TIMING YOUR INVESTMENT STRATEGIES USING BUSINESS CYCLES AND STOCK SECTORS

Developed by Peter Dag & Associates, Inc.

Fig. 1

Business Cycle

Growth Potential

Phase 2

Phase 3

Phase 4

Phase 1

Growth Cycle

Fig. 1
Introduction

The business cycle goes through 4 major growth phases. As growth in business activity rises (phase 1 and phase 2) and then declines (phase 3 and phase 4), it causes major and important changes in the way the markets price various asset classes. These changes reflect businesses’ reactions as they modify their strategies to seek new opportunities.

Small changes in the growth pattern of the business cycle create investment opportunities. These changes have an effect on which asset classes and stock sectors fall out of favor and which ones tend to outperform the broad market averages.

The strategic points of the business cycle have been identified with sequential numbers going from 1 to 8 and back to 1 (see Fig. 1). These milestones were selected because they signal important changes in the direction of most asset classes. Investment strategies should, therefore, reflect these new trends.

As the business cycle moves slowly through the various phases, investors need to re-balance their portfolio to take advantage of the opportunities offered by the next phase of the business cycle.

Because of the uncertainties involved in recognizing new trends, adjustments to the portfolio should be made gradually and slowly. Investors should not think in terms of “buying” or “selling,” rather “increasing” or “decreasing” a position in their portfolio.

What happens at each one of these points is discussed in what follows. Detailed explanations are also found in the books Profiting in Bull or Bear Markets and Investment Strategies using Stock Sectors.
What happens in Phase 1, Point 1

The economy expands slowly and growth stabilizes. The ISM indexes are well below 50, but now they stop declining. The cumulative effect of increased liquidity, much lower inflation, interest rates, and commodity prices has its usual positive effect on consumers, business, and investors. It took some time -- more than 12 months -- for these trends to have their typical beneficial effect on the economy (see Phase 4, Point 8 below).

Commodities are weak. Because of weak economic conditions (business activity is still growing below its long-term average growth), demand for raw materials is soft, placing downward pressure on commodity prices.

Short-term interest rates are falling. The weak economy discourages short-term borrowing needed to finance inventories and other working capital requirements. The outcome is continued decline in short-term interest rates. The financial press suggests the Fed is easing to stimulate the economy.

Inflation continues to decline. Lower commodities and interest rates accompanied by lower growth in wages reduce the rate of inflation. The weaker demand for goods due to the growth recession is also having a dampening effect on prices.

Bond yields keep declining. Because of the slow growth environment, demand for long-term funds remains subdued. The decline in bond yields is also caused by the lower inflation premium built into yields.

Outlook. The economy shows signs of improving. The forces of recovery continue to improve quite strongly. These trends begin to appear in Phase 4, Point 8.

   a. The growth of the money supply is rising much more rapidly. Business and investors recognize that business activity is at a turning point. Optimism about the outlook improves. This optimism is accompanied by faster demand for capital, reflected in more robust growth in liquidity.
   b. The dollar is rising, reflecting the improved optimism of business and investors.
   c. The yield curve continues to steepen, reflecting the aggressive easing of the Fed.

Investment strategies

- High-grade bonds: Prices rise. These bonds continue to provide excellent returns.
- Low-grade bonds: Low-grade bonds remain attractive.
- Commodity: Commodities are still weak.
- The broad stock market: The stock market is strong.
- Stock sectors: Investment in commodity driven stocks remains unattractive. Financial stocks and technology stocks outperform the broad market.
What happens in Phase 1, Point 2

**Economic growth continues to rise.** The ISM indexes are now moving higher, but are still below 50. The effect of rising growth in the money supply and a steepening yield curve add momentum to the growth in business activity.

**Commodities remain weak.** Investors need to be careful because the markets are close to a transition point as the economy keeps gaining momentum. Although commodities are weak at this stage of the business cycle, they are much closer to a bottom than a top.

**Short-term interest rates are falling.** Short-term interest rates are not declining as rapidly as before. Investors are beginning to sense that the nature of the markets is changing. Short-term interest rates, as commodities, are much closer to the bottom than the top. The financial press is hinting that the Fed may soon stop easing.

