The Great Unwind will continue

What is the one thing investors need to know in 2016? In 2015, the answer was easy – just avoid anything connected with commodities and emerging markets. The rationale for the collapse was that a "Great Unwinding" of stimulus by policymakers had started in the middle of 2014 and was gathering pace. China's decision to abandon stimulus meant that vast surpluses of oil, iron ore, copper, coal and many other commodities began to weigh on markets. In turn, this crashed the economies and currencies of commodity-exporting countries in a wide arc from Latin America through Asia and the Middle East to Russia.

My view is that this Great Unwinding idea will continue to be a reliable guide in 2016. Its core insight is that the key effect of stimulus has been to destroy the role of price discovery in important markets. Media and analyst commentary no longer focused on the fundamentals of supply and demand, but rather on whether we might see more stimulus or its reverse. I suspect we will now see the impact of the unwinding of this stimulus spread from commodity and currency markets into stockmarkets and interest rates (with a knock-on impact on house prices).

If this happens, then 8.5 will be the one thing we need to know in 2016. What is 8.5, you may ask? It is the core valuation metric used by Benjamin Graham, the father of value investing, as described in his 1949 classic, *The Intelligent Investor*, which Warren Buffett has described as "by far the best book on investing ever written". In it, Graham identifies 8.5 as the appropriate p/e ratio for a company expected to maintain its current earnings for the next ten years.

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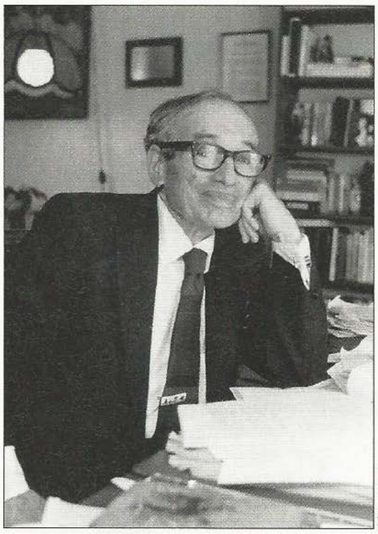
Any increase or decrease in projected annual earnings over this period changes the metric by a factor of two. So a company that can grow its earnings by 5% a year from now till 2025 would be fairly priced on a p/e of 18.5. We don't have to take Buffett's word for Graham's genius: 1987 gave us a real-time experiment in valuation, with the Black Monday crash of 19 October. As the Harvard Business Review reported in May-June 1988, Graham's simple formula, when adjusted for interest rates, predicted the precise decline in the Wilshire 5000 index, and the closing prices for many top companies that day. No other valuation model even came close. Focusing on Graham's formula provides another benefit. It reminds us that true investment is long term – ten years or more. It is not about short-term trading based on "will she, won't she" guesses about the Federal Reserve's next move on interest rates, or "risk on, risk off" strategies.

"The one thing you need to know in 2016 is '8.5'"

Instead, 8.5 provides us with a simple, yet extremely powerful way of assessing whether a company is relatively over- or undervalued today. As a result, I think it will prove to be the one thing investors need to know as the Great Unwinding continues through 2016.

Paul Hodges publishes The pH Report (www.iec.eu.com/the-ph-report).



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Benjamin Graham: investment genius