CHAPTER 1

The Investment Rate

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The Investment Rate is the core of all of my analysis, and it is the catalyst for all of my trading strategies, too. It influences everything we do. Given the sweeping importance of this tool, I will start our discussion on how to make money in a volatile market by explaining the origins and properties of this tool and then build from that foundation as we move forward. Although proof of the Investment Rate is important, the discovery process itself is equally important as it reveals the simplicity of this model. Therefore, I think it is important to address this first. So, let's begin.

Economics Is All About People

My empirical journey to the land of economics did not begin with a Harvard MBA, or a doctorate from MIT. My drive to be the economist and independent market strategist I am today started another way. In fact, I confess that economics bored me in college. Although my grades were at the top of my class, I could barely stay awake during lectures. Initially, all of it seemed boring. The study of economics came easily to me, but the thought of applying those tools in the real world cast me from the science at that time. I was extremely social, and crunching numbers in a small office while surrounded by my intellectual peers seemed like the last thing I wanted to do. I was studying the works of Karl Marx, Thomas Malthus, and John Maynard Keynes, to name a few. The chairman of the Federal Reserve was Alan Greenspan, but he was not any different from the rest of them in my eyes. They were all bookworms; they were all number crunchers; and they all seemed to accept a lifestyle that did not interest me. Although I respected these intellects, I also feared the life that awaited me if I chose their path.

Without question, I was not a bookworm. Economics was just second nature to me. The number crunchers who were my peers in school had to work a little harder to achieve the same marks, but they did well and seemed satisfied with their results. Unfortunately, I was not satisfied with

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mine. Instead, to become satisfied I had to push myself in a different way. I did not need to study as much, but I needed to find motivation somehow. My peers already had it. Grades motivated them. However, because good grades came easily to me, that was not enough. There had to be something more, I thought, but I was not seeing it then. Every day my frustration grew, and I distanced myself from the science that I now find so compelling.

Imagine having a gift and not wanting to use it. What if you were a swimmer of the caliber of Michael Phelps but you decided that swimming was boring? What if you used to beat Kobe Bryant on the court when you were a child, but you stopped playing basketball because you did not like it anymore? What if your name was Tiger Woods, but because playing golf required so much patience, you decided to run track instead? I am not claiming to be in the same league as these athletes, but I did (and still do) have a skill, and I was not pursuing it appropriately. That was a major hurdle. Over time, I have found that everyone has hurdles like this. Helping us overcome them is one of my objectives. Everyone needs motivation—a drive, and a reason to move forward. I too was in desperate need of motivation as I pondered my future in relation to this wonderful science, which bored me before I completely understood it.

Luckily, my abilities and my diverging interests were clear to those who knew me. My economics professor at St. Mary's College of California, Stanley Wingate, sat down with me one afternoon after observing my disparaging attitude. Economics was already his life and his passion. Gracefully, he wanted to share some of his motivation with me. I cannot thank him enough for that simple half-hour conversation; it changed my life.

During our conversation, Professor Wingate explained that economics is all about people. If you understand people, you can understand economics. If you understand economics, you can understand people. Amazingly, in a blink of an eye, I found a parallel between my social activities and my education. I love interacting with people, and economics came easy, so synergies popped up everywhere. Eventually, I realized that economic theories—such as Random Walk theories—have a much broader range than just identifying opportunity. They apply in explaining many aspects of our social behavior. It is not about numbers; it is about people. Thanks to Professor Wingate, I was able to see this for the first time, and my eyes began to open. Almost immediately, I found correlations. Soon economics compelled me more than I ever thought it could.

Excited, I was motivated to move forward and to apply my new passion to my career. I did this by subtly changing the way I looked at the world. In turn, that opened a series of doors and provided endless opportunities for both inner growth and the expansion of my career. My transition was seamless and empowering at the same time. Eventually, I realized that this same simple revelation could change the perception of economics for

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many others as well. My drive, my passion, and my motivation have been unyielding ever since. However, I also realize that barriers to entry exist for many people, just as they did for me. Therefore, addressing these will be important to our end goal.

