How to Trade the News

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The stock markets famously display a sustained upward trend over the long term. But it's the intermittent tailspins—like the 50% drop endured by most major markets during the 2008-09 global credit crisis—that test the fortitude of an investor.

The nimblest investors can make money no matter what is happening in the world. Trading the news should be an integral component of your investing strategy. While a day trader may trade the news constantly, a long-term investor might do so only occasionally.

Regardless of your investing horizon, learning to trade the news is an essential skill for astute portfolio management and long-term performance.

Classifying News

News can be broadly classified into two categories:

- Periodic or Recurring: This includes the scheduled releases of news that moves the markets, including interest rate announcements by the Federal Reserve, economic data releases, and quarterly earnings reports from companies.
- Unexpected or One-Time: These are bolts from the blue such as a terrorist attack, a sudden geopolitical flare-up, or the threat of debt default by an indebted nation. As a rule of thumb, unexpected news is more likely to be bad than good.

News can be specific to a particular stock or it can affect a sector, an industry, or the markets as a whole.

Trading the News

Here are a few examples of historical events and the actions that an investor could have taken in response.

A Federal Reserve Announcement

The Federal Open Market Committee's (FOMC) interest rate announcements have always been among the biggest market-moving events, but its announcement in mid-March 2020 was of unusual interest, not least because it was issued on a Sunday.

In an effort to ease the economic effects of the 2020 coronavirus crisis, the Fed cut its main lending rate by 1%. It was the second cut of the month. It also announced plans to buy $700 billion in government securities.[1]

The next day, the Dow Jones Industrial Average dropped 3,000 points for its worst day since the 1987 crash.

Many investors would have bet on a great day on Wall Street, and they would have been wrong. Other headlines dominated, including comments from President Donald Trump saying that the pandemic could last until August. (It turned out to be much worse.)

Nevertheless, investors who held on for just a few more weeks would have been amply rewarded when the markets started climbing again.

An investor in stocks who was looking to hedge potential downside risk could have done any of the following immediately after the Fed's announcement:

- Trimmed positions in highly profitable equity positions to take some money off the table.
- Purchased puts either on specific stocks in the portfolio or on a broad market index like the S&P 500 or Nasdaq 100. Purchasing puts gives the investor the right to sell a stock for an agreed-upon price at a future time. If the security's market price falls below the agreed-upon price, the investor gains by selling at the higher contractual price.
- Bought inverse exchange-traded funds (ETFs) to protect portfolio gains. These move in the opposite direction of the broad market or a specific sector.

While these reactive moves would typically be carried out after the Fed announcement, a proactive investor could implement the same steps in advance of a scheduled Fed statement.

This reactive or proactive approach to an important event or piece of news, of course, depends on the investor's confidence in predicting the market's near-term direction. An individual's risk tolerance and trading approach (passive or active) also are factors.

A Jobs Report

In terms of economic data releases, few are more important than the U.S. jobs report because of its wider implications.

Traders and investors closely watch the employment level because it has a substantial impact on consumer confidence and spending, which accounts for 70% of the U.S. economy.
Job numbers that miss economists' forecasts are generally interpreted as signs of incipient economic weakness, while payroll numbers that surge past forecasts are seen as a sign of strength.

In March 2021, the government announced that nonfarm payroll employment had increased by 916,000 the previous month, lowering the unemployment rate to 6%. About 210,000 new jobs were expected to be created.[2] Crucially, many of the new jobs were in the travel industry, signaling a rebound in discretionary spending.

After a seesaw session, the Dow Jones Industrial Average closed up 171 points.
The investor playbook for trading jobs data is based on predictable market reactions.

- Payroll numbers below expectations: Suggests that the Fed will be forced to keep interest rates low for an extended time period. The impact on specific asset classes could be predicted in this table:

Asset/Instrument	**Immediate Impact**
Equities	⬆️ (up)
Bonds	⬆️ (up)
US Dollar	⬇️ (down)
Volatility	⬇️ (down)
Gold	↔️ (no clear trend)
Commodities	↔️ (no clear trend)

- Payroll numbers above expectations: Implies that the Fed may scale back the pace of asset purchases, which could send bond yields and market interest rates higher. The likely result:

Asset/Instrument	**Immediate Impact**
Equities	⬇️ (down)
Bonds	⬇️ (down)
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Volatility	⬆️ (up)
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An investor could use these market reactions to formulate an appropriate trading strategy to implement either in advance of the jobs report or after its release.

A Corporate Earnings Report

If you invest in individual stocks, it is advisable to have a trading strategy in place in advance of the relevant company earnings reports.

A stock's price can soar or tank in minutes after releasing numbers that impress or disappoint. Imagine having a huge short position in a stock and watching it soar 40% in the after-market because its earnings were much better than expected.

Trading an earnings report is by no means required. If you're in a stock for the long term, and you believe in its potential, you can ride out any quarterly storms.

But if you have a large position in a stock, long or short, you need to weigh the merits of leaving it unchanged over the earnings report or making changes just before the report comes out. Factors that should play a part in this decision include:

- The current state of the overall market (bullish or bearish);
- Investor sentiment for the sector to which the stock belongs;
- The current level of short interest in the stock;
- Earnings expectations (too high or comfortably low);
- Valuations for the stock;
- Its recent and medium-term price performance;
- The earnings and outlook reported by its competitors.

For example, an investor with a 15% position in a big-cap technology stock that is trading at multi-year highs may decide to trim positions in it ahead of the earnings report so that it constitutes only 10% of the portfolio.

An alternative option could be to buy puts to hedge downside risk. While this would enable the investor to leave the position unchanged at 15% of the portfolio, this hedging activity would incur a significant cost.

Key points to note: Avoid taking an unduly large position, and have a risk mitigation strategy in place to cap losses if the trade does not work out.

What Are the Most Important Economic Indicators?

Investopedia identifies the 10 most important reports that an investor should keep an eye on to understand the big economic picture: quarterly gross domestic product; monthly employment; industrial production; consumer spending; inflation; home sales; home construction; construction spending; manufacturing demand, and retail sales.

Collectively, these reports can give you a good sense of the current state of U.S. business and its likely near-term direction.

What Is a Leading Indicator vs. a Lagging Indicator?

A leading indicator is an economic report that can be used to anticipate a trend. The new construction starts report indicates whether the home-building industry is betting on higher or lower sales in the short-term future.

A lagging indicator confirms a trend. The home sales report tells you whether home builders were correct in their assumptions.

Investors tend to pay more attention to leading indicators. They want to anticipate the news, not react to it.

What Is Market Sentiment and Should I Pay Attention to It?

Market sentiment is the mood of the market. In short, it's the herd mentality. It's best avoided unless you judge that the sentiment, upbeat or downbeat, has a sound basis in fact. Ignore it and you qualify as a contrarian.

The Bottom Line

Trading the news is crucial for positioning your portfolio to take advantage of market moves and boost your overall returns. But your trading decisions should be made in a thoughtful and measured way. Keep an eye on the news and watch for meaningful trends. Panic decisions are almost always a cause for regret.

Reference

[1] American Action Forum. "Timeline: The Federal Reserve Responds to the Threat of Coronavirus, https://www.americanactionforum.org/insight/timeline-the-federal-reserve-responds-to-the-threat-of-coronavirus/."
[2] U.S. Bureau of Labor Statistics. "TED: The Economics Daily. https://www.bls.gov/opub/ted/2021/payroll-employment-increased-by-916000-in-march-2021.htm"

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