Chapter Six

STOCK SECTORS AND BUSINESS CYCLES

1. <u>Introduction</u>

The previous chapter introduced the concept of relative strength. Its main purpose is to identify sectors rising faster than the broad market. These sectors show a *rising* relative strength line. In a rising market, sectors with a relative strength line moving higher offer above average profit opportunities and the chance to outperform the market. In a rising market, sectors with a declining relative strength line should therefore be avoided.

In this chapter, investors gain an in depth understanding of the nature of a market move. Business and financial indicators are used to determine the type of environment or phase of the financial and business cycle. Depending on the configuration of indicators, some sectors perform well relative to others. As the configuration of indicators changes, and a new financial environment develops, new sectors emerge and become more attractive. Investing in a sector with above average strength cushions the portfolio from losses because most stocks are in a leading sector. As they say, a rising tide lifts all boats. In so doing the timing in the stock selection is important, but not crucial.

Investors are able to follow changes in market preference as reflected by changes in the relative strength line of each sector and know why this is happening. As the business and financial cycle moves from one configuration to the next (see Fig. 3.2), investors adapt their investment strategy by changing the allocation of their capital to the strongest sectors.

This is achieved by identifying how each configuration of business cycle indicators introduced in Part One is linked to the relative strength of each sector. Investors can invest with a high degree of confidence in those sectors likely to perform best within the economic and financial scenario they anticipate. These sectors offer the greatest profit opportunities with the lowest risk. Diversification, which is widely understood as investing also in under performing sectors, reduces the returns of the portfolio and increases its risk. Diversification is recommended only within the selected sectors. The approach of this book is to focus on a few sectors likely to out perform the market and then choose several stocks – diversify – within the selected sectors.

The analysis presented in this chapter is based on the following approach. First, one needs to identify the periods when a sector has a rising relative strength line. Then, for each of these periods, the main economic and financial indicators are used to explain the strength of that sector. The outcome of this step is to establish what kind of economic and financial environment is favorable to that particular sector. The objective of this chapter is not to determine whether the market is going to rise. This methodology has been extensively explored in the book *Profiting in*

Bull or Bear Markets and Part One of this book. The purpose here is to establish when and why some sectors are stronger than the market only in some phases of the business cycle.

The sectors used are those defined by Dow Jones (www.djindexes.com). They are also found on the site BigCharts.marketwatch.com/industry. These web sites show also the stocks used to compute the indexes. Because of lack of space, only representative sectors are discussed. Investors, however, can apply the same approach to all other sectors.

Investors should use predictable sectors. These sectors have a close correlation with a specific business and financial environment, as discussed below.

At the end of this chapter, investors are able to determine:

- *What to buy or sell*. It is possible to determine which sectors are attractive and which ones offer the greatest risk for the economic conditions being anticipated. The most reliable and readily available economic and financial indicators are reviewed for this purpose.

- *When to buy or sell*. As the business and financial indicators move from one configuration to the next, investors have now a blueprint of when they should start accumulating or selling stocks of a given sector.

- *Why should you buy or sell*. To know why to buy or sell is another important step of the investment process. The knowledge of the economic and financial fundamentals driving the prices of stocks within a sector provides reliability to the investment process and information on the risk involved.

In the following chapter, a methodology to select stocks within a sector is discussed in detail. Once a portfolio of stocks belonging to the strongest sectors has been established, it is important to examine how to use the performance of the portfolio to improve its return.

2. The indicators used to understand the investment environment

The following business and financial indicators are used in our analysis of stock sectors. They are the most reliable to identify the economic and financial environment favorable to a particular group.

- *Growth of the money supply.* An increasing change in the money supply is a measure of increasing liquidity in the banking system, which will eventually flow into the rest of the economy. A decline in the growth of the money supply suggests that liquidity is decreasing.

- *Yield curve.* A steep -- or steepening -- yield curve is an indication the Fed is committed to providing liquidity to the banking system by agreeing to lower the inter-bank rate (the fed funds rate). A flattening yield curve confirms that short-term interest rates are rising and liquidity in the system is decreasing.

- *The dollar.* A rising dollar is an indication international investors find it attractive to invest in the US. This is a positive trend for the markets. A declining dollar reflects problems in our economy making US investments unattractive. A declining dollar suggests that domestic and foreign investors prefer to invest their capital outside the USA.