**Inflation is heading down.** The economy is too weak for inflation to rise. Consumers remain sensitive to price increases because of the uncertain labor market.

**Bond yields continue to head lower.** The slow economy and lower inflation are the main reason for declining bond yields. They are, however, much closer to the bottom than the top.

**Outlook.** Growth keeps gaining momentum. Business activity continues to strengthen because of the following trends.

a. The growth of the money supply is rising quite strongly.
b. The dollar is also strong as foreign investors realize the US economy has finally turned around.
c. The yield curve continues to steepen as short-term interest rates decline more rapidly than bond yields.

**Investment strategies**

- High-grade bonds: prices are not rising as rapidly. They provide solid returns.
- Low-grade bonds: These bonds remain attractive.
- Commodities: Commodities are not declining as rapidly. They are much closer to a bottom than a top.
- The broad stock market: Stocks remain strong.
- Stock sectors: Financial and technology stocks remain attractive. Commodity-driven stocks, however, are gradually improving their relative strength and are becoming attractive.
What happens in Phase 1, Point 3

**Economic growth is strengthening.** The ISM indexes are close to 50 and moving higher. The economy is growing at its average pace with good momentum.

**Commodities are close to a bottom.** Most commodities stop declining and start trading in a range. This is an important transition time, as the trend in commodities is changing from down to up. This change is caused by increased business demand for commodities as business activity grows at potential and possibly even faster. This is an excellent time to look at the level of real interest rates. If they are below inflation, the odds favor a larger-than-average rise in commodities.

**Short-term interest rates are at a bottom.** Short-term interest rates stop declining. Stronger business activity encourages business to borrow more money to finance needed inventories and other working capital requirements. This is a very important turning point in the financial markets. The financial press is speculating the Fed may be forced to tighten in the not too distant future to cool off the economy and reign in inflationary pressures.

**Inflation bottoms.** Demand for goods increases as the economy creates more and more jobs. Wage increases become more widespread. Consumers are more aggressive in their buying patterns.

**Bond yields bottom.** The stronger economy stimulates more demand for long-term capital, and the lack of improvement on the inflation front creates a floor under bond yields.

**The economy is on the verge of much stronger growth.** Business activity is going to be much stronger, and the possibility of overheating could become an important issue. These are the most visible trends pointing to more growth ahead.

- The growth of the money supply is rising.
- The dollar is firm as the strong US economy attracts foreign capital.
- The yield curve is now very steep, reflecting the easing of the Fed.

**Investment strategies**

- **High-grade bonds:** The bond market is beginning to struggle. A more cautious strategy is in order.
- **Low-grade bonds:** They remain attractive, but a more cautious strategy is reasonable at this point.
- **Commodities:** Some commodities begin to strengthen. This is an excellent time to become more optimistic about hard assets.
- **The broad stock market:** The stock market continues to rise. The strong growth phase of the bull market is over. Stocks begin to rise more slowly.
- **Stock sectors:** Financial and technology stocks begin to sputter, while commodity-driven stocks become stronger than the market.
What happens in Phase 2, Point 4

**Economic growth is strong.** The ISM indexes are now well above 50, rising with strong momentum.

**Commodities are rising.** Commodities are rising rapidly. Business is buying aggressively raw materials to replenish inventories.

**Short-term interest rates are rising.** Short-term interest rates are rising as business increases aggressively short-term demand for money to finance higher employment, higher inventories, and rising needs for raw materials. The Fed releases the FOMC minutes justifying higher inter-bank rates to bring inflation under control.

**Inflation is rising.** The increase in wages, as the labor market tightens, the increase in raw material prices, and capacity shortages force business to raise prices. Inflation is picking up momentum as consumer demand rises. Higher inflation, however, has the crucial negative effect of reducing real income of consumers.

**Bond yields rise.** Rising commodities and inflation raise the inflation premium priced into bond yields. The need for additional capacity increases the demand for long-term funds, placing further upward pressure on bond yields.

