rule for speculation in the market.

Market Rules

In the market, there are many maxims that many follow like gospel. They follow these rules without understanding the rationale and the governing factors. Take the Fed rate hike as an example. The rate hike is used by the Fed to lower inflation. Higher interest rate will slow down the economic activities which is the expectation of Fed to reduce the goods' demands. As the result the return of the company will be lower. The normal situation market reaction will have the index (i.e., the barometer of stocks) lowered. When Fed increases the rate, the American treasury will be paying a higher rate so there is incentive to buy US\$. The result is that the US\$ will rise relative to other currency. When the US\$ rises, the inflation hedging effect of gold is reduced so the price of gold comes down.

This is the rule that demonstrated many times. Only, the market reacts differently this time.

There are many experts who are busy writing explanations why it is different this time. Since I am not the expert so I am not prepare to explain. What I would like to discuss is how to be defensive.

Rise on speculation down on fact

If the market is so predictable, every financial analyst should be billionaire many times. The fact it is not very predictable. The most common explanation when the market does not react like the past, people says that the market already discounted the situation.

When people make up the law of economics and markets, they use a statistical model which means over a very large number of events it tends to behave in a certain way. This means the market is not a simple robot that you can predict. Sometimes the rule does not work because the underpinning criteria are not satisfied. There unpublished criteria are the source of the problem. When people interpret the market, some do in-depth analysis and some just doing the tea leave reading.

Even the rule is right but there are exceptions. So it is very dangerous to trade by speculation. This is especially true nowadays with all these hedge funds which could move the market with all their billions or even trillions of dollars.

Tautology

The term tautology in logic means it is true under all circumstances. In a volatile market the tautology to preserve capital is put the money in the T-bill which will pay you interest which may be lower than many investment vehicles' return but it does not lose money.

The compound rule is also another very powerful rule that people keep on overlooked. If you could, put the money you earn back to the investment, it can grow unexpectedly fast. More could be explain in the legendary Richard Russell's piece.
http://ww1.dowtheoryletters.com/DTLOL.nsf/htmlmedia/body_fixed_income.html.

The other tautology is never over invested in a single sector or a single company. Violating this rule may make you very rich but it also has the chance to lose all the marbles.

Be safe, be defensive then you may find happiness later.