

SPECIAL REPORT

April 3, 2010

Telling You What Wall Street Doesn't Want You To Know

STRETTALKADVISORS

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Riding The Waves

Economic & Business Cycles

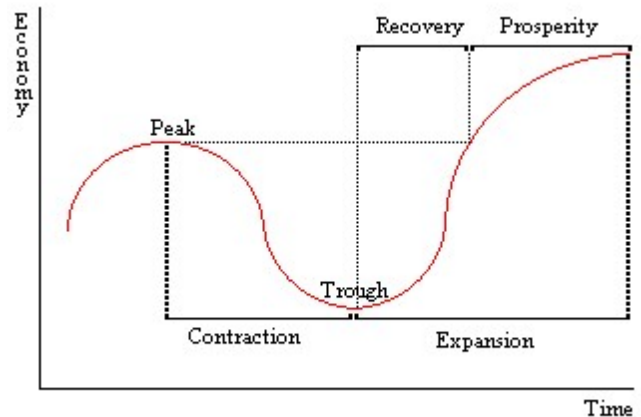
Understanding where we are in the current Economic or Business cycle is critical in knowing not only “When” to invest in stocks but “Where” to invest. Since, rising and falling interest rates, inflation, consumer spending, corporate profits and investor psychology directly relate to the value placed on individual companies – understanding how individual company’s respond to these variables is important in the management of investment risk.

The question that investors must try to answer is, ‘Where are we in this particular business cycle?’

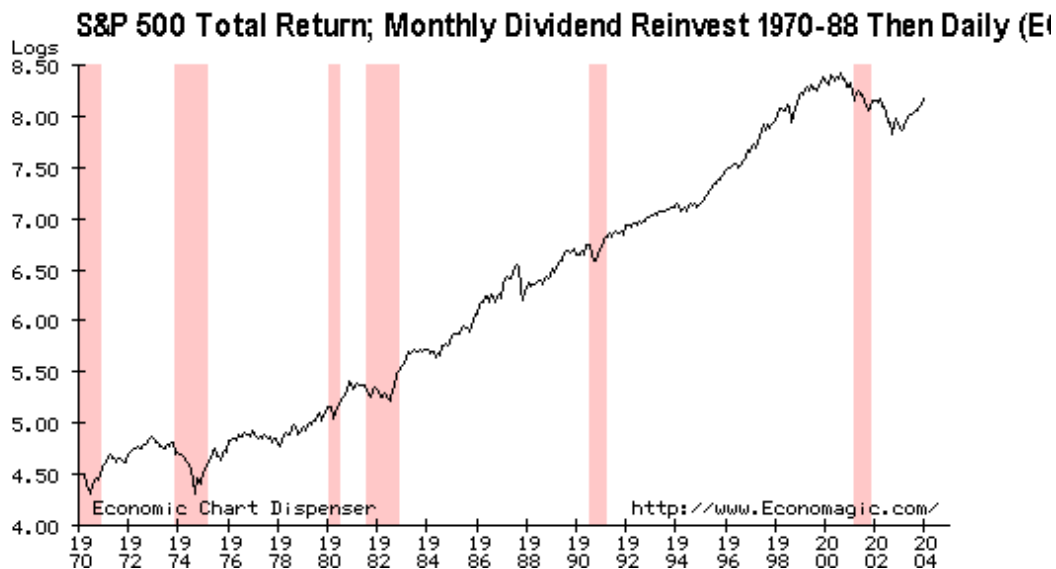
What Is A Business Or Economic Cycle?

The **business cycle** or **economic cycle** refers to the somewhat simultaneous ups and downs in most parts of an economy. They tend to repeat at fairly regular time intervals.