**Outlook.** The economy is entering the overheated stage of the business cycle. This stage of the business cycle creates developments causing growth to decline to more subdued levels, close to long-term average growth rates. It will take more than 12 months for these forces to have a negative effect on the economy.

   a. The growth of the money supply begins to slow down, as rising interest rates and credit risk discourage businesses to increase borrowing.
   b. The dollar fails to reach new highs as capital begins to flee the US. Investors sense more difficult financial times ahead.
   c. The yield curve stops steepening and begins to flatten.

**Investment strategies**

- High-grade bonds: Yields are rising and bond prices are declining. Bonds begin to perform poorly at this stage of the business cycle.
- Low-grade bonds: These bonds are unattractive at this stage of the business cycle.
- Commodities: Commodities are very strong. Hard assets in general perform very well now, providing handsome profits for those investors who started buying them at the end of Phase 1.
- The broad stock market: The stock market begins to sputter, as liquidity starts to grow more slowly.
- Stock sectors: Commodity driven stocks outperform the broad market.
What happens in Phase 2, Point 5

The economy is growing very rapidly. The ISM indexes remain well above 50, but seem to have problems rising. They make little or no progress for a few months. This is an indication the economy has reached the highest rate of growth for the current business cycle. The inventory cycle is in full swing as business increases production to replenish inventories and keep up with sales.

Commodities continue to rise sharply. Strong demand for commodities, due to the rapid pace of business expansion and inventory build up, continues to be reflected in higher commodity prices.

Short-term interest rates continue to rise. Demand for short-term funds is strong to finance working capital. The outcome is that short-term interest rates rise rapidly, much faster than the increase in bond yields. The Fed is worried about rising inflation and raises the inter-bank rate.

Inflation continues to move higher. The economy is too strong for inflation to stabilize. Consumer and business optimism causes prices to rise at a faster pace.

Bond yields continue to rise. The rising inflation premium sends bond yields even higher.

Outlook. The economy is expanding too rapidly. The forces causing the economy to slow down are beginning to have their typical restraining effect.

a. The growth of the money supply has been declining for more than a year. The slowdown in liquidity continues as interest rates keep rising, discouraging investors and business to borrow.

b. The dollar declines, reflecting the concerns of foreign investors about the outlook of the US economy.

c. The yield curve flattens as short-term interest rates rise faster than bond yields.

Investment strategies

- High-grade bonds: These bonds are becoming attractive.
- Low-grade bonds: Low-grade bonds remain unattractive.
- Commodities: Commodities remain very strong. Hard assets in general continue to perform well, providing handsome profits for those investors who started buying them toward the end of Phase 1.
- The broad stock market: The stock market fails to make any progress, and stocks begin to show visible declines.
- Stock sectors: Commodity driven stocks remain very attractive.
What happens in Phase 3, Point 6

**The economy begins to slow down.** The ISM indexes, although above 50, decline. Following a protracted decline in liquidity and rising inflation and interest rates, the economy slows down to correct the excesses (rising inventories, commodities, inflation, and interest rates) created as it transitioned from Point 3 to Point 5. The larger these excesses, the more pronounced the slowdown is likely to be. This is an important strategic point of the business cycle.

**Commodities show little or no progress.** The decline in the growth of the economy has a dampening effect on the demand of commodities as business tries to reduce the growth in inventories to match the slowdown in sales. Business recognizes that inventories have been growing too rapidly relative to sales.

**Short-term interest rates rise at a much slower pace.** The reduced demand for working capital to finance employment, inventories, and raw materials causes short-term interest rates to stop rising. The Fed recognizes the economy is correcting and fails to raise the inter-bank rate.

**Inflation peaks.** The slowdown in commodity prices and weaker demand for goods (caused by higher inflation and reduced real income) is finally having its effect. Inflation stops rising and pauses.

**Bond yields peak.** Bond yields begin to trade in a broad range as the inflation premium stabilizes and demand for long-term capital declines due to the weaker pace of the economy.

**Outlook.** The economy is weakening. Some analysts begin to worry. The forces foretelling improving business conditions continue to head lower.

a. The growth of the money supply keeps heading lower. Liquidity cannot improve at the current level of interest rates and credit risk. They are still too high and investors and business maintain a conservative posture.

b. The dollar declines, reflecting the concerns of the international community.

c. The yield curve stops flattening as short-term and long-term interest trade in a range.

**Investment strategies**

- High-grade bonds: This is an important point of the business cycle. Investors should consider increasing their exposure to long-term bonds.
- Low-grade bonds: They remain unattractive.
- Commodities: Commodities fail to rise and begin to head lower. Investment in commodities and in hard assets should be reduced.
- The broad stock market: The stock market remains in a downtrend.
- Stock sectors: Investment in commodity driven stocks should be reduced and exposure to financial stocks should be increased slowly.
What happens in Phase 3, Point 7

The economy continues to slow down. The ISM indexes are close to 50. The economy is expanding at a pace close to its long-term average. Growth will continue to decline until there is unquestionable evidence that the excesses created in Phase 2 and Phase 3 are being brought under control.

Commodities decline. The much weaker economy causes commodities to decline in a visible way due to the on-going inventory correction.

Short-term interest rates peak. The greatly reduced demand for working capital to finance employment, inventories, and raw materials causes short-term interest rates to decline. The Fed, recognizing the economy is too weak and inflation is under control, allows the inter-bank rate to start declining.

Inflation begins to decline. Much reduced demand for goods and lower business costs cause inflation to decline.

Bond yields begin to decline. Bond yields decline as the inflation premium is reduced.

Outlook. The economy is weak. Some analysts are beginning to talk about the possibility of a recession. The forces foretelling business is likely to improve, however, are still heading lower and point to weak economic conditions ahead.

a. The growth of the money supply continues to decline. Interest rates and inflation are still too high to stimulate a renewed wave of borrowing and investing. Credit risk, although declining, is still too high.

b. The dollar continues to decline, reflecting the concerns of the international community due to still high cost structure for business and high inflation.

c. The yield curve begins to steepen.

Investment strategies

- High-grade bonds: Investors should become more aggressive in buying bonds.
- Low-grade bonds: These bonds remain unattractive.
- Commodities: Commodities continue to display widespread weakness.
- The broad stock market: The stock market is weak due to negative monetary conditions.
- Stock sectors: Commodity driven stocks begin to sputter. Financial stocks begin to outperform the market.
What happens in Phase 4, Point 8

The economy grows slowly. The ISM indexes fall below 50. The economy is in a growth recession as growth declines below its long-term average. Its slow pace, however, is now having some positive effects.

Commodities continue to decline. The decline in commodities is quite visible. Much lower commodity prices have a positive effect on profit by lowering the impact of raw material prices.

Short-term interest rates continue to decline. The greatly reduced demand for working capital to finance employment, inventories, and raw materials – caused by the weakening economy -- keeps downward pressure on short-term interest rates. The Fed continues to lower the inter-bank rate trying to stimulate the economy.

Inflation continues to decline. Lower commodities and interest rates accompanied by lower growth in wages reduce the rate of inflation. The weaker demand for goods due to the growth recession is also having a dampening effect on prices.

Bond yields continue to decline. Bond yields decline as the inflation premium shrinks.

Outlook. The economy is very weak. The causes of the economic slowdown (rising commodities, interest rates, wages, and overall inflation) are now declining. The cost structure of business begins to improve. It is time to become more optimistic. The forces that typically anticipate improved economic conditions become increasingly more visible. It will take more than 12 months for these forces to have a positive visible effect on the economy.

a. The growth of the money supply begins to rise. The decline in interest rates, inflation, and credit risk and the improved cost outlook for business encourage investors and companies to increase their borrowings. Liquidity begins to increase in the system, accompanied by a more conciliatory stance of the Fed.

b. The dollar begins to firm. The international community recognizes that economic imbalances are under control and begins to increase its investments, causing the dollar to improve.

c. The yield curve is steepening as interest rates fall faster than bond yields.

Investment strategies

- High-grade bonds: Investors should become more aggressive in buying bonds.
- Low-grade bonds: Low-grade bonds are now attractive.
- Commodities: Commodities remain weak.
- The broad stock market: The stock market bottoms, responding favorably to the increase in liquidity and much lower interest rates.
- Stock sectors: Investment in commodity driven stocks remains unattractive. Financial stocks and technology stocks outperform the broad market.