How to Pick Industry Sectors:

Economic Cycle or Calendar Seasonality?

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How to Pick Industry Sectors: Economic Cycle or Calendar Seasonality?

By Jim Fink (bio at end)
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I have always considered myself a "bottom up" investor, which means that I start my search for attractive investment opportunities by analyzing individual companies, regardless of their industry sector. I keep a list of outstanding businesses in a watch list and wait for the inevitable irrational market decline to let me buy the stock at an under-valued price. I also like to run stock screens, based on a set of fundamental and technical criteria, that allow me to discover stocks that I never would have found otherwise.

Something Is Missing

But, in the back of my mind, I have always known that something is missing in my investment process. In William O'Neil's investment classic *How to Make Money in Stocks*, his research shows that three out of every four stocks follows the trend of their respective index. In other words, no matter how good one is at isolating great businesses with improving fundamentals, if its industry group is out of favor, the stock will most likely go down anyway. Similarly, David Swensen, the investment guru who runs Yale University's $27 billion endowment, wrote on page 4 of his book *Pioneering Portfolio Management* that a bottom-up approach is insufficient:

> Asset allocation relies on a combination of top-down assessment of asset class characteristics and bottom-up evaluation of asset class opportunities. Because bottom-up insights into investment opportunity provide information important to assessing asset class attractiveness, effective investors consider both top-down and bottom-up factors when evaluating portfolio alternatives.

Let's face it, finding winning stocks that outperform the indices is a difficult process that often feels like finding a needle in a haystack. We need every possible edge available and simply analyzing individual stocks will not get the job done.

Top-Down Analysis Helps

I think I have found an "easy button" to help me along. Specifically, a "top down" analysis, which analyzes the macro economy and business cycle, helps steer me towards those industry sectors most likely to outperform. Once I find the good sectors, then -- and only then - is it time for me to focus on individual companies.

Market Cycle Charts

All well and good, but how do you find which industry sectors perform best in each part of the business cycle? Actually, it is pretty easy with a little Internet research.

I was able to find five separate market cycle charts on the subject from the following sources: (1) stockcharts.com; (2) EquiTrend Weekly Market Watch; (3) Standard & Poor's; (4) The Market Oracle; and (5) Jim Cramer. Although a bit different, they share similar conclusions. The stock market anticipates the economy by a few months, so you need to differentiate between the industry and the stocks of that industry by purchasing the stocks ***before*** their industry's corporate earnings improve.

For example:

- Some industries are interest-rate sensitive and do best early in an economic recovery when interest rates have bottomed, so their stocks anticipate and start out-performing late in a recession (e.g., financial and utilities).
- Others benefit from inflation and do best when the economy is peaking, so their stocks out-perform starting in the middle of the economic recovery (e.g., energy, basic materials, precious metals, and tobacco).
- Technology and big-ticket consumer discretionary industries, like autos and housing, do best in the middle of an economic expansion when prices are still moderate yet people are employed, so these stocks out-perform at the start of the economic recovery.
- Early in a recession, consumer staples, like food and healthcare, do relatively well because everything else that is more economically sensitive does much worse, so these stocks out-perform near the economic peak.

Check any of the market cycle charts I link to above for more details.

Process of Elimination

Looking at the market cycle charts, I am going to start by eliminating from contention all industry sectors that perform best in recessionary conditions and early in an economic recovery: (1) utilities, (2) financials, (3) technology, and (4) consumer cyclical/discretionary.

That leaves at least four industry sector ETFs in the sweet spot of today's stock market based on their historic out-performance starting in the middle of an economic expansion and ending near an economic peak:

- Energy Select Sector SPDR (NYSE: XLE)
- Industrial Select Sector SPDR (NYSE: XLI)
- Materials Select Sector SPDR (NYSE: XLB)
- Metals and Mining SPDR (NYSE: XME)

Although some economists are concerned that the economy is peaking, I am not convinced since Europe and Japan remain weak with negative interest rates and have never fully recovered since the 2008-2009 global financial crisis, so their still-to-be-seen economic resurgence should prolong the strength of the U.S. economy. Furthermore, U.S. jobless claims are at 48-year lows, and, historically, a U.S. recession has never occurred earlier than six months after jobless claims start to rise.

Still, it may be wise to monitor incipient signs of out-performance by consumer staples and healthcare, so keep these two early-recession sector out-performers on your watch list for later investment.

Uh Oh . . .

