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The Business Cycle

It's the Economy

If you want to understand how the US stock market behaves, it is best to start by looking at the US economy. After all, the stock market in aggregate reflects how investors feel about the financial health of companies, their employees, customers, suppliers, and vendors, among others. In other words, the economy as a whole. In the short term, the stock market can be described as a voting mechanism. Each individual market participant is essentially voting with their feet when they buy or sell a stock. The prices of stocks can fluctuate wildly as sentiment shifts around for a particular company. By looking at the history of the market, we can observe periods of time when investor sentiment was overly optimistic as well as periods when sentiment was overly pessimistic. The pendulum between greed and fear tends to swing abruptly from one side to the other with very little time spent in the fair and balanced middle.

As it turns out, neither extreme is a good indicator of stock prices beyond the immediate future. Whereas in the long-term, the stock market can be described perhaps more accurately as a weighing mechanism. Over time, companies can prove their ability to generate real sustained earnings. While short-term sentiment may overly deflate or inflate prices, long-term earnings performance drives the value that investors are looking for. When successful companies post consistent earnings year after year, the prices of those stocks begin to reflect their true value or 'weight' in the economy. Therefore, we probably shouldn't be overly influenced by the price of a particular stock while the 'voting' is happening, but instead consider the stock's long term importance or 'weight' in the overall economy.

Seasoned market participants understand the nature of these short-term fluctuations that often occur around a long-term upward trending market. In many cases, these relatively short-term shifts in sentiment are the very basis of the investment strategy. There are many ways to invest. Understanding how the

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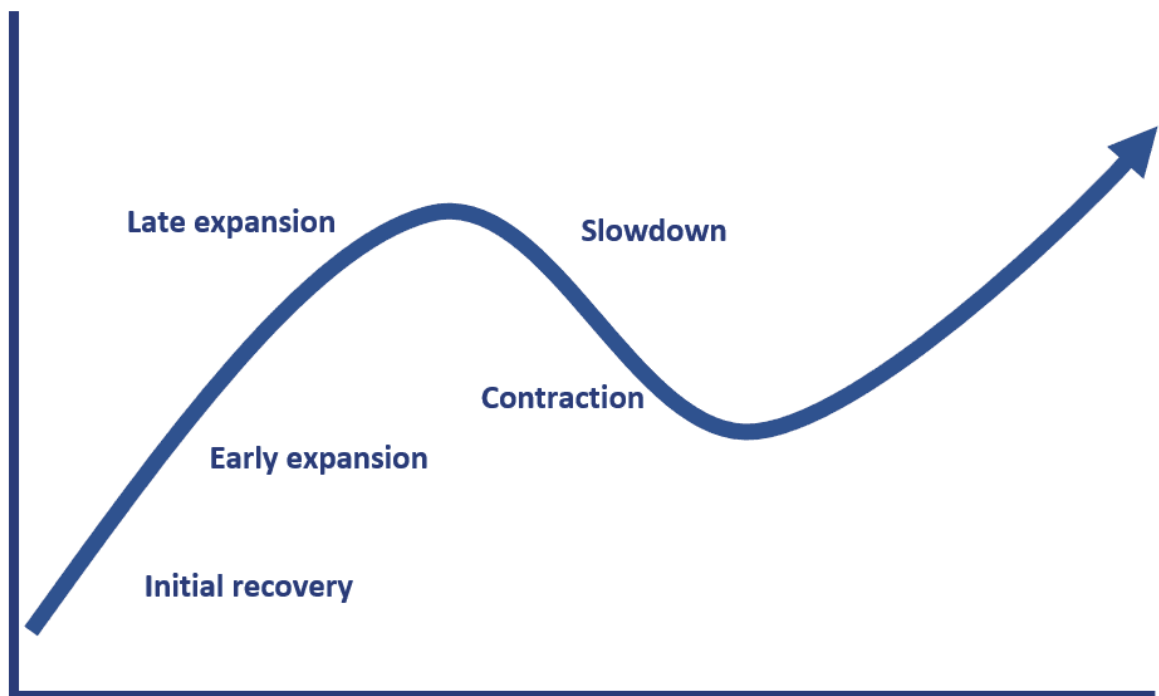
economy is doing and where we are in the business cycle should help market participants make better decisions.

The Five Phases

Measures of consumer and small business sentiment are often cited as an early signal of how the economy is doing at any given time. Along with a long list of leading economic indicators, the stock market is constantly trying to determine where the economy is headed over the near to intermediate term. One of the ways market participants decide how to invest at any given time is to look at where we are in the business cycle.



The business cycle represents fluctuations in the United States - Gross Domestic Product (GDP), i.e., the economy. These cycles can last as long as 9 to 11 years. As shown above, the typical business cycle has five phases: initial recovery, early expansion, late expansion, slowdown, and contraction. Market participants often position portfolios not necessarily for the current stage but in anticipation of the next. Therein lies one source of constant market friction, investors trying to predict when the next stage will arrive and what to do about it.

