INVESTMENT STRATEGY, STOCK SECTORS, AND PHASES OF THE BUSINESS CYCLE

Fig. 1 shows the behavior of the business cycle since 2000. The business cycle goes through 4 phases.

- **<u>Phase 1</u>**. The economy slows down below its long-term trend (below the 50 level in Fig. 1). During these times, investors can expect inflation, bond yields, short-term interest rates, and commodities to decline. The bear market bottoms and stocks start a new bull market.

- **<u>Phase 2</u>**. The economy strengthens from a period of slow growth. Its pace is still slow (below the 50 level). During these times, investors can expect inflation, bond yields, short-term interest rates, and commodities to stop declining. The stock market is still strong, but its appreciation takes place at a much slower pace than in Phase 1.

- **<u>Phase 3</u>**. The economy is strong and growing at well above potential. During these times, investors can expect inflation, bond yields, short-term interest rates, and commodities to start rising. The stock market is now growing at a slow pace and reaches a top toward the end of this phase.

- **<u>Phase 4</u>**. The economy reaches the top in its growth rate and begins to slow down under the pressure (negative feedback) of rising interest rates, inflation, and overall business costs. During these times, investors can expect inflation, bond yields, and commodities to lose considerable momentum and eventually peak. Short-term interest rates usually peak toward the end of Phase 4. The stock market is now struggling with the majority of stocks making no progress. The advance-decline line declines.

Our research shows investors need to change investment strategies when the business cycle moves through the various phases. Each phase presents investment opportunities and risks. Specific strategies need to be implemented to take advantage of what is happening.

The most recent data suggest the business cycle is transitioning into Phase 4. Our stock sector selection and choice of stocks as shown in our managed portfolio reflect our belief that the business cycle has entered Phase 4. The stocks we are recommending have typically performed well under current circumstances.

Our strategy concentrates on the strongest sectors and the strongest stocks within these sectors. We have eliminated or reduced our investment in the poorly performing stocks (e.g. banks and S&L) and added to the best performing ones (REITS and other high yielding stocks).

Marine transportation, advanced medical supplies, oil and gas (secondary), and gas utilities are the best performing groups on a relative strength basis. We are concentrating on the best companies of these sectors providing the highest yields. Their performance suggests the markets agree with us.

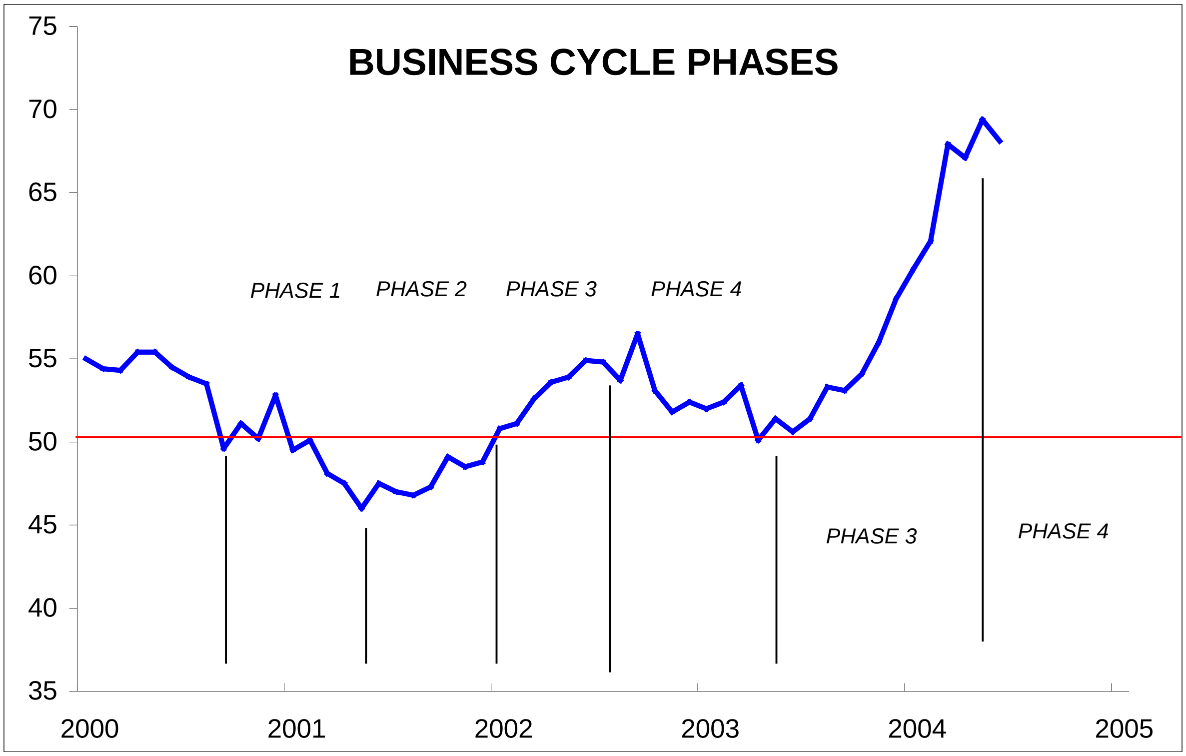

Fig. 1. This is a very important graph because it depicts the behavior of the business cycle since 2000. As the economy moves through the various phases shown in this chart, investors need to change their investment strategy to take advantage of new emerging opportunities driven by the directional changes of inflation, interest rates, and commodities.

Note how in 2003 the business cycle slowed down, but it did not go below 50, reflecting a relatively strong economy. Phases 1 and 2, therefore, were by-passed and the cycle moved right into Phase 3.

The current behavior of the economy suggests that the business cycle is now entering Phase 4, a period of more subdued growth. We have been changing our investment strategy accordingly.

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