The Economic Cycle and Its Impact on the Stock Market

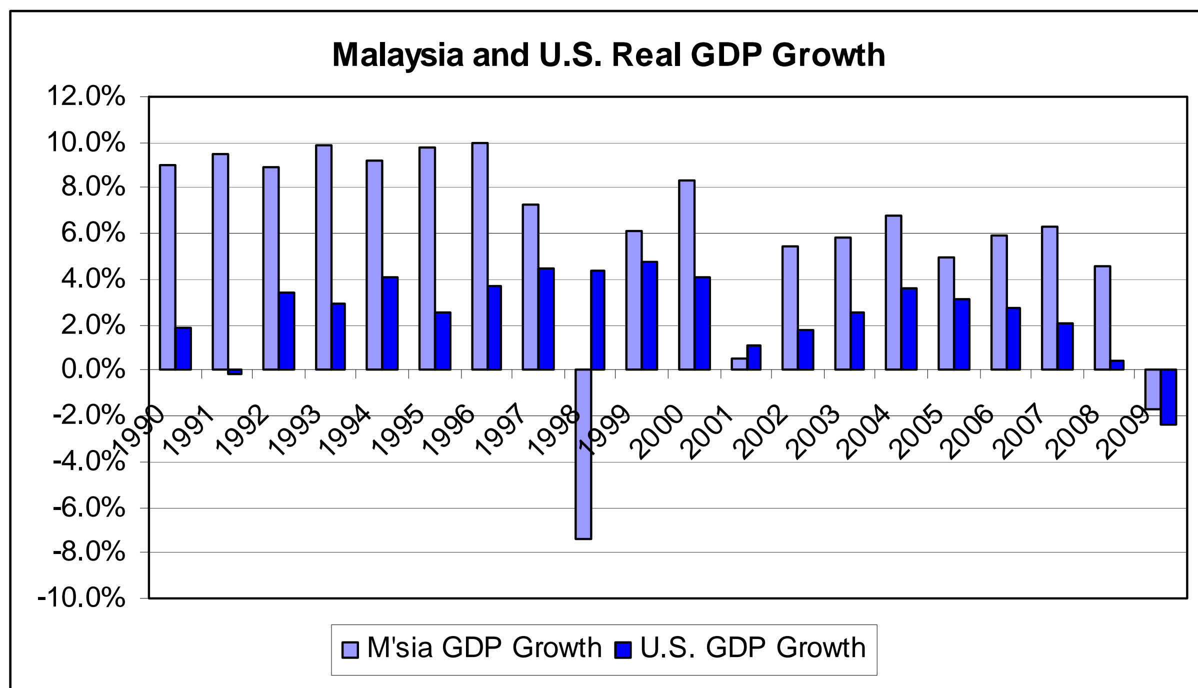
"What goes up must come down."

Usually used to explain gravity, the saying can also be used to describe the economic cycle. Economies do not grow in a straight line – instead, they expand, dip into a recession and then embark on a recovery which leads to the next expansion. Economic cycles are driven by various factors such as credit cycles, asset bubbles, demographics and technological breakthroughs.

For instance, the Malaysian economy entered into a steep recession in 1998 following the Asian financial crisis. After recovering in 1999 and 2000, the Malaysian economy slowed down again in 2001 due to the global economic fall-out following the U.S.-led technology bust (see chart 1).

In the most recent global recession of 2009, the Malaysian economy contracted by 1.7% as exports were dampened by the decline in the U.S. economy and other major economies amidst tight credit conditions and weak job markets.