- *Real short-term interest rates.* During periods of difficult economic times the Fed attempts to protect the banking system and the economy by forcing short-term interest rates well below the inflation rate (see also Chapter 6 of the book *Profiting in Bull or Bear Markets*). Higher inflation and much higher commodity prices have accompanied low real short-term interest rates below 1.4. High real short-term interest rates above 1.4 are disinflationary.

- *ISM's vendor performance index.* A rising vendor performance index above 50 indicates the economy is improving and is becoming stronger. A declining vendor performance index below 50 suggests the economy is rapidly weakening.

- *Short-term interest rates.* Declining short-term interest rates are associated with a rising stock market and lower risk. When short-term interest rates stabilize, following a protracted decline, they suggest the stock market is likely to continue to rise, but at a slower pace. Rising short-term interest rates identify periods of high risk for stocks.

- *Commodity indexes (CRB raw industrial index (spot) and futures).* Rising (declining) commodity prices confirm the economy is strengthening (weakening). An above average increase in commodity prices should be anticipated when real short-term interest rates fall below 1.4.

- *Inflation at the consumer and producer levels.* Inflation is closely related to trends in commodity prices. Higher inflation has a negative impact on consumers and business and drives bond yields higher. Declining inflation has a positive impact on purchasing power and the cost structure of business and drives bond yields lower.

- *Bond yields.* They follow closely the trend of inflation and commodities.

3. Phases of the business cycle and asset class strategies

Transitions in the growth of the economy have a major impact on the trends of asset classes. Prices rise or decline depending the direction of the growth of the economy. In Fig. 6.1 the idealized pattern of the growth of the economy is shown in a complete cycle.

Business Cycle

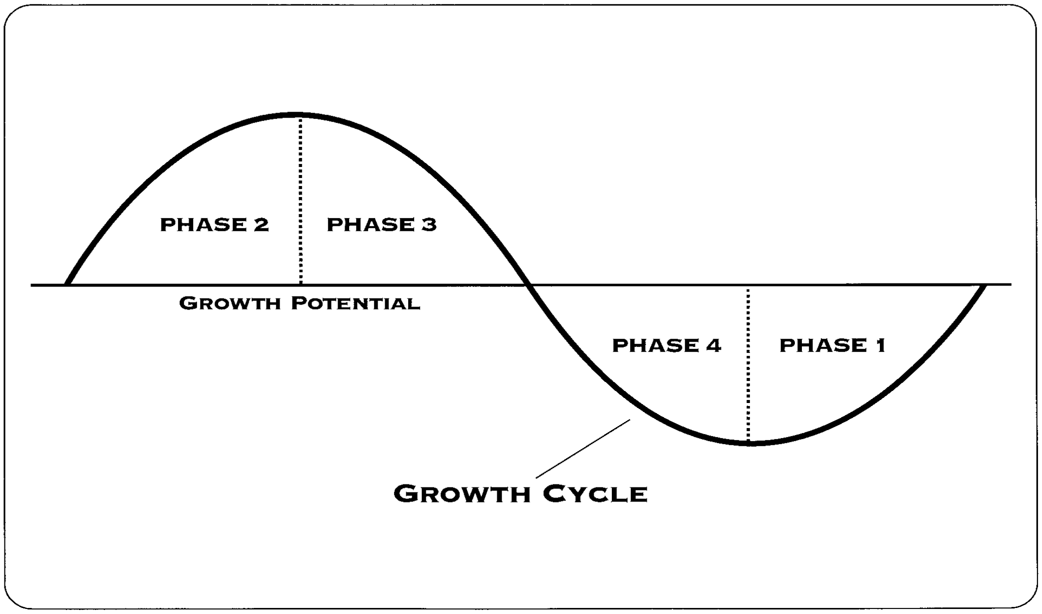

Fig. 6.1 The business cycle, as reflected by the growth pattern of the economy, goes through four distinctive phases. Prices of asset classes change depending on the phase of the business cycle. The growth potential for industrialized countries is between 2.5% and 3.0%. Using the ISM index as a proxy for the business cycle, 50 would be the level associated with the growth potential.

Business activity goes through four distinctive phases. Each phase is characterized by the following unique trends.

Phase 1.

- Business growth rises but remains below its growth potential.
- Money growth, stocks, and the dollar rise. The yield curve steepens.
- Inflation, commodities, bond yields, and short-term interest rates bottom after this phase is under way.

