February 2023 | Investment perspectives

The economic cycle and your investments

With soaring inflation and rising interest rates, 2022 was a bumpy ride for investors. We explain how the economic cycle can help you understand what's happening to your investments.

The economic cycle, also known as the business cycle, refers to a series of stages in the economy as it expands and contracts over time. The growth periods, or booms, are characterised by expansion. During periods of decline, or recessions, the economy contracts.

Economic cycles are usually measured by the rise and fall of a country's gross domestic product (GDP). GDP is the value of all goods and services, and is used to depict the overall wealth of an economy. If GDP growth is positive then an economy is growing, and if it is negative then the economy is contracting.

No two cycles are the same. They can range from as short as two years or less to more than a decade, but usually last on average for just over five years. Appreciating the different phases of the cycle is important for investors because it can help them understand why the value of their investments may be going up or down at different times.

What are the stages of the economic cycle?

A typical economic cycle goes through four stages (figure 1):

1. Mid-stage. The economy experiences strong growth and expansion. Interest rates are often on the low side, making it easier for households and businesses to borrow money (and therefore spend back into the economy).