The Relationship Between Market Trends and Economic Cycles

After graduation, I entered the financial industry. Early in my career as a retail stockbroker, Colonial Mutual Funds approached me. Mutual fund companies often woo brokers to sell their funds. This gathers assets for the fund and generates recurring management fees for the firm. This Colonial wholesaler presented me with a sales kit for the funds he was pitching at the time. That kit included a comparative demographic study that pitted birth rates against the stock market. There were interesting correlations in that study. This was an eye opener. It was my first real-life exposure to this type of analysis. It showed me that the actions of people affect not only the economy, but the stock market, too. That broadened my interest even further. More important, it was also my first step toward developing the Investment Rate. Although the Colonial model was clearly flawed, it was on the right track. Over time, with that inspiration in hand, I continued to refine that imperfect model to produce a much more precise measure of current and future investment demand. That is the Investment Rate.

Although the Investment Rate includes variables, growth analysis, and quantum theories, its foundation is the simple study of human nature. It measures consumer demand for investments (demographic demand cycles). This is not a study of GDP. This is a study of investment demand, and it is extremely revealing. I will offer details in the next chapter.

Generally, most people experience similar personal financial cycles throughout their lives. In their early years, they are spenders; in the middle, they are savers; and from there until retirement, they are investors. Because I was looking for demand ratios, I was most interested in the third phase. Specifically, I wanted to know when people became investors. Interestingly, this is a consistent variable. Aside from unique circumstances, this happens at the same time for almost everyone. More specifically, skew is negligible over time, and demand cycles revert to the mean as well. As a result, investment behavior is predictable, and I have exploited that to identify longer-term economic cycles in advance. That is the Investment Rate. But, let me be more specific.

Everyone becomes an investor at some point in his or her life, and our aggregate demand for investments drives the economy. Because this is a demographic study, my references are to the entire population. When the overall demand for investments is increasing over time, the economy grows, and

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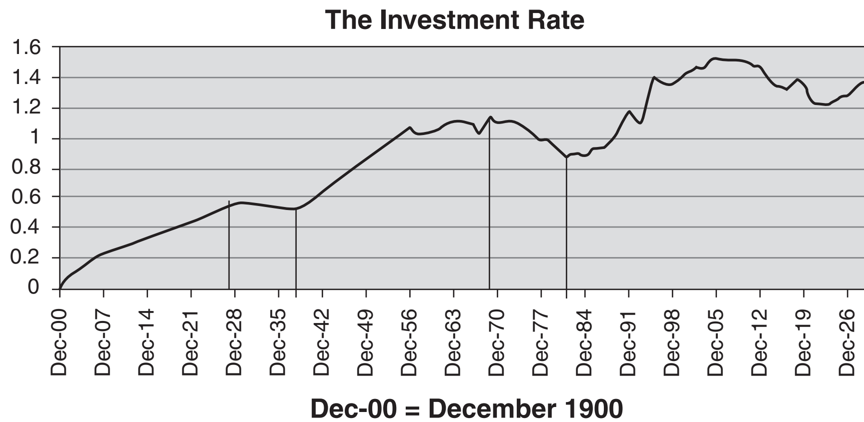

FIGURE 1.1 The Investment Rate.

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the stock market rises. When net investment decreases over time, the economy comes under pressure and the stock market fails. This is the essence of the Investment Rate. The Investment Rate tells us when this happens.

Studiously, I compared my theory to the economic history of the United States from 1900 to 2009. The Investment Rate actually extends through 2030, but I was looking for correlations to past economic cycles in this review. My findings were significant. Importantly, my retroactive analysis proved that the Investment Rate has identified every major economic cycle throughout our history in advance. In turn, that past parallel suggests future parallels as a result. That is how my forward model began. This analysis accurately identifies periods of significant weakness, and it precisely identifies the boom periods, too.

Although I will go into more detail in the next chapter, Figure 1.1 offers insight into that relationship. The most revealing may be the first down period. After all, we all know what happened after 1929.