This phase reflects the end of the disinflationary period of the business cycle. The strength of the dollar and the increase in liquidity, accompanied by low and stable short-term interest rates, support a broad stock market rise.

Phase 2.

- Business growth rises above its long-term growth potential.

- Money growth, stocks, and the dollar peak before the end of this phase. The yield curve also begins to flatten after the peak in the growth of monetary aggregates.
- Inflation, commodities, bond yields, and short-term interest rates rise during the whole period.

The economy begins to overheat in this phase. Inflationary pressures rise. This is the time to watch closely the level of real short-term interest rates. If they are low as they were in the 1970s, 1992-1993, and after 2001, investors should expect a large movement in commodities and stronger than average inflationary pressures.

Investors should shift their emphasis to hard asset based stocks and asset classes, and away from interest rate sensitive investments.

Phase 3.

- Business growth declines, but remains above its long-term growth potential.
- The growth of the money supply continues to decline. Stocks and the dollar are also weak. The yield curve keeps flattening.
- Inflation, commodities, bond yields, and short-term interest rates continue to rise, but they peak before the end of this phase and begin to trade in a range as the economy continues to slow down.

This is a transition phase. Inflationary pressures begin this phase on the upside. By the end of phase 3 commodities, short-term interest rates, and bond yields begin to break from their trading range and start heading lower.

Investors' have to adjust their investment strategy and gradually shift away from inflation hedge asset classes and get ready for investments that will be more profitable once the business cycle enters phase 4.

Phase 4.

- Business growth declines and falls below trend.
- Money growth, stocks, and the dollar bottom and the yield curve begins to steepen before the end of this phase. The Fed lets the inter-bank rate fall and attempts to stimulate the growth rate of liquidity to cushion the banking system from further deteriorating economic conditions. This action sets the stage for the next pick up in business activity. This is the time when the business cycle enters Phase 1.
- Inflation, commodities, bond yields, and short-term interest rates continue to decline.

Some analysts suggest that the economy may enter into a recession. Investors must recognize that trends in the financial markets are the same as when the economy is in a recession or in a growth recession. In a recession the economy shrinks. In a growth recession, the economy grows below potential. This is the main reason why in this book market trends have been related to growth rates rather than levels of economic activity.

Investors’ investment strategy should now be more aggressive relative to the stock market.

Some basic patterns are evident.

- Turning points in the growth of the money supply, the dollar, and the yield curve tend to be clustered close to each other. They do not turn at exactly the same time, but the pattern of any one of them is confirmed after a few months by the other indicators. If investors see the growth of the money supply and the dollar declining, it is reasonable to assume that the next development to expect is a flattening of the yield curve. The change in the shape of the yield curve usually follows by several months the turning points of the growth of the money supply and of the dollar.

- Turning points in commodities, short-term interest rates, bond yields, and inflation tend to be grouped together. Changes in commodity prices tend to lead changes in inflation.

- Turning points in vendor performance follow the turning points of the growth of the money supply and precede turning points in commodities, short-term interest rates, bond yields, and inflation.

These relationships will be used to study the behavior of the most important sectors in the following sections.

3. Inflation-hedge stock sectors

These sectors are very important. The main reason is that inflation is not going to go away. Prices will always rise. It is only a matter of degree. Some business cycles experience sharp increases in inflation when the growth of the money supply goes well above the 7% historical average pace and real short-term interest rates are well below inflation.

These are the times when the Fed recognizes there are serious problems in the economic and financial system and they do whatever they can to protect the banking and financial system. Unfortunately, this policy inevitably causes sharply higher inflation, as it happened in the 1970s, or much higher commodity prices, as in 1992-1993 and after 2002.

The only way for investors to protect themselves against the loss of purchasing power is to hedge against higher inflation and the decline of the dollar. One way is to purchase foreign bonds in strong currency countries. ETFs are an excellent vehicle to implement this strategy.

Another way to hedge against a declining dollar and rising inflation is to buy stock sectors that perform much better than the broad stock market during such times. The stocks belonging to these sectors are those of companies mostly involved in the production, transportation, or distribution of commodities.

An investment strategy designed to protect your portfolio from rising inflation is typically implemented in Phase 2 and Phase 3 of the business cycle (see Fig. 6.1 above). Investors should gradually start investing in inflation-hedge stock sectors toward the end of Phase 1 and begin to reduce their exposure to inflation-hedge sectors toward the end of Phase 3. This strategy is particularly effective during times of low real interest rates.

