Chapter 4.1

Market Rotations

MARKET ROTATIONS

Stock markets ebb and flow as investors move their money in and out of the markets themselves as well as in and out of various sectors within the markets. Investors are always looking for the most profitable places to put their money, and when they see an opportunity to make a better return on their investment in one market over another, or in one market sector over another, they are willing to move out of the less attractive investment and move into the more attractive investment.

The forces of supply and demand operate as investors move their money from one investment to another. As demand for one investment increases a growing number of investors move their money into that investment so that its value increases. Meanwhile this is often balanced by an increasing number of investors moving their money out of other investments, decreasing their value. It is these fluctuations in supply and demand that cause the ebb and flow of prices in the stock market.

You will see the ebb and flow of supply and demand manifest themselves in the following types of investment rotation:

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MARKET ROTATION

Investors are not limited to the stock market when they make their investment decisions. They can invest in bond markets, commodity markets, real estate markets and more. To make a decision on where to put their money investors look at the potential return available in any one market and the amount of risk they would be forced to accept to participate in that market. If a market does not offer a potential return which justifies acceptance of the potential risk then investors will avoid that market.

Two markets between which investors tend to freely move their money back and forth are the stock market and the bond market. In fact typically most investors trying to follow a diversified approach to investment have money in both markets at the same time. Bonds and shares complement each other nicely within a portfolio. Bonds offer a degree of security and stability coupled with regular interest payments and a guaranteed return of the face value of the bond. Shares, on the other hand, offer less security but the potential for much greater returns.

These diversified investors have two main concerns. They need to know what percentage of their money to keep in each market at any given time, and they need to know when to readjust their allocations. When the financial markets are performing well, when economies are growing and investors are confident in the future, many investors tend to shift a greater portion of their assets away from bonds and into shares to take advantage of the growth in the stock market. This influx of cash raises demand for shares which, in turn, pushes the value of shares higher. However, when the financial markets are performing poorly, when economies are stagnating or shrinking and investors are not confident in the future, many investors shift a greater portion of their assets away from shares and into bonds to protect their investment capital. This influx of cash raises demand for bonds which, in turn, pushes the value of bonds higher.

Accurately identifying the market cycles when demand for shares is increasing, and likewise those cycles when demand for bonds is increasing, can help you to make profitable share or ETF trades.

When you see demand shifting from bonds to shares, and shares then begin to increase in value, you can profit by doing either of the following:

- Buying stock index ETFs that are likely to go up as shares increase in value

- Selling bond ETFs that are likely to go down as bonds decrease in value

When you see demand shifting from shares to bonds, and bonds begin to increase in value, you can profit by doing either of the following:

- Buying bond ETFs that are likely to go up as bonds increase in value
- Selling share index ETFs that are likely to go down as shares decrease in value

Of course, there are market conditions that can cause both bonds and shares to increase or decrease at the same time. However, these two markets have tended to move in opposite directions from each other historically.

SECTOR ROTATION

Investors group shares with similar characteristics into market sectors. For instance, investors group shares from companies that operate within the health-care field into the health-care sector and shares from companies that operate within the micro-processor industry into the technology sector. These sector groupings are helpful for investors because companies that operate in similar industries tend to be affected by the same market and economic forces - forces which tend to cause the shares from those companies to move in unison.

Knowing that shares within a market sector tend to move together can help you to make investment decisions. When you see one share within a sector start to move there is a chance that the other shares within the same sector will be affected by the same market forces and begin to move. This gives you an opportunity to identify a suitable investment within the same category and trade it.

At any given time in the market some sectors will be moving higher whilst other sectors will be moving lower. Rarely will you see every sector in the market moving, as one, either up or down at the same time.

The self-same forces of supply and demand drive price movement within market sectors also drive investors to shuttle their money between the stock and bond markets. Often when investors see one sector begin to gain momentum they will start moving their money into that sector. This increase in demand and the influx of cash typically cause the shares within a popular sector to gain more momentum.

On the flip-side as investors are eagerly moving their money into popular sectors they are pulling their money out of less-popular sectors. This increased supply and decreased demand in the less-popular sectors typically cause the shares within those sectors to lose value.

Accurately identifying when demand for shares in some sectors is increasing, and likewise then demand for shares in other sectors is decreasing, can help you to make profitable share or ETF trades.

When you see demand shifting from one sector to another, when and the shares within the popular sector begin to increase in value and the shares within the unpopular sector begin to decrease in value, you can profit by doing any of the following:

- Buying ETFs that cover the sectors that are gaining in popularity
- Buying individual shares within the sectors that are gaining in popularity
- Selling ETFs that cover the sectors that are losing popularity
- Selling individual shares within the sectors that are losing popularity

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