

November 8, 2006 – The Business Cycle – Part III

Last month we looked at what happens in the economy that leads to performance changes in stocks, bonds and commodities. A typical cycle has both an expansion period and a contraction period. During the contractionary stage of the cycle, the economy takes the form of a decline in economic activity; i.e., a recession. But sometimes, the Federal Reserve is able to engineer a “soft landing”.

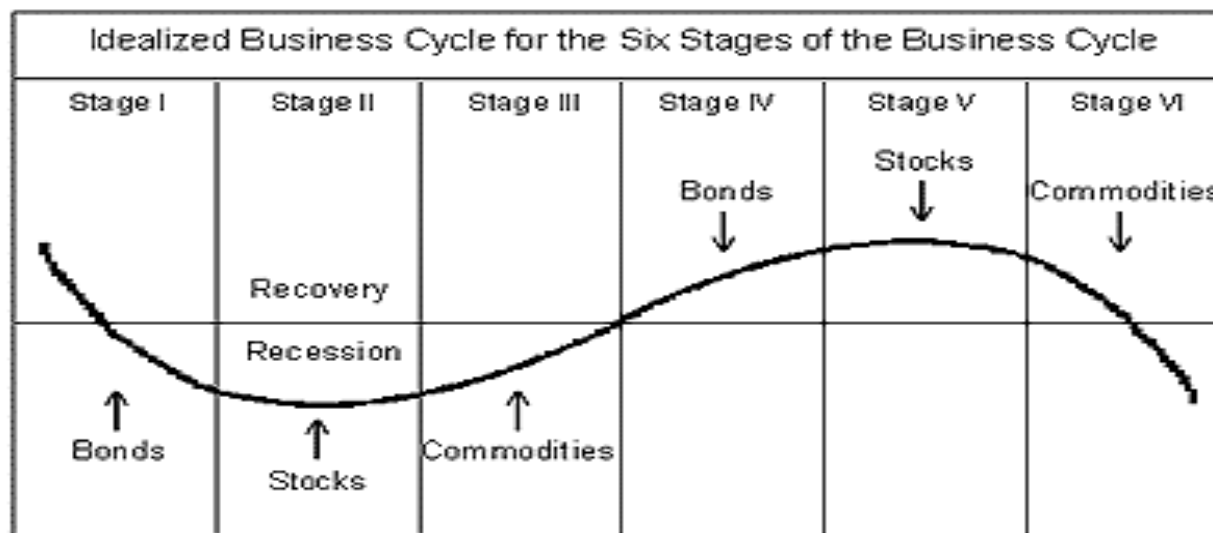


Figure 1

2002

2003

2004

2005

2006

2007?

Figure 1 shows a “typical” business cycle. The sine wave, in Figure 1, represents the path of economic contraction and expansion and the horizontal line distinguishes periods of contraction from those of growth in the economy. This sequence of events tends to repeat itself roughly every 3 ½ to 5 years.

The cycle begins in Stage I, when economic activity is declining and interest rates peak. There is usually a “flight to quality” and investors put more of their portfolios in bonds, a relatively safe investment. In Stage II, stocks begin moving up in price. Stocks reversal has often been signaled when the Fed begins cutting interest rates. Lower rates increase business activity and the demand for commodities. Prices for commodities tend to rise from higher demand and this signals the beginning of Stage III. Rising commodity prices lead to higher inflation forcing the Federal Reserve to raise interest rates to slow down economic growth and reign in inflation. This signals the start of Stage IV – and bonds decline when interest rates rise.

Rising interest rates usually make it more difficult for companies to increase earnings and stocks begin to decline in anticipation of lower corporate profits - Stage V. Slowing corporate growth tend to reduce the demand for commodities (GM builds less cars and uses less steel, oil, etc.) and they begin to come down in price – a sign the economy is in Stage VI. If a recession is to occur, it usually happens at this point in the cycle. What will happen today? Nobody knows but it appears the US economy is in Stage V or VI.

I put the year labels from 2002 to 2007 under Figure 1. If you look at the performance of bonds, stocks and commodities, they followed the business cycle perfectly except for the recent rise in stocks. Is the rally sustainable? Only time will tell.

Dave

Scripter and Associates is not affiliated with Mutual Service Corp.

248.643.4965 • dave@davefulkerson.net • www.davefulkerson.net • fax: 248.643.4896

Securities and Advisory Services offered through Mutual Service Corporation, a Registered Investment Advisor. Member NASD/SIPC.