Investors need to follow a very important guideline that will minimize the risk of making costly mistakes. Always invest in sectors with a rising relative strength line; it is the only way to have a chance of outperforming the market. Remember: rising water lifts all boats. It is very difficult, and very risky, to find a strong stock in a weak sector with a declining relative strength line. The odds of outperforming the market with this strategy are greatly reduced.

3. <u>The mining sector</u>

The mining sector has a pronounced cyclical behavior. The typical economic scenario favorable to this sector is a strengthening economy and rising commodities. This scenario takes place during Phase 2 and Phase 3 of the business cycle.

Investors should be careful with these stocks when the conditions are in place for an economic slowdown. It is important to remember that commodities peak after the business cycle is well into Phase 3 and the ISM indexes decline close to 50.

This sector performs unusually well in times of low real interest rates when the Fed is particularly and unusually aggressive in lowering short-term interest rates well below market rates and below the underlying inflation rate.

4. <u>The precious metals sector</u>

This sector performs very well when real interest rates are low. This situation took place in the 1970s, in 1992-1993, and after 2001. During these years, the precious metal stocks performed well and displayed rising relative strength, a sign suggesting that these stocks were outperforming the market.

This sector is particularly attractive, from a business cycle viewpoint, when the economy is growing and the ISM index is moving decisively toward the 50 level and commodities are rising in response to a stronger economy.

This sector is not attractive and shows poor performance in its relative strength line when the economy slows down, commodities decline, and interest rates rise above the inflation rate.

5. The pipelines sector

The profitability of pipeline companies is closely connected to the energy industry and the transportation of gas and crude oil. Like truck transportation, they make money if the commodity they transport rises in price. It is no coincidence, therefore, to experience a strong pipeline sector when commodities, and natural gas and crude oil in particular, are rising. This scenario is experienced when the ISM index rises strongly, preceded by a large infusion of liquidity by the Fed.

Exposure to this sector should be reduced when the economy begins to slow down, the ISM index declines, commodities begin to show some cyclical weakness, and the growth in the PPI index begins to decline. A weaker economy reduces the demand and the price of the fuels transported by the pipelines. For this reason this sector cannot be expected to perform well toward the end of Phase 3, Phase 4, and the beginning of Phase 1.

6. The oil companies (secondary) sector

This sector offers excellent opportunities to hedge against the loss of purchasing power during times of rising inflation and sharply higher commodity prices. This sector can also be used to hedge the portfolio against a weak dollar. The reason is that the dollar declines the most when commodities display unusual strength. These periods follow times of aggressive Fed easing reflected in unusually low real short-term interest rates and very steep yield curve.

The financial and economic scenario most favorable to this sector is one characterized by a strong economy reflected by rising ISM indexes moving above 50. The strength of the economy is also causing rising commodities and higher growth in the producer price index.

Exposure to this sector should be avoided when the economy slows down, commodities peak, and the growth in producer prices declines.

7. The marine transportation sector

The marine transportation sector is another excellent inflation hedge. As pipeline companies transport fuels through pipelines on the ground, marine transport companies transport goods, raw materials, and fuels using large ships. The outcome is that a major factor in their profitability, and therefore in the action of the stock, depends on the trend of commodities and inflation.

The economic and financial environment favorable to this sector is one characterized by a strengthening economy followed by rising commodities and much higher growth in producer prices. Like all other inflation hedge sectors, the marine transportation sector is particularly attractive in Phase 2 and well into Phase 3. These stocks are especially strong when the Fed forces short-term interest rates below the inflation rate.

Exposure to this sector should be reduced when the economy begins to slow down, followed by weaker commodity prices and lower growth in producer prices.

8. Stock sectors thriving in disinflationary times

The following sectors perform and out perform the market when inflation declines. Periods of lower inflation are anticipated by many developments and are easy to recognize.

Lower inflation is the outcome of slower economic growth. Some analysts do not agree with this statement. It is a statistical fact, however, that turning points in the growth of business activity are followed by turning points in inflation after one to two years.

A period of declining inflation is first anticipated by a flattening yield curve and slow growth in monetary aggregates. During such times, a weak dollar and an anemic stock market become part of the financial landscape.