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- *Initial recovery*

Once the economy has hit rock bottom, otherwise known as an economic trough, there is a swift phase called the initial recovery. Coming off the heels of the preceding recession means that inflation should be declining, and unemployment is generally still high. As a result, consumer confidence may still be low although confidence may be rising among businesses. The government often provides a helping hand during this phase via monetary and or fiscal policy. Stock prices tend to rise strongly, and bond prices tend to peak.

- *Early expansion*

The initial recovery provides an all clear signal to consumers and businesses that confidence is up, and the economy is gaining positive momentum, setting the stage for the early expansion. This is the healthiest phase because it represents economic growth without the signs of an overheating economy or threats of inflation spikes. During this period, the unemployment rate is in decline and consumers are willing to borrow to improve their lives. Businesses tend to perform well while simultaneously making investments into the business for future prosperity. Stock prices are usually trending higher. Bond prices tend to stabilize and then begin to decline slightly.

- *Late expansion*

The law of diminishing marginal returns takes hold at some point when the economy is no longer catching up with its full potential but instead weighed down by increased cost and scarcity of labor. In this stage, confidence is at its peak creating a 'boom mentality'. A growing economy eventually may bring about rising inflation. Unemployment is low but the economy starts to show signs of overheating. Stock prices tend to peak and stay volatile for some time, while bond prices generally decline.

- *Slowdown*

With the economy running hot, inflation continues to accelerate putting pressure on the purchasing power of consumers and businesses. Inventory

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begins to decline. Unemployment tends to be stable while overall confidence declines steadily. Stocks enter a downward trend while bonds prices find a bottom and begin to climb back up.

- *Contraction / Recession*

Inflation usually peaks during the contraction / recession stage. Generally, a period of rising interest rates causes the economy to cool own or contract. This leads to a notable increase in the unemployment rate. During this phase, consumer and business confidence tend to be at its weakest point. The more dramatic the fall of the economic activity, the deeper the recession. The longer it lasts, the more damage it can do. While the average recession lasts about 18 months, no two are exactly alike in terms of the severity and length. At some point during this difficult stage, stocks eventually find a bottom and then start to look poised for recovery going into the next business cycle.

	Economy	Confidence	Capital Markets
Initial Recovery	Inflation: Declines Unemployment: High	Bottoming	Stocks: ▲ Rising Strongly Bonds: ▲ Prices Peaking
Early Expansion	Inflation: Low Unemployment: Falls	Increasing	Stocks: ▲ Trending Higher Bonds: ▲▼ Stable to Lower
Late Expansion	Inflation: Gradually Up Unemployment: Low	Boom Mentality	Stocks: ▲ Peaking & Volatile Bonds: ▼ Declining
Slowdown	Inflation: Rises Faster Unemployment: Stable	Decreasing	Stocks: ▼ Declining Bonds: ▼▲ Bottoming
Contraction / Recession	Inflation: Peaks Unemployment: Rises	Weak	Stocks: ▼▲ Bottoming Bonds: ▲ Rising

You Are Here

The chart above summarizes the characteristics of the five phases of the business cycle. Investors should understand the five phases of the typical business cycle, not only identify which phase they are in, but also make judgments as to the investment implications. It is important to note that each cycle is different because of the unique outside events and factors that affect each

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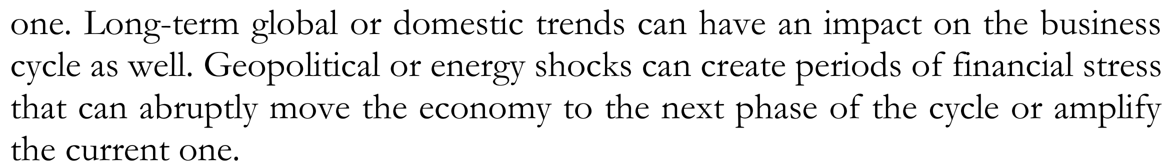

one. Long-term global or domestic trends can have an impact on the business cycle as well. Geopolitical or energy shocks can create periods of financial stress that can abruptly move the economy to the next phase of the cycle or amplify the current one.

One of the benefits of understanding the business cycle is to better align portfolios with financial goals. For example, if we know your retirement is less than 5 years away, we may want to be ever more vigilant as to where we are in the cycle to avoid carrying too much risk just ahead of a market downturn. We often counsel clients to set their overall asset allocation to a risk level they can tolerate throughout the entire cycle rather than try to time the market in or out of risk assets. While there are many ways to invest, a general awareness of the typical business cycle can offer meaningful insights into what investors can expect in the near term.

Call/email me for additional insights or for more information.

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