A·A·M
ADVISORS ASSET MANAGEMENT

Navigating Market Cycles
Economic and Business Cycles

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Economy is growing
- Yield curve stabilizes and steepens
- Inflation rises

Economy overheating
- Federal Reserve (Fed) raises interest rates (tightens)
- Businesses are strong; stock prices are generally rising
- Yield curve stable
- Institutional investors sense slowdown and begin to tactically invest in longer duration securities

Economy peaks
- Fed continues to tighten monetary policy or may pause
- Yields rise on shorter duration securities; yield curve starts to flatten or invert
- Spreads between AAA- and BBB-rated securities is tight, indicating a decline in incremental yield gained from lower-rated securities
- Stock prices are volatile

Economy slows
- Fed pauses or hints at a potential decrease in interest rates
- Institutions buy heavily on long-end of yield curve, causing long yield to drop
- Yield curve is likely flat or inverted, as investors await Fed action
- Businesses and stock prices come under pressure
- Investors become conservative; rein in spending and investing
- Spreads between AAA- and BBB-rated securities widen

Economy weakens
- Fed seeks to stimulate growth by lowering interest rates
- Businesses reduce inventory
- Stock prices still under pressure
- Yield curve steepens, especially on short-end of the yield curve

Economy is very weak
- Fed has fueled economy with lower interest rates and may pause
- Bank credit is tight, making it more difficult to borrow
- Institutional investors sense a turning point
- Long-end of yield curve may rise as institutions begin to shorten duration
- Yield curve continues to steepen

Economy bottoms
- Yield curve continues to steepen moderately
- Investors' "*wall of worry*" is abundantly clear

Economic growth begins
- Yield curve approaches steepest point as corporate profits improve
- Fed maintains its easing stance due to lack of long-term inflationary pressures
- Investors cautious about economic recovery as evidenced by "*wall of worry*"
- Recent economic history still fresh; businesses cautious about spending and hiring

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Managing Market Risk and Credit Risk

During the relevant part of the economic and business cycle, we believe an investor should consider:

1 2 3 4 5 6 7 8 1

Portfolio Adjustment: ↓Credit Risk

- Harvest gains from lower credit quality securities which likely improved with a strong economy
- Increase portfolio credit quality and/or enhance portfolio asset allocation by considering:
  - Government-related debt
  - U.S. Treasuries
  - Corporate bonds
  - Municipal and taxable municipal bonds
- Be cautious with BBB-rated credits in seeking to avoid credit risk

Portfolio Adjustment: ↑Market Risk

- Seek to lock-in yields; short-term rates tend to decline after economic peaks
- Increase duration/volatility beyond benchmark
- Consider using market or discount coupons

3, 4, 5 - Continue theme: ↓Credit risk / ↑Market risk

Portfolio Adjustment: ↑Credit Risk

- Take "reasonable" credit risk based on investor objectives, seeking gains in an improving economy
- Harvest any gains from AAA-rated credits
- Increase exposure to corporate bonds
- Look for value in:
  - Fallen angels
  - Sympathy bonds
  - High yield securities may start to look appealing, as spreads likely near their widest point

Portfolio Adjustment: ↓Market Risk

- Reach benchmark levels
- Harvest gains from shorter-maturity, high-quality issues; emphasize credit risk
- Consider premium bonds and/or cushion bonds
- Be cautious of both interest rate and duration risk

7, 8, 1 - Continue theme: "Reasonable" credit risk / ↓Market risk

A yield curve shows the relationship between the yields on short-term and long-term bonds of the same investment quality. A premium bond has a price higher than its face value. A premium bond generally occurs when a particular bond's coupon rate exceeds the interest rates prevailing at the time. Fallen angels are bonds whose rating declined from investment grade to high yield. A cushion bond is a type of callable bond that sells at a premium because it carries a coupon rate that is above market interest rates. A sympathy bond trades lower as part of a broad sector move, despite having different fundamentals and metrics. Bond credit spreads refer to the difference in yield between a US Treasury bond and another debt security of the same maturity but different credit quality. Credit spreads are often used as a barometer of economic health; widening is viewed as "bad" and narrowing is viewed as "good".