After one to two years, the economy responds and begins to slow down. This is the beginning of the disinflationary times. Commodities stop rising after a lag of a few months. Then inflationary news becomes more benign. Bond yields stabilize and decline. These events take place toward the end of Phase 3, in Phase 4, and in Phase 1 of the business cycle. The disinflationary process becomes more prominent when real short-term interest rates are above 1.4.

9. The money center banks sector

The financial sector is one of the most predictable sectors. The relationship with the business cycle is simple and straightforward. This sector outperforms the market when short-term interest rates decline and the yield curve steepens. The decline in short-term interest rates can be compared to the decline in raw material prices for a manufacturing company.

The decline in commodities lowers production costs and improves the profitability for the companies. The same relationship applies between the decline in short-term interest rates and banks profitability. Short-term interest rates represent the raw material of banks. They "buy" money from consumers and pay a price – short-term interest rates – and "re-sell" it to borrowers by charging long-term interest rates, which are much higher than short-term interest rates most of the time. This is the main reason bank stocks do well when short-term interest rates decline and the yield curve steepens.

Investors recognize that the economic and financial environment most favorable to this sector is toward the end of Phase 3, Phase 4, and the initial part of Phase 1.

This sector under-performs the market when short-term interest rates rise because this trend reduces the profitability of the banking sector. The flattening of the yield curve is also a negative development for banks. As a result, Phase 2 and Phase 3 reflect an economic and financial environment unfavorable for this sector.

10. The Savings & Loan/Thrift sectors

This is an excellent sector to be used as an investment vehicle. Since 1992, it has outperformed the Nasdaq by a wide margin and with much less volatility. As the Nasdaq was collapsing more than 70%, the S&L sector kept rising steadily from 2000 to 2002.

The S&L sector is particularly attractive because of its low volatility, especially during a rising market. This sector tends to outperform the market when business begins to slow down. A good entry point is toward the middle of Phase 3. Stocks in this sector are strong during the slow growth phase of the business cycle (Phase 4) and the improving phase (Phase 1). In other words, this sector is attractive when the economy does not perform well.

Exposure to the stocks in this sector should be reduce hwhen business activity begins to grow at an above average rate. This takes place in Phase 2 and during most of Phase 3.

11. The cosmetics sector

This sector is attractive because of its defensive features. There are two major trends impacting these stocks. Let's review first the long-term developments that impact favorably this group.

There are two main measures of inflation. The most important one is, of course, the change in consumer prices. These are the prices charged by producers to consumers. The other important measure of inflation is the change in producer prices -- prices producers charge each other. If producer prices rise faster than consumer prices, producers have a big problem. The reason is that they cannot pass to the consumer the increase in prices they experience. The most favorable period for producers is when consumer prices rise faster than producer prices. During such times, producers' margins improve because they can increase prices faster than the increase in the price of goods they have to buy.

Why is this important? This sector is particularly sensitive to how consumer prices grow relative to the growth in producer prices. The cosmetics sector is particularly favorable, performing better than the broad stock market averages when the growth in producer prices declines relative to consumer prices. In other words, this sector is strong when producers of cosmetics have pricing power at the consumer level. This sector performs poorly relative to the overall stock market when producer prices are rising faster than consumer prices.

Another factor impacting this sector is the behavior of the yield curve. This sector is stronger than the market when the yield curve steepens, as short-term interest rates decline relative to long-term bond yields. When the yield curve flattens, however, as short-term rates rise faster than bond yields, this sector under performs the market.

12. <u>The household products (non-durables) sector</u>

This sector does not show the long-term performance that makes it particularly attractive. Since 1992, this sector outperformed the market only during two distinct periods: 1994-1997 and 2000-2002. There have been shorter instances when this sector was strong.

Two conditions are present when non-durable stocks are strong. The first one is that short-term interest rates are declining. The second feature, closely related to the first one, is that the yield curve is steepening. For these conditions to be present, the economy must be weakening with stable or declining commodities (although this condition does not necessarily have to be met).

This sector is unattractive when interest rates rise, the Fed is tightening, and the yield curve is flattening. It is quite common to see commodities strengthening during these times.

13. <u>The electric utilities sector</u>

This sector has two distinct patterns: the long-term and short-term price behavior. Over the long-term, the electric utilities sector has under performed the market from 1993 to 2000. These years were characterized by high real interest rates and a strong dollar. These years were disinflationary years, as inflation declined and commodities showed little volatility. Real interest rates hovered well above 1.4 in this period. Before and after these years, this sector has shown periods of above average performance.