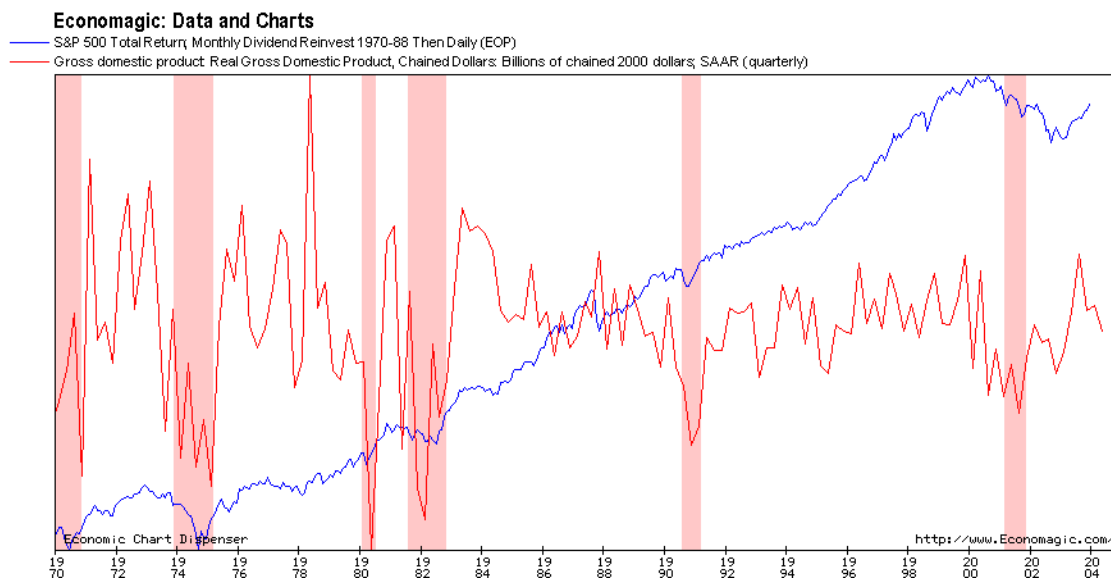
The cycle involves shifts over time between periods of relatively rapid growth of output (recovery and prosperity), alternating with periods of relative stagnation or decline (contraction or recession). These fluctuations are often measured using the gross domestic product. Most observers find that the lengths of cycles (from peak to peak, or from trough to trough) vary, so that cycles are not mechanical in their regularity.



Since no two cycles are alike in their details, some economists dispute the existence of cycles and use the word "fluctuations" (or similar) instead. Others see enough similarities between cycles that the cycle is a valid basis of studying the state of the economy. A key question is whether or not there are similar *mechanisms* that generate recessions and/or booms that exist in capitalist economies so that the dynamics that appear as a cycle will be seen again and again.



As you can see in the chart above the markets experience a recession or “economic contraction” on average about every 6 years or so (34 years divided by 6 recessions). As you will also notice by looking at the chart more closely is that stock market returns tend to fair the worst during these periods as more clearly shown in the chart below.



The main types of business cycles enumerated by Joseph Schumpeter and others in this field have been named after their discoverers or proposers:

1. The Kitchin inventory cycle (3-5 years) -- after Joseph Kitchin.
2. The Juglar fixed investment cycle (7-11 years) -- after Clement Juglar.
3. The Kuznets infrastructural investment cycle (15-25 years) -- after Simon Kuznets, Nobel Laureate.
4. The Kondratieff wave or cycle (45-60 years) -- after Nikolai Kondratieff.

In the Juglar cycle, which is sometimes called “*the*” business cycle” is the main focus of this article as it is most clearly the type of economic and business cycle that we are most familiar with.

It is the recovery and prosperity periods which are associated with increases in productivity, consumer confidence, and aggregate demand and it is these “growth periods” which usually end with the failure of speculative investments built

on a bubble of confidence that bursts or deflates.

In these cycles, the periods of contraction and stagnation, which follow recovery and prosperity, reflect the purging of unsuccessful enterprises as resources are transferred by market forces from less productive uses to more productive uses. It is during these periods of contraction and stagnation that investors and consumers retrench, reduce spending, reduce investment, and increase savings thereby creating “pent-up” demand for goods and services. The stock market is generally feared during these times and money is diverted into “safe” vehicles such as money market and savings accounts.

Because the periods of stagnation are painful for many who lose their jobs, pressure arises for politicians to try to smooth out the oscillations. An important goal of all Western nations since the Great Depression has been to limit the dips, and until 2001 or so, a comparable period of economic malaise was avoided. Government intervention in the economy can be risky, however.

No-one argues that managing the money supply and fiscal policy to even out the cycle is an easy job in a society with a complex economy, even when Keynesian theory is applied. According to some theorists, notably nineteenth-century advocates of communism, this difficulty is insurmountable. Karl Marx in particular claimed that the recurrent business cycle crises of capitalism were inevitable results of the system's operations. In this view, all that the government can do is to change the *timing* of economic crises. The crisis could also show up in a different *form*, for example as severe inflation or a steadily increasing government deficit. Worse, by delaying a crisis, government policy is seen as making it *more dramatic*.

The business cycle is an inevitable fact of capitalist economies. The government and/or the central bank begin to interfere with the free markets, which causes recessions as an unintended consequence, by manipulating short term interest rates. This in turn leads to corporations setting investment decisions based on the price on investment capital.