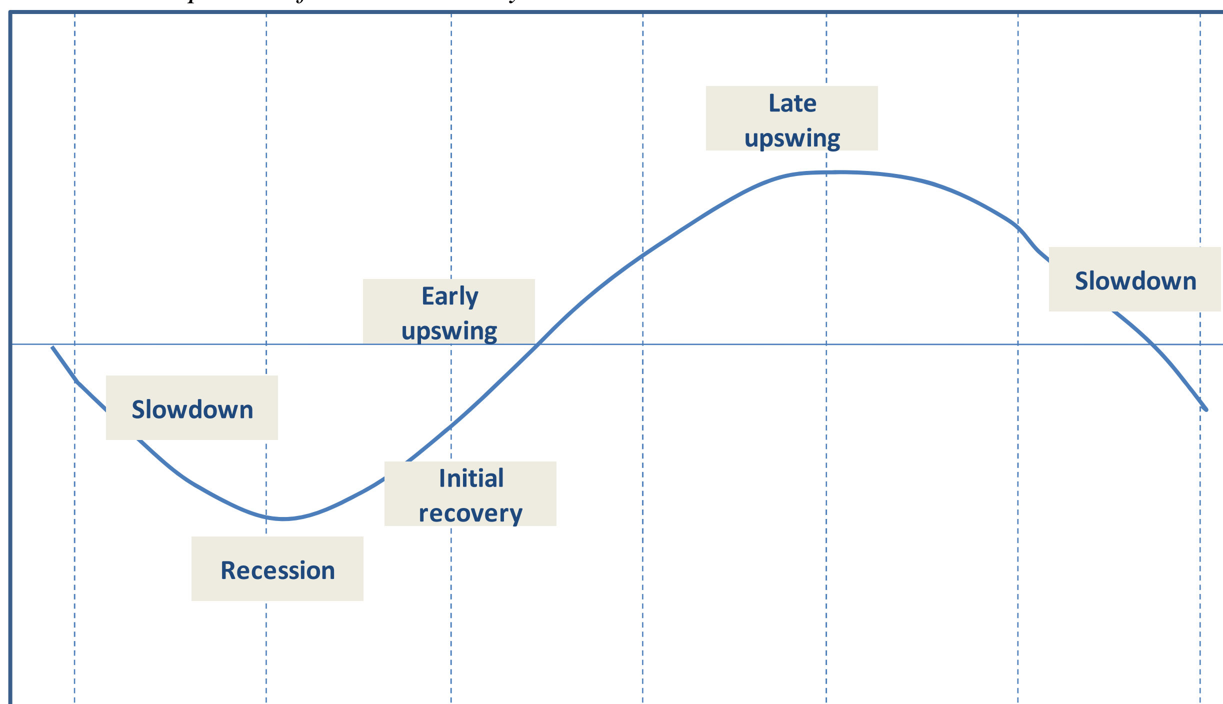
Chart 1: Real GDP Growth for Malaysia and U.S.A. (1990-2009)



In general, the term economic cycle (or business cycle) refers to fluctuations in economic activity around a long-term growth trend, and typically involves shifts between periods of relatively rapid growth (upswing or boom), and periods of relative decline (downturn or recession).

A typical economic cycle has five phases, as depicted in Chart 2.

Chart 2: Five phases of the economic cycle



Initial recovery. Usually a short phase of a few months, the initial recovery phase marks the period when the economy first recovers from a recession or slowdown. There are often stimulatory government initiatives in place such as stimulus spending and/or low interest rates. Business confidence is rising and inventories are starting to be rebuilt. With unemployment still high though, consumer confidence may still be low.

Early upswing. This is the healthiest phase of the economic cycle, as growth can be robust without overheating or higher inflation. This phase usually lasts a year to several years provided growth is at a not-too-rapid and thus sustainable pace. During this period, the inventory rebuilding that we saw in the initial recovery period leads to greater hiring activity by firms and, as employment rises so too does consumer confidence. This in turn leads to strong sales. To meet increased demand for their goods and services, businesses invest to expand capacity.

Late upswing. The economy is now operating at full capacity and is in danger of overheating. Confidence is high among both consumers and businesses, and unemployment is at very low levels. Inflation is picking up and wages are accelerating as shortages of labour occur. To combat rising inflation, central banks raise interest rates.

Slowdown. The economy slows, usually as a result of higher interest rates. Business confidence starts to waver, and firms start to reduce their inventories, which has a knock-on effect on unemployment and private sector spending.

Recession. A recession is conventionally defined as two successive quarters of negative GDP growth. During this phase, there is often a large inventory pullback and a decline in business investment.

Unemployment can rise quickly, putting downward pressure on inflation. Consumer spending on durables declines. In a severe recession, the financial system may be stressed by bad debts, making banks cautious to lend.

Because of the different dynamics at work in each of the phases of the economic cycle – varying inflation rates, consumer and business confidence, capacity utilisation rates, unemployment rates and corporate profitability – the stage of the economic cycle can significantly affect how different sectors of the economy and the various parts of the capital market perform. Unit trust performance will be affected accordingly, depending on the assets and sectors in which the various funds are invested.

A word of caution

"Prediction is hard, especially about the future." – Yogi Berra.

The description of a typical economic cycle and its impact on market performance may suggest that forming market expectations in the short and medium terms is relatively straightforward. However, economic cycle turning points are often difficult to predict. The phases of different economic cycles may vary in length and amplitude. Recessions can be steep (think of the 1930s and the early 1980s) or they can be short-lived affairs with only a small decline in output and a modest rise in unemployment. The cautious investor also needs to bear in mind that the sequence of the various phases of the economic cycle is not fixed in stone. A particular phase in the economic cycle may not take place and there may also be a reversion to an earlier phase.

Because prescient market timing is often difficult, there are several investing rules-of-thumb that would benefit the investor's portfolio in the long term, and prevent the often disastrous "investing at the top and exiting at the bottom". Ensuring sufficient portfolio diversification by investing in unit trusts for example, is one such rule, otherwise known as "not putting all your eggs in one basket". Investing for the long term is another good rule, which will help prevent ill-timed panic selling by the investor influenced by the short-term performance of the market. Investors can also adopt the practice of Ringgit-cost averaging, which entails purchasing a fixed ringgit amount of a unit trust or other investment on a regular basis, regardless of unit price. By investing on a fixed amount regularly, the investor can take advantage of market dips without worrying about when they will occur.