There is no doubt, however, that these stocks fit well in a defensive investment strategy. The reason is that they strengthen when the yield curve begins to flatten. These are times when the Fed is concerned about inflationary pressures and lets interest rates rise. The economy is quite strong during such times.

The electric utilities sector performs poorly when the rest of the market tends to be quite strong. This sector should be avoided when the yield curve steepens, a sign the Fed is trying to stimulate the economy by letting interest rates fall.

14. The technology sector

This is a very difficult sector to predict because of the considerable speculation and volatility of these stocks. The index soared until 2000 and sank to the bottom in 2002 with a loss of 70% in the Dow Jones Technology index. Investors need to be superb market timers to avoid the financial pain these stocks may cause when they decline. Investing in volatile stocks is not a recommended strategy because of the difficulty in managing the performance of the portfolio and timing when to buy or when to sell.

Aggressive investors can improve the appreciation of their capital by adding technology stocks to their portfolio because they tend to follow closely the trend of the overall market. This is a tricky strategy and only the most sophisticated investors should follow it. If investors expect the stock market to decline, then they should readily reduce the exposure to technology stocks.

This sector tends to be sensitive to economic growth. It outperforms the market when the economy is projected to grow at a strong pace for a prolonged time. Because of its volatility, this sector should be used as an investment vehicle when one expects a strong stock market.

15. High-grade and low-grade bonds

This chapter is not complete without mentioning the bond market. Bonds are an important asset class from the middle of Phase 3 to the end of Phase 1. They are an attractive and convenient asset class to use as investment during disinflationary times. The correlation with the slower growth phases of the business cycle is high enough to produce attractive returns during such times. A more complete discussion on how to select bonds and manage a bond portfolio is found in Chapter 9 of *Profiting in Bull or Bear Markets*.

There are times when bonds offer superb investment opportunities as in the 1982-2002 years. Of course, these are chances of a life time and do not repeat themselves often. There are three main bond categories: high-grade bonds, high-yield corporate bonds (low-grade or "junk" bonds), and Treasury inflation-indexed bonds.

✓ *High-grade bond yields*. Bond yields decline (bond prices rise) when commodities (futures and spot) decline or inflation at the consumer and producer level moves lower. These are times when the economy is slowing down and inflationary pressures subside. This typically happens following the beginning of Phase 3 until the end of Phase 1.

✓ *Low-grade bond yields*. These bonds are one of the most profitable asset classes on a risk-adjusted basis. The main reason, as discussed in several research papers, is that the market prices a risk premium into the yields of these bonds above their average default rate. In other words, investors are so concerned about the viability of the companies issuing these bonds that they require a yield well above the market risk. It is this mis-pricing that makes the total return from this asset class particularly attractive.

The price of these bonds parallels closely the trend of the equity market. The main difference is that they offer a very attractive yield. This is why these bonds represent value and protection on the downside. Their attractiveness is due to their high yield and capital appreciation when the stock market rises, and protection from capital losses due to the high yield.

The simple investment model is to invest in these bonds when long-term interest rates on Treasury bonds are declining or are stable (see also previous section).

Investors should choose mutual funds investing in high-yield bonds. A word of caution is necessary at this point. Investors should select high-yield mutual funds not, repeat not, based on performance. The high performance high-yield funds are very volatile. Investors should look at the long-term performance, which is easily available on the Internet. Look at the number of years showing a positive return and the number of years showing a negative return. Investors should prefer those mutual funds with the lowest number of years showing losses. These are the mutual funds with the best disciplined team experienced in the management of high-yield bond portfolios.

✓ *Treasury Inflation-Indexed Securities*, often called Treasury Inflation-Protected Securities or TIPS, are a special type of Treasury notes and bonds. As with other notes and bonds, when investors own TIPS investors receive interest payments every six months and a payment of principal when the security matures. The difference is this: Interest and redemption payments for TIPS are tied to inflation.

Based on the Consumer Price Index, the leading measurement of inflation for this type of bonds, the principal value of investors’ TIPS is adjusted by the rate of inflation. At maturity the security is redeemed at its inflation-adjusted principal amount or its original par value, whichever is greater. In all likelihood, inflation will occur over the life of the security and the payment to investors at redemption will be greater than the original par value of the security. For the unlikely event of deflation, the final payment cannot be less than the original par value.

