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## Looking for 3 out of 4

The path of the business cycle follows a regular pattern. However, the timing, extent, and duration of each cycle can vary widely.

Over the **past month** we have seen a continuation of the **progression towards recovery**.

Pacwest's proprietary **active asset allocation model** helps us **rebalance among equities, fixed income, and cash**. The model consists of four broad indicators. On a purely quantitative basis, over the past 48 years, each indicator on its own has been successful in improving asset allocation decisions that would have increased overall returns while reducing risk and volatility. **Combining the indicators into an overall timing model** has shown to be even more effective. This is because each indicator has its own strengths and weaknesses, and a weakness in one indicator is overcome by the strengths of other indicators. The model is constructed such that no one indicator can dominate the other three.

**Credit expansion** is one of the four indicators in our timing model. Reducing exposure to equities when loan growth declines by a significant degree, and maintaining an underweight to stocks until loan growth resumes would have improved overall results mainly by signaling trouble prior to equity market declines in 1970, 1974, 2002, and 2008. However, this indicator also sometimes signaled trouble when there wasn't trouble, or signaled too early or too late. Such weaknesses are often overcome by the Interest Rate Indicator.

Reducing exposure to equities when rates are rising or when the yield curve is flat or inverted, and maintaining an underweight in stocks until rates decline or the yield curve steepens would have improved results. The strength of our **Interest Rate Indicator** is that it signals when tightening (loosening) credit is a headwind (tailwind) to the economy and stock prices. The weakness of this indicator occurs in the later stages of an economic expansion when the Federal Reserve raises rates and thus tightens credit in order to slow down a strong economy to reduce the threat of inflation. At that point in the cycle, strength in corporate earnings often overcomes the headwind of tightening credit such that stock prices continue to rise. This weakness is often overcome by our Economic Indicator.

Reducing exposure to equities when the Index of Leading Economic Indicators (LEI) is declining and maintaining the underweight until the LEI rises

would have improved results. The strength of our **Economic Indicator** is that it tends to keep you on the correct side of the long term economic and market trend. The weakness of this indicator is that it often signals a change in trend a bit late. This weakness is often overcome by our Market Internals Indicator.

The strength of our **Market Internals Indicator** is that it signals quickly because it is based upon daily market data rather than weekly or monthly economic data. The weakness of this indicator is that it can reverse itself quickly and often. This weakness is often overcome by the other three indicators.

**In a normal business cycle**, The Federal Reserve will loosen credit by reducing short-term interest rates in order to stimulate the economy from recession to recovery, and thus our Interest Rate Indicator would turn bullish. The **reduction in interest rates would lead to increasing lending activity**, and thus our Credit Expansion Indicator would turn bullish. The stock market would anticipate a recovery, and our Market Internals Indicator would turn bullish. **Low rates and expanding credit would lead to increased economic activity**, and our Economic Indicator would signal bullish. An economic expansion would follow as evidenced by rising GDP, rising corporate earnings, and increasing stock prices.

**In the current business cycle**, our **Interest Rate Indicator has been bullish** for quite some time as the Federal Reserve began lowering rates back in 2007, and the yield curve un-inverted in the first quarter of 2008. The **credit crunch** coupled with a **spike in energy prices** overcame the tailwind of lower rates in the summer of 2008 and threw the economy into recession. Since then, energy prices have corrected, however, **credit is not yet expanding**. The credit crunch is improving as the level of loans has stopped declining and a reduction in the BAA corporate spread indicates that **credit is becoming more available**. However, our Credit Expansion Indicator will remain bearish until credit expands. Our **Economic Indicator is on the verge of turning bullish** as we have seen improvement in the LEI over the past three months. If either the **Credit Expansion Indicator or the Economic Indicator joins the bullish Interest Rate and Market Internal indicators**, the overall timing model will **turn bullish** as no one indicator can overturn the other three.

**ASSET MIX:** With cash continuing to yield very little, and our current over-allocation to investment grade bonds in place, **we expect to increase exposure to equities if we see more evidence of improving conditions**.

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