A Leading Indicator

I first offered the Investment Rate to the public in 2002. In early 2002, the market was reeling. Arguably, overall demand for stocks had dried up completely. Investors were scrambling to protect themselves from the Internet debacle, and meltdowns were occurring left and right. On the surface, this was very similar to our experience in 2008, but there are subtle differences. Panic drove the market lower in 2002, and although my proactive strategies were performing extremely well, the selling pressure was unnerving to

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my clients, too. Unfortunately, I later discovered that this uneasiness also prevented many investors from doing the right thing. Instead of protecting wealth and realizing opportunities within my well-established models, many investors sat idle and watched their wealth dissolve as the stock market declined around them.

Right in the thick of things, I launched the Stock Traders Daily website in January 2000. This was the peak of the Internet bubble and an extremely volatile time. Therefore, I began to offer proactive trading strategies without thinking twice. Longer-term investments were not even a consideration at the time. However, even though we focused on trading strategies, I also recognized the power of the Investment Rate, and I respected its influence on the economy and the stock market over time. Reasonably, this long-term theory of market cycles lingered in my mind, but it was not important to me when I first started. I was only interested in providing solid returns. The Investment Rate did not become important to my clients and me until the market began to fall apart.

Thoughtlessly, at the height of the Internet bubble, major brokerage firms (including Morgan Stanley, Smith Barney, Merrill Lynch, Prudential, A.G. Edwards, Goldman Sachs, J.P. Morgan, and others) had "strong buy" ratings on stocks like Amazon, Yahoo, CMGI, eBay, and others. If it had dotcom in the name, it was on their list. Therefore, if the retail clients of these firms were following the direction of those institutions, they were also holding significant positions in these overvalued Internet stocks when the Internet bubble peaked in 2000. From there, as we know, the resulting declines were detrimental not only to real wealth, but also to investor sentiment as well.

Expectedly, many retail clients were confused, and most investors did not know what to think. If these analysts were indeed superior prognosticators and if they believed those Internet stocks offered significant opportunity, then why not just ride out the storm?

Unfortunately, following the guidance of those analysts pushed some investors over the edge. Between 2000 and 2003, many investors learned the hard way. Major brokerage firms have arthritic reactions to policy changes and analysis for their retail clients. This is especially evident during periods of market weakness. In fact, and more specifically, according to many analysts who offered opinions on Internet stocks for these major brokerage firms between 2000 and 2003, those stocks were "strong buys" in the $100s. Then, sell ratings came when the stocks were in the low single digits. This was a classic case of buying high and selling low. Obviously, they got it wrong.

After the fact, we all know that major brokerage firms provided retail investors with some terrible advice during the Internet bubble. The subsequent freefall in many stock prices resulted in the collapse of many tech-heavy portfolios, too. My focus in 2002, when I developed and introduced

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the Investment Rate, was to address and quell the fears that resounded so heavily throughout the market as a result. Even though my proactive models were rewarding my clients with exceptional returns, surprisingly, fear still lingered. My clients, like most investors, seemed to be uncomfortable investing in a declining market. Underneath, they really wanted the market to increase, and frankly, so did I. Interestingly, as my knowledge grew, I discovered that this was a mistake.

Understanding and dealing with this emotion has become much more important to me now than it was prior to 2002. In fact, I failed to recognize the consequences of that emotional bias when I first developed my trading strategies. These strategies were essentially short term, and our trading discipline left little room for fear anyway, so I never paid much attention to emotional conditioning on a long-term basis. Reflexivity was part of our models already. At the same time, though, I had not yet applied the strategies stemming from my understanding of the Investment Rate to our longer-term investments. More important, we had not even considered longer-term investments until the going got tough. In 2002 that changed—the focus now is also on longer-term investments as well, and building and protecting wealth accordingly.

However, that does not suggest constant higher moves by any means. Instead, I have grown to recognize that market direction does not matter, even to longer-term investments. Opportunities exist on both sides of the curve, and we must recognize them.

