Part Three

STOCK SECTORS AND BUSINESS CYCLES (1997-2001)

A CASE STUDY

Introduction

In Part Three investors will review the practical strategic and investment choices faced during the going from 1997 to 2001 using the approach presented in the previous chapters. The analysis focuses on the behavior of the indicators presented in this book. Political and special events such as the fall of the Asian tigers in 1997-1998, the following Latin America's crises. Russia's bond default, Y2K, and 9/11 are not mentioned.

This is done on purpose. The main objective is show that the data tell the whole story. Investors can benefit greatly by gaining objectivity in the careful understanding of the relationships between economic and financial variables.

The author recognizes this is a bold statement. It reflects the firm belief that economic and financial history is best interpreted by few trends of carefully selected indicators. The markets determine prices, and prices drive consumer and business behavior. The Fed or the political party in power can distort the performance of the market over short period. Eventually the markets take over and change in the price of assets corrects the distortion.

For instance, it is quite typical for the Fed to force short-term interest rates well below the level of inflation. This has happened in the 1970s (a period of war and aggressive expansion of social programs), in 1992-1993 (real estate and S&L crises), and after 2001 (implosion of the a financial bubble). Low real interest rates, however, caused sharply higher commodity prices and short-term interest rates, creating investment opportunities. The point is that focusing on the data, investors can formulate profitable strategies, rather than wondering about the implications of political and economic events.

The objective of this analysis from the investor's viewpoint is to predict the direction of the variables driving the various sectors. It is possible then to formulate a strategy based on the selection of the strongest sectors and in avoiding the weakest ones.

Data used

- Leading indicators
  Growth in the money supply
  Dollar
  Yield curve
  Percent change in bond yields (inverted)

- Coincident indicators
  ISM index (total and vendor performance)

- Lagging indicators
  Short-term and long-term interest rates
  Commodities
  Inflation

- Other indicators
  Bond yield spreads between BAA and Treasury bonds
  Real short-term interest rates