Governmental control of money supply through central banks means that interest rates are artificially set and therefore the price of investment capital does not reflect the real demand for it. This means that capital is misallocated and the business cycle is a periodic *correction* of this misallocation. Therefore, the real problem is not the efficiency of capitalism, but a government-controlled money supply and/or interest rates. Whatever the validity of this theory, the U.S. Federal Reserve seems to have encouraged most of the recessions in the United States between World War II and the year 2000 by raising interest rates.

How Do Economists Keep Track Of The Business Cycle?

For many years, economists have tried to understand why there are ups and downs in that nation's economy. They want to learn what can be done to prevent recessions and maintain prosperity. Therefore, they ask the following questions: (1) In what phase of the business cycle is our economy at the present time? (2) Where is the business cycle heading?

To date, economists believe that there are five causes of the business cycle.

The first cause is changes in capital expenditures. When the economy is strong, businesses have expectations of sales growth; they invest heavily in capital goods. After a while, businesses may decide that they have expanded to their limit,

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so they begin to pull back on their capital investments and cause an eventual recession.

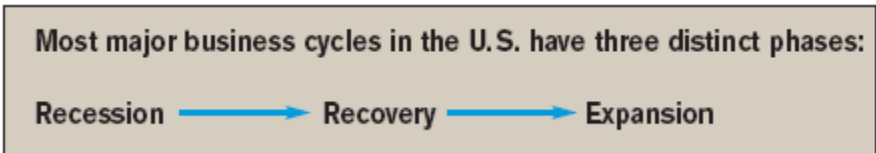
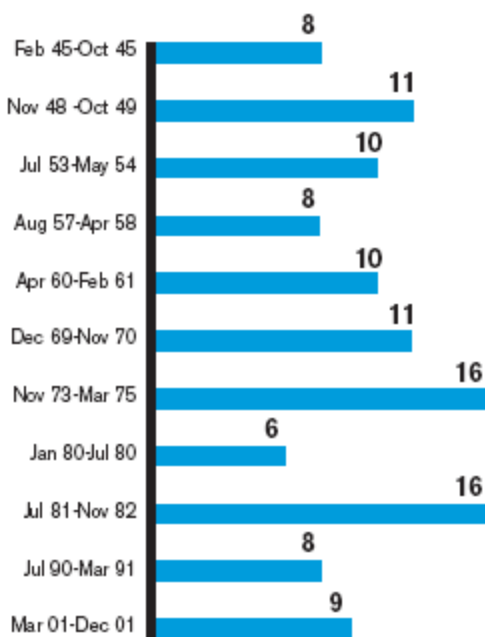
The second cause of the business cycle is inventory adjustments. At the first sign of an economy reaching its peak, there are some businesses that cut back their inventories and then build them back up again at the first sign of a trough. Either action causes the real GDP to fluctuate. Innovation and imitation are the third causes of the business cycle. Innovations include new products, new inventions, or a new way of performing a task. When a business innovates, it often gains an edge on its competitors because its costs decrease or its sales increase. Whatever the case, profits increase and the business grows. If other business in the same industry want to keep up, they then copy what the innovator has done (imitation) or they come up with something better. Imitation companies usually invest heavily and an investment boom follows. Once the innovation spreads to another industry, the situation changes. Further investments are unnecessary and economic activity may slow.

The fourth cause of the business cycle are the credit and loan policies of commercial banking. When "easy money" policies are in effect, interest rates are low and loans are easy to get. They encourage the private sector to borrow and invest, thus stimulating the economy. Eventually the increased demand for loans causes the interest rates to rise, which discourage new borrowers. As borrowing and spending slow down, the level of economic activity declines. The economy keeps declining until interest rates fall and the business cycle begins over again.

The fifth and final cause of the business cycle if external shocks. Shocks such as increases in oil prices, wars, and international conflict, have the potential to either drive the economy up, or drive it down. The economy may benefit when a new supply of natural resources is discovered. Such was the case with Great Britain in the 1970's when an oil field was discovered off its coast in the North Sea. The British economy of course profited seeing that world oil prices were at an all time high, but the high prices hurt the United States at the same time.

The Anatomy of a Business Cycle

As stated earlier the economy experiences periods of recurrent expansion and contraction; the pattern of recession, recovery and expansion is called the business cycle. It's a tried-and-true saying that a bust follows every boom. However, trying to figure out when that boom, or expansion, will end and the bust, or contraction, will begin can make economics and investing very complex



Phase I: Recession

A recession is typically defined as an overall slowing of economic activity. Since there are many measures of economic activity, as well as what constitutes a "slowing," there can be many definitions of what constitutes a recession. One common and often cited definition of the beginning of a recession is two consecutive quarters of decline in real Gross Domestic

Product (GDP).

The National Bureau of Economic Research, a non-profit organization that assigns dates to the beginning and end of downturns, defines a recession as "*a period of declining output and employment.*" Because the government's GDP numbers are released three months after the end of the quarter and subject to revisions, a recession is typically underway for several months before it's officially announced.

For example, the recession of 2001 began in March, but wasn't officially announced until nine months later.

Recessions feed on themselves. During a recession, business people spend less than they once did. Because sales are failing, businesses do what they can to reduce their spending. They lay off workers, buy less merchandise, and postpone plans to expand. When this happens, business suppliers do what they can to protect themselves. They too lay off workers and reduce spending. As workers earn less, they spend less, and business income and profits decline still more. Businesses spend even less than before and lay off still more workers. The economy continues to slide.

The chart above lists all of the recessions since the end of World War II and the number of months that each lasted. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough. Between trough and peak, the economy is in an expansion. Expansion is the normal state of the economy; most recessions are brief, lasting an average of 11 months, and they have been rare in recent decades.

Early Warning Signs of a Recession

Decline in the Institute for Supply Management Index (ISM):

A national survey of purchasing managers and suppliers. When this index falls below 50, the manufacturing sector is contracting.

Decline in the Leading Economic Indicators:

A composite index of ten economic indicators designed to predict economic activity six to nine months in the future. Examples of these indicators are initial jobless claims, building permits, level of the S&P 500, manufacturers' orders for goods and materials, and the interest rate spread between the 10-year Treasury note and the federal funds rate.

Falling Interest Rates:

When the economy slows, the Federal Reserve tries to jump start it by reducing short-term interest rates, which makes it cheaper for businesses to borrow and expand.

Corporate Earnings Fall and Stocks Decline:

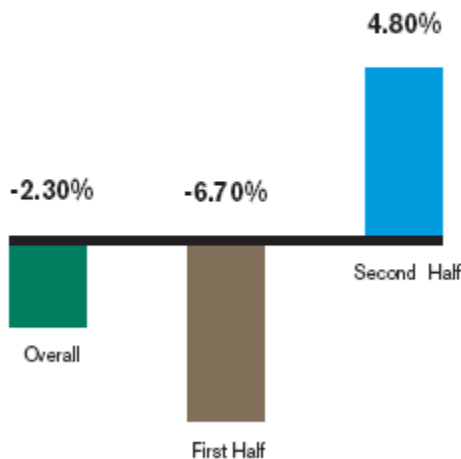
In the early stages of a recession, companies often report a fall in earnings, and consequently, many stocks tumble as well.

Once a recession has set in, the mood of the nation typically changes from positive and perhaps euphoric (evident during the bull market in 1999) to a more somber mood as the recession took hold during the 2000-2002 bear market.

The best indicator of this shift in attitudes is the consumer confidence survey, which measures representative households' attitudes toward issues such as current business conditions, employment and family income. Once this indicator starts to show weakness it is prudent to pay attention as the consumer is the backbone to both the economy and ultimately the stock market.



Relative Performance of Small Caps vs. Large Caps During Recessions



Where to Invest during a Recession?

A recession is not a cause to change or stop an overall investment strategy, particularly one that includes some level of risk management or active asset allocation. However, one strategy for investing during a recession is to think about recession resistant companies with stable growth prospects. Think about the essentials that people need, regardless of the economy, such as pharmaceuticals and food stocks.

The business cycle also seems to favor large company stocks instead of small company stocks during the first half of a recession. Small company stocks seem to be more economically sensitive and react more dramatically in the early stages of a recession.

Phase II: Recovery

As the recession comes to an end business begins to improve a bit, firms will hire a few more workers and increase their orders of materials from their suppliers.

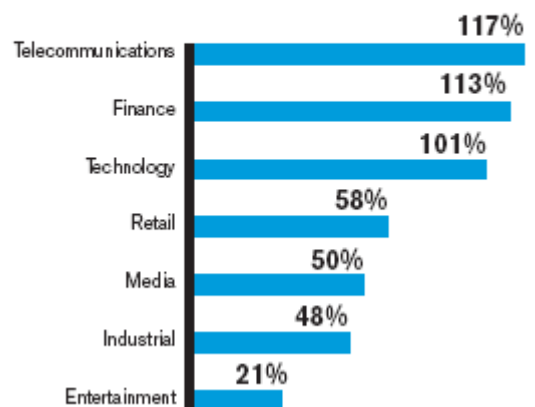
Increased orders lead other firms to increase production and rehire workers. More employment leads to more consumer spending, further business activity, and still more jobs. Economists describe this upturn in the business cycle as a period of expansion and recovery.

The first sign that a recession may be ending shows with the stock market anticipating a recovery. The stock market, a forward-looking indicator, has almost always started to rally well before previous recessions ended.

In 11 recessionary periods since 1948, the S&P 500 reached its trough and began trending upward an average of 5.4 months before the recession ended. The average return of the S&P 500 during those periods before the recession ended was 25.5%.

The stocks that tend to move first coming out of a recession are cyclical stocks like autos, electronics and technology products consumers tend to put off buying during a recession. Just as cyclicals are the first to move right before and after a recession, so do small

Best Performing Sectors Out of Last Five Recessions Since 1964

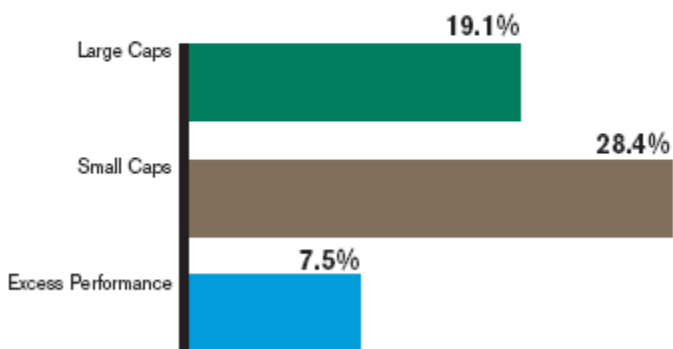


company stocks as the economy recovers from the initial shock of the recession. Smaller, more nimble companies can take advantage of the recovery more quickly. Small companies also tend to be big borrowers and can take more advantage of falling interest rates.

Phase III: Expansion & Peak

As the economy and stock market recover, consumers become more confident. Wages rise, manufacturing increases, and the Fed stops reducing rates since the economy no longer needs to be stimulated. At the top, or peak, of the business cycle, business expansion ends its upward climb. Employment, consumer spending, and production hit their highest levels. A peak, like a depression, can last for a short or long period of time. When the peak lasts for a long time, we are in a period of prosperity.

Relative Performance of Small Caps vs. Large Caps 12 Months After Recessions



One of the dangers of peak periods is that of inflation. During periods of inflation, prices rise and the value of money declines. Inflation is more of a threat during peak periods because employment and earnings are at high levels. With more money in their pockets, people are willing to spend more than before. In this way, demand is increased and prices rise.

The End Leads To The Beginning

Like life itself - where one cycle finds its end so does another find its beginning...

At some point, prices begin to rise as demand outstrips supply. The bond market gets worried about inflation and prices go down as yields go up. The Federal Reserve also may get worried about inflation and raise interest rates to cool off the economy when they believe the expansion is too rapid.

Inflation – Cause & Effect

Inflation, which occurs when prices rise as an economy overheats and demand outstrips supply, is the 800-pound gorilla that strikes fear into the heart of Wall Street, Main Street and Washington. But it is one part -- the other part being recession -- of a broader, continuous economic cycle. Governments take measures in an effort to control the economic cycle, and ensure that changes in the cycle are gradual and smooth, not sudden and chaotic. This economic cycle affects all of us, not only as employees (or employers), but also as investors since the cycle influences the market.

Here's a simplified explanation of the cycle:

- The economy is strong, people are employed and making money. Demand for goods -- food, consumer appliances, cars -- increases to the point where it outstrips supply.

What makes us different?

It's really pretty simple. We believe that managing risk is the key to long term success. Conserve the principal and the rest will take care of itself.

Risk = Loss

Seems like a simple concept – yet most people take way too much risk in their portfolio which is fine as long as the market goes up. The problem comes when it doesn't.

Managed Risk = Returns

By applying some simple risk management to a portfolio of assets the potential for large draw downs of capital is reduced thereby allowing the portfolio to accumulate returns over time.

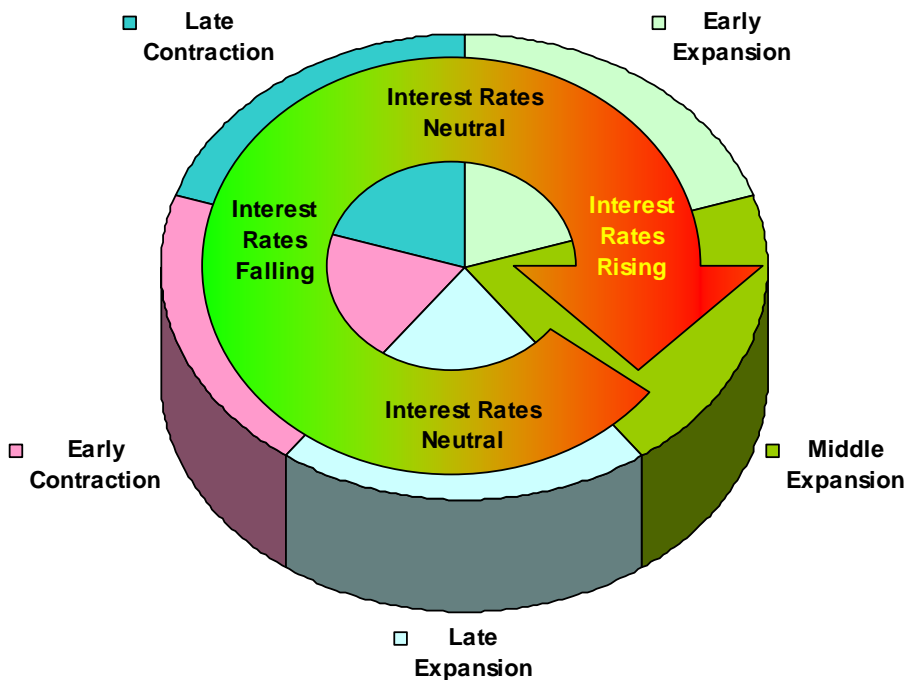
Total Return Investing

We believe that portfolio should be designed for more than just capital appreciation. There are times when markets do not rise. During those periods we want income from dividends and interest to be supporting the portfolio.

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- ☑ This demand fuels a rise in prices, or inflation. As prices increase, people ask for higher wages. Higher employment costs translate into higher prices for goods, fueling an upward spiral effect.
- ☑ When prices get too high, consumers decide goods are too expensive. Hence, demand decreases. When demand increases, companies lay off workers because they don't need to make as many goods.
- ☑ Decreasing demand fuels declining prices, which means the economy is in a recession.
- ☑ Companies lower prices to spur demand. As demand picks up, people begin buying again, fueling the need for greater supply. And the cycle goes back to the beginning.



When the economic cycle doesn't run smoothly, it can have consequences as disastrous as the Great Depression. That's why governments intervene to keep checks on the market. For example, if it appears that inflation is rising too quickly, the **Federal Reserve** (the central bank of the U.S. charged with handling monetary policy) may decide to raise interest rates to curtail spending.

Sectors	Expansion			Contraction	
	Early	Middle	Late	Early	Late
Capital Goods		X			
Service		X			
Consumer Cyclicals					X
Technology	X				
Transportation	X				
Basic Materials			X		
Energy			X		
Financial Services					X
Utilities					X
Consumer Staples				X	
Health Care				X	

The economic cycle has implications for markets and investors. Broadly, a recession often corresponds with a sustained period of weak stock prices, or a bear market. And a healthy, expanding economy that keeps inflation from rising too quickly often corresponds with a bull market, or period of sustained market growth.

But there are investment strategies for both parts of the cycle, thanks to cyclical and noncyclical stocks. Cyclical stocks are stocks of companies that do well when the economy is experiencing good times. Industries that fall under this group include travel and leisure companies, airlines, consumer electronics firms and jewelry makers. Noncyclical stocks are those of companies that make goods that are necessities, such as food and health care. These stocks tend to provide more stability during an economic downturn.

Are Business Cycles a Bad Thing?

Six to 12 months later, the Fed's actions begin to take effect, and we start the cycle all over again. Business cycles are not bad things because they keep our economy efficient. Think about how a recession forces companies to become more productive and restructure due to intense competition. This is almost always a good exercise because it strengthens companies in the long run. In other words, recessions act like pit stops for the economy as efficiency and productivity improve.

It is important for investors to understand the very nature of business and economic cycles in order to better anticipate the risk / reward for investing in certain sectors during varying economic conditions. The difference between success and failure as an investor is understanding the "where" and "when" to make investment decisions – not the "if".

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