Coincidentally, in 2002, an interesting phenomenon surfaced, and this influenced my study. During a period when the stock market was experiencing significant declines, positive flows of new money into our economy continued virtually unabated. The difference lay in the positioning of that investment money. Money began flowing out of the stock market and into real estate and private business. As a result, the stock market stayed under heavy pressure, and real estate prices began to increase.

Everyone can see that investment shift now, but very few were able to identify that simple transition in 2002. In fact, during periods of weakness in the stock market, almost everyone becomes blind to reason. Therefore, in 2002, investors were more concerned with the value of their mutual funds, managed accounts, and 401ks. If they were holding Internet stocks based on the "strong buy" recommendations offered by the major brokerage firms at that time, those concerns derailed structured and disciplined investment strategies even further.

My nervous clients and other concerned investors everywhere wanted to know if an improving economy would be enough to sustain a recovery in the stock market. I aimed to prove it one way or another. During my pursuit of insight into the future trend of the stock market, the main distinction I identified was that a simple shift in asset classes had taken place, and that was all. Otherwise, demand was still robust, and new money continued to

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flow into our economy. According to my theory, the Investment Rate, the market would recover swiftly from that decline. I said so in a work I published titled "Will an Improving Economy Be Enough?" That report included a concise understanding of the Investment Rate, a tool I had been developing for quite some time. Until then, I had never dignified this powerful theory with publication.

My report proclaimed that, according to the Investment Rate, there would be a prompt upward retracement in the stock market rooted in an overall increasing demand for investments. The report advised investors that investing in stocks would be intelligent again at some point soon. Therefore, with that evidence in hand, I knew that we should also be looking for precise opportunities to buy when the time was right. From there, I reviewed Fibonacci calculations and technical tools to help me identify the bottom within a few points. The result was not surprising to some of my clients who had already been following my proactive trading models religiously. The result of my preemptive analysis was that I defined the bottom of the market in 2002 almost exactly. More important though, that report also revealed important facts about the long-term health of the economy and the stock market that eventually reshaped the way we approach our long-term investments today.

As we know, in 2002, the market resumed a very strong upward trend that lasted until 2007. The Investment Rate had been a bullish leading economic and stock market indicator in the face of the Internet debacle, and it was virtually exact.

However, there is more. Attempting to defuse the fear of investing during the Internet debacle was initially restricted to proving that the market was still ascending. Inherently, most people held the misconception that they could comfortably buy the dips forever. However, as we have learned over time, it is also every bit as important that investors not fear participating in a declining market either, where opportunities also abound. To that end, the Investment Rate is equally valuable. It assists my clients to understand future economic conditions and market direction whether up or down. This goes a long way to unburdening their fears. With the Investment Rate, they have the tools to take advantage of whatever market opportunities exist. That is the first step toward the comfort zone!

Therefore, the Investment Rate, as I employ it for the benefit of my clients, is not limited to a demographic analysis. It must also include a second component, and that component produces actionable strategies in relation to the findings of the demographic study. The first component is a measurement of the increase or decrease over time of new investment into the economy. This is a predictor of economic trends. The second component is the technical tools I have developed to pinpoint support and resistance levels. These allow us to find turning points in advance. In my opinion, the combination of these components has produced the most accurate leading

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longer-term stock market and economic indicator ever developed. I will discuss both of these in the next chapter.

The Investment Rate is a long-term fundamental analysis of the economy and the stock market. It is the core of all of my research. It is rooted in all of my investment strategies. A review of the Investment Rate should be conducted before any investment decisions are finalized. This includes investments in stocks, bonds, real estate, businesses, and any other investment class that requires a positive inflow of capital to grow. I advise all of my clients to have a concrete understanding of longer-term trends before they engage any active (short-term) trading strategies, and I use the Investment Rate as a tool to satisfy this objective appropriately. If we can first understand longer-term cycles, we are more readily able to accept change—when change is required.

New Money Drives the Market

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In summary, the Investment Rate measures the amount of new money available for investment into the economy over extended periods. In turn, that directly influences the demand for investments throughout that same cycle. Specific investments such as stocks, real estate, and other asset classes within the economy are impacted. The Investment Rate ultimately affects the value of all the investments we make, and that is obviously important to all investors. Nothing is sheltered from this demand-side analysis and that is why everyone should review the Investment Rate before making any investment decisions. Figure 1.2 explains how the Investment Rate affects the investments that are important to us.

The Investment Rate helps us to understand and to predict current and future economic cycles by measuring the demand for new investment, the prime driver of the economy. Simple in concept, it enables us to weed out the noise that clutters so many other economic models unnecessarily. This refined approach then allows us to focus on strategies designed to make us money regardless of market direction. More precisely, the Investment Rate gives us confidence in our strategies, and that is priceless!

The Investment Rate is powerful, it is far reaching, and it influences everyone. It should be used by governments to help them determine long-term economic policies. It should be used by corporations to help them manage business cycles. But most important, it should be used to help individual investors manage their wealth over time as well.

Appropriately, in the chapters that follow this will be a focal point. However, more important, our next step is to prove the theory I introduced here. In the next chapter, I will be specific, and the effectiveness of this demand-side analysis will come to light.

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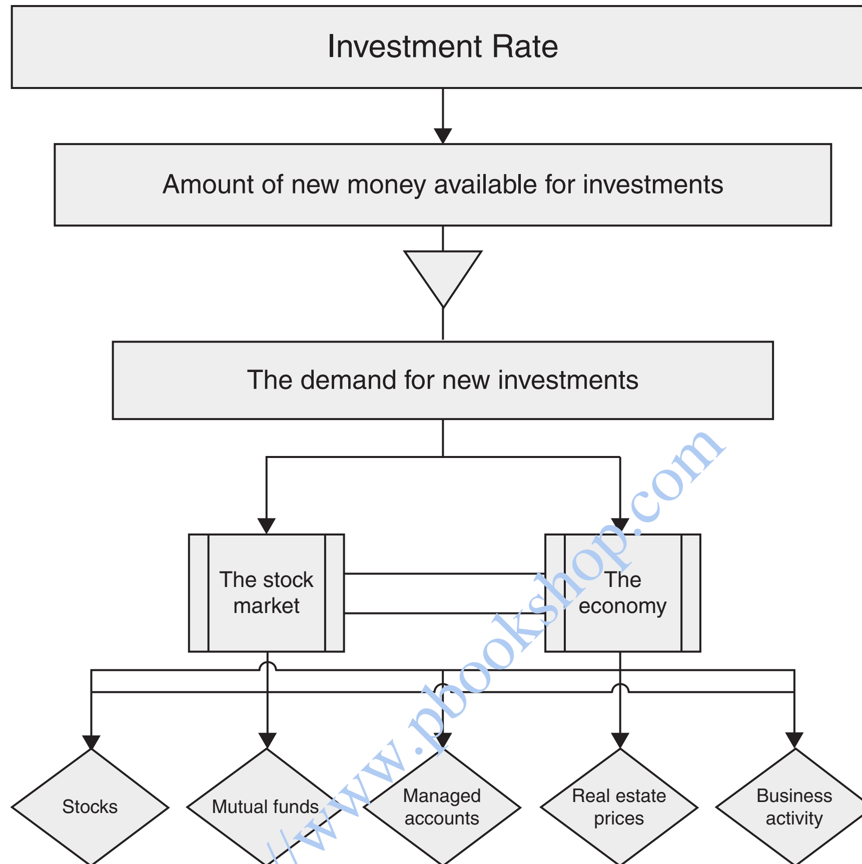

FIGURE 1.2 How the Investment Rate affects our investments.

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Summary

Below is a summary of the most important topics in this chapter:

- Economics is all about people.
- The Investment Rate is a demographic study that measures the inflows of new money into our economy annually and over extended periods of time.
- The Investment Rate reveals up and down cycles in advance, and accepting these as opportunities is the first step toward the comfort zone.

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