Like other notes and bonds, TIPS pay a fixed rate of interest. But this fixed rate of interest is applied not to the par amount of the security, but to the inflation-adjusted principal. So, if inflation occurs throughout the life of investors, every interest payment will be greater than the previous one. On the other hand, in the rather unusual event of deflation, your interest payments will decrease.

TIPS can be purchased directly through the Internet from the US Treasury (Public Debt). These bonds should be in any portfolio as a long-term protection against inflation and should be used as a long-term investment.

16. <u>The broad stock market</u>

The stock market, like all the leading indicators, can best be predicted using lagging indicators such as short-term interest rates, commodities, and inflation. For this reason declining or stable short-term interest rates are an important development because they identify a favorable period for the broad stock market.

The broad stock market can be best understood if investors look also at the advance-decline line. When the advance-decline line rises, the majority of the issues listed, say, on the NYSE are rising. This pattern tells investors that there is an increasing number of investment opportunities.

When the advance-decline line flattens and declines, it reflects weakness in the market. An increasing number of declining stocks is the reason for the poor performance of the advance-decline line. Investment opportunities become more difficult to find during such times.

The market averages can be heavily influenced by specific groups and often tend to obscure the view of what is really happening. The typical example is what took place in 2000-2002 when the technology sector imploded. The averages collapsed because they were bloated with overvalued technology stocks. The advance-decline line, however, after a short period of weakness, resumed its upward trend while the averages sagged. In other words, the advance-decline line was telling investors that the majority of stocks was rising and there were profits to be made in spite of declining market averages.

Of course, there is no single measure that can tell investors what is really happening. Investors should follow many averages and many indicators of market strength. The advance-decline line, however, is an important gauge.

The easiest way to predict the trend of the stock market is to relate its pattern to the trend of short-term interest rates. Depending on the trend of short-term interest rates, investors can identify the phase of the stock market within the business cycle and its level of risk.

There are three main stock market phases.

✓ <u>*Short-term interest rates decline*</u>. The market moves strongly higher following a peak in short-term interest rates. Investment risk declines rapidly as short-term interest rates decline due to weak economic conditions. The stock market averages and the advance-decline line rise rapidly.

✓ *Short-term interest rates stabilize*. The economy is now improving, but is still growing slowly. Short-term interest rates cease to decline to reflect improving business conditions. Investment risk is still low, but is now gradually rising and will continue to move higher. The stock market and the advance-decline line are still heading higher, but at a slower pace.

✓ *Short-term interest rates rise*. The economy is now expanding rapidly. Commodities are strong. Short-term interest rates are rising. They will decline only when the economy slows down to a crawl. This period of rising short-term interest rates is the most crucial one for investors. Risk is very high and a defensive investment strategy is a must. It is difficult to make money during this phase and investors should emphasize capital preservation and those sectors that benefit from rising commodities and rising inflation.

17. Conclusions

The main objective of portfolio management is to be invested in those stock sectors that are, or are likely to become, the strongest sectors. This chapter has provided the main elements on how to approach the issue of finding the greatest opportunities. Investment success depends on focusing on sectors that are predictable using business cycle indicators. Investors should avoid those groups that are volatile and difficult to relate to the business cycle. It is inherently risky to invest in sectors that do not follow predictable patterns because of the low probability of success in planning buy and sell decisions.

If the market is likely to rise, this is the time to examine the indicators and sectors presented in this chapter and establish which ones are going to outperform the broad market averages. We have presented only a few sectors. The objective was to discuss a methodology.

If investors want to outperform the market, they need to be in sectors that are likely to perform best under expected economic conditions. It is important to recognize:

a. The current phase of the business cycle: Phase 1, Phase 2, Phase 3, or Phase 4.
b. The indicators supporting the assessment. These indicators should also be used to monitor the behavior of the business cycle.
c. What is the next phase of the business cycle?
d. Select the sector or sectors that perform well in the current phase.
e. A strategy based on stock sectors should be planned to make the transition from the current phase to the next one.

The investment strategy should be based on the diversification of the investors' capital only in those sectors favorably impacted by the current phase of the business cycle. Furthermore, by using the stock selection methodology presented in the next chapter, investors are able to build a portfolio of companies with a business model, which will make them strong market performers during the phase of the business cycle being anticipated.

The important message of this chapter is that two main concepts have to be kept in mind at all times:

1. Always invest in stocks within a sector with a rising relative strength line.

2. Be very focused on how and why the business cycle makes the transition from the current phase to the next.