

October 6, 2006 – The Business Cycle – Part II

Last month we discussed the importance of monitoring what stage of the business cycle we are in to help control risk and improve our returns. Now let's look at what happens in the economy that leads to performance changes in stocks, bonds and commodities. The following describes what "typically" happens throughout a complete business cycle. History shows, business cycles happen in all free market economies around the world and last approximately four years.

- The economy is expanding. This raises demand for, commodities, raw materials for construction, people to meet job growth needs, and capital for business expansion. The effect is an increase in inflationary pressures. (Prices tend to go up with increased demand.)
- Rising inflation data eventually cause the Fed to increase interest rates to slow the growth of the economy and ensure inflation remains in check. (Sound familiar? We have been in this stage of the economy about the last 18 months.) Rising interest rates cause bond prices to decline. This is why our bond investments do poorly during rising interest rate environments.
- As the economy begins to slow, stock prices start to decline in anticipation of declining corporate earnings. Recessions generally begin at this point of the business cycle. The severity depends on how far corporate earnings decline and if other "bad news" occurs during this stage. If everyone remembers the financial collapse of Worldcom and Enron and obviously the 9/11 attacks - they all occurred when the economy was already weak. Markets can absorb bad news during expansion but not so well during slowdowns. Note: the stock market has been rallying since July of this year...is this rally sustainable? Time will tell.
- The economy slows. It can be a "soft landing" or "hard landing (recession)". We are still uncertain what will happen in late 2006/2007.
- Commodity prices top and begin to decline as demand slows. (We are seeing this today – it could be just a simple correction in commodity prices or it could be a long-term bearish trend that usually happens at this stage of the business cycle.)
- Bond yields top when the market senses the economy has slowed and the Fed is unlikely to continue raising short-term rates. (Appears to be where we are today, as economists discuss when the Fed is going to begin to cut rates.)
- The Fed keeps short-term rates too high, too long, the yield curve inverts signaling a recession is likely. (Short-term rates are at 5.25% and the 10 year bond is at 4.56% - inverted.)
- The Fed begins to cut rates. Declining bond yields signal the end of the slowdown/recession is near. Bond investments do well.
- Stocks bottom and begin to trend up.
- The economy responds to declining interest rates, economic expansion begins and the cycle starts over.

Analysis of the current state of the business cycle indicates, if a recession is going to occur, it is likely to happen in the near future...a guess would be 2-6 months. If the Fed engineered a "soft landing" we could be spared and the four year economic expansion we have been experiencing since 2003 could continue without a significant pullback of the stock market. If you are interested in learning more about the business cycle and the impacts it has on our investments, The All-Season Investor by Martin Pring would be a great place to start.

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