Should you go out and buy these industry sector ETFs today? Before you do, consider a study entitled *Sector Rotation Across the Business Cycle*. Its main conclusion:

> Despite exhaustive testing, we find little support for the conventional wisdom that sector rotation across business cycles outperforms the general market.

On the bright side, the study found that a limited and altered form of sector rotation actually does work with 7% historical out-performance, but it involves buying a broad-based index fund during the early stage of an economic recovery and only engaging in sector rotation during recessions and late-stage recoveries. Fortunately, we are nowhere near an early-stage economic recovery, so sector rotation should prove very effective in the current economic environment.

Economic Cycles Difficult to Identify; Calendar Seasonality to the Rescue!

The problem with this economic approach is that it is extremely difficult to determine precisely where we are in the business cycle. Much easier said than done. Unfortunately, easy buttons never seem to live up to their advanced billing.

Fortunately, for those of us without an economics Ph.D or a business cycle crystal ball, there is a ***second type*** of industry sector cyclicality that one can identify with exactitude and which has proven useful in finding the best-performing industry sectors: calendar seasonality. That's right, if you can read a calendar you know exactly when the stocks of various industry sectors have historically tended to outperform the general market. Of course, past historical trends may not repeat, but it is better than nothing!

Summer vs. Winter Industry Sector Seasonality

A 2009 academic paper found that consumer-related stocks (e.g., food, drugs, beer, leisure, utilities, media, and retail) out-perform the overall market between May 1st and October 31st, and manufacturing and production stocks (e.g., consumer durables, chemicals, construction, mining, and steel) out-perform between November 1st and April 30th. All industry sectors perform better in the November-April period, but consumer stocks do reasonably well year-round whereas manufacturing and production stocks really stink up the joint during the summer and early fall. Consequently, the paper's most important conclusion is that investors can beat the market by ***avoiding the manufacturing and production stocks*** in the May-October period.

Hmmm….May starts next month.

Month-Specific Industry Sector Seasonality

There are two other sources for industry-sector seasonality worth noting: (1) Stock Trader's Almanac and (2) EquityClock.com.

According to the Stock Trader's Almanac, no industry sectors are good buys starting in May, but we are still in a bullish phase for computer and Internet stocks, which began in April and ends in July. There are several good shorts to initiate on May 1st: consumer cyclicals, gold/silver, and materials. Get ready to short banks and natural gas beginning in June.

According to EquityClock.com, which regurgitates information from *Thackray's Investment Guide*, the bullish periods for large-cap value stocks and the Canadian dollar finish at the end of the month (April 30th) and the metals and mining bull market will end on May 5th. New bull markets include consumer staples (begins April 23rd) and bonds (begins May 1st). Personally, I am looking forward to the biotech bull that starts on June 23rd (my sister's birthday) because biotech bulls are usually quite explosive.

Seasonality Tool Provided in *Jim Fink's Options for Income*

Last, but certainly not least, my option trading service *Options for Income* offers members a powerful seasonality tool that provides the price performance of any individual stock or industry-sector ETF between a start date and future option expiration dates over the next six months. Discover not only which stocks rise 90% and 100% of the time during a specific time period (i.e., frequency), but also by how much (magnitude).

This seasonality software cannot be found anywhere else and is definitely worth your time to check it out.

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See About the Analyst below

About the Analyst

Jim Fink is chief investment strategist for *Jim Fink's Options for Income* and *Velocity Trader*. He has traded options for more than 20 years and generated personal profits of more than $5 million. Jim also serves as an investment analyst at Investing Daily's flagship investing publication, *Personal Finance*.

Hopelessly overeducated, Jim holds a bachelor's degree from Yale University, a master's degree from Harvard's Kennedy School of Government, a law degree from Columbia University, and an MBA from the University of Virginia's Darden School of Business. For good measure, he has been a member of the Illinois and D.C. bars and is a CFA charterholder.

Prior to joining Investing Daily, and when not incurring student loans hiding out in academe, Jim practiced telecommunications regulatory law for nine years until he realized that he made more money trading stock options than writing briefs. After attending business school, Jim switched gears to the investment realm full-time, working for a university endowment, a private wealth management firm, an insurance and financial planning company, and as a Senior Analyst for an online investment newsletter service that encourages the wearing of funny hats.

A possible but unlikely descendant of legendary brawler and boatman Mike Fink, Jim defies his heritage, believing that investing success requires patience and analysis, not swashbuckling bravado. Besides his passion for analyzing and writing about stocks, Jim likes to hike in the desert Southwest, vacation in Las Vegas, play tennis, and feed his toddler son Cheerios.