Using Fair Value in Fundamental Analysis

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By: DailyForex.com

Fundamental Analysis is essentially the use of economic analysis to determine either the real value of an asset or whether a trend exists in the real value of an asset. The first method allows the derivation of the “fair value” or “real value” of an asset, allowing a trade to be placed if the current market price deviates significantly from that real value. The latter method allows a trader to have confidence in a trend if there is a trend of actual market price changes mirroring the fundamental trend.

Fundamental Analysis in Trading Stocks

For example, both of these methods of fundamental analysis are commonly used in trading stocks. Stock traders that are prepared to hold trades over the long-term may follow a macro rule of only being long in a bull market, and the use of fundamental analysis to detect improving global or local economic fundamentals is usually a part of making a call as to whether a bull market is in existence.

On a more micro level, fundamental analysis is also commonly used to derive a fair value for individual stocks, in order to determine which stocks are likely to be undervalued and therefore good bargains for relatively long-term buy and hold strategies. This is typically done through the use of price to earnings ratios (as earnings of a publicly quoted company may be easily and transparently discerned). Another method is to take recent dividend payments as discounted cash flow, with the “fair value” price of the stock being the discounted total value of the anticipated next twenty dividend payments.

Fundamental Analysis in Trading Commodities

Using fundamental analysis in trading commodities is usually considerably more difficult than it is trading stocks. This is because commodities are usually prone to sharp fluctuations based upon demand and supply issues and all manner of localized events which may be hard to foresee. Furthermore, different types of commodities behave differently and have strongly variant characteristics.

One example might be energies such as oil and natural gas. Fundamental factors affecting energy commodities typically include the economic health of large energy consumers (for example, Chinese industry’s appetite for oil consumption at any given time), as well as supply factors such as political instability affecting production areas. It is much harder to determine the “fair value” of a barrel of oil as changes in technology and other factors affecting the cost of extraction and/or production must be taken into account. What may have been the “fair value” of a barrel of oil ten years ago is quite different today due to big changes in extraction technology.

The Interesting Case of Gold

Gold is typically considered to be the quintessential store of value as mankind’s precious metal since the dawn of time: additionally, it has few dual uses to distract from its anointed role. It is seen as the ultimate “store of value” as unlike fiat currencies, as a store of value its “fair value” might be expected to remain constant. A study conducted a few years ago (http://gardenofecon.com/2013/05/roman-centurions-and-the-price-of-gold-today/#comments) by financial academics Campbell R Harvey and Claude Erb found that in terms of gold, a Roman centurion during the reign of the Emperor Augustus

was paid about the same as a modern-day U.S. Army Captain, which would be their equivalent rank. Additionally, the price of a loaf of bread in 6th century B.C. Babylon was about $4 per loaf, which is not too far away from what a good-quality loaf might cost you in the modern-day U.S.A.

This study calculated that the “fair value” of an ounce of gold in 2012 was approximately $800, and that throughout history the price eventually reverts back to its “real price” after a significant deviation. This would have worked as a trading strategy in 2012 over the medium-term.

Fundamental Analysis in Trading Forex

Obviously straightforward methods of fundamental analysis can be applied to currencies by analyzing the economic data of nations. The use of “fair value” methods is even more attractive here, as it appears it can be easily derived by simply comparing retail prices of common goods in various countries, and then applying the differentials to the relevant current market exchange rates. For example if $10 worth of currency in country A buys more goods than $10 worth of currency in country B, it would be said that country A’s currency is overvalued and country B’s currency is undervalued. The undervalued currency would be bought and the overvalued currency sold in the hope that the exchange rate would move in that direction.

The problem with “fair value” in Forex is that it has not worked well at all over recent years. To test this theory, I looked at the value of the seven major global currencies (NZD, JPY, EUR, GBP, AUD, CAD, CHF) against the USD over a 9.66 year period, from January 2005 until April 2014.

The strategy used was fairly crude: at the beginning of each month, I hypothetically bought the three currencies that were the most undervalued against the USD according to the previous year’s OECD Purchasing Power Parities data, and sold the three currencies that were most overvalued. Each position was exited automatically after a month.

The results we present do not include the actual interest payment differentials that would have been earned or deducted. The results are simply based upon the changes in the exchange rates between the currencies and do not include transaction costs.

The results were as follows:

9.66 Year Return	4.92%
Annualized Return	0.50%
Average Monthly Return	0.00%
Median Monthly Return	0.50%
% Winning Months	51.79%
Max Consecutive Winning Months	5 (Feb-14)
Max Consecutive Losing Months	4 (Sep-12)
Max Drawdown	119.47%
Standard Deviation	13.64%

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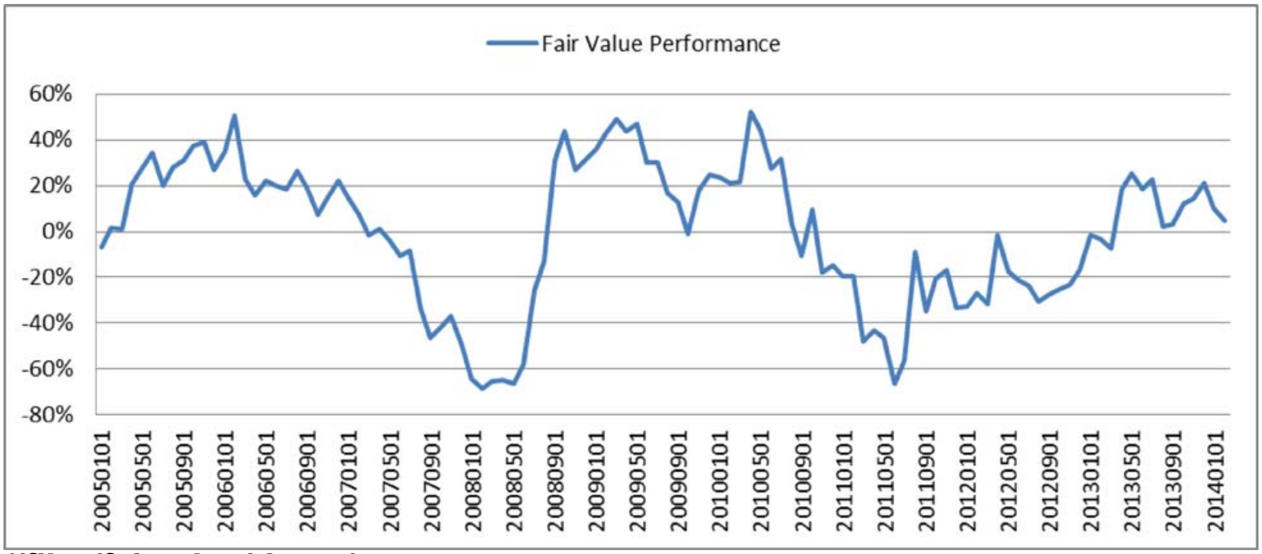

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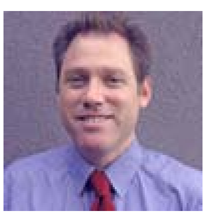
Conclusion

Using “fair value” is much more effective in long-term investing than it is over more short-term trading. Like most fundamental analysis, in my opinion it is likely to work best as an additional filter applied to conclusions derived from technical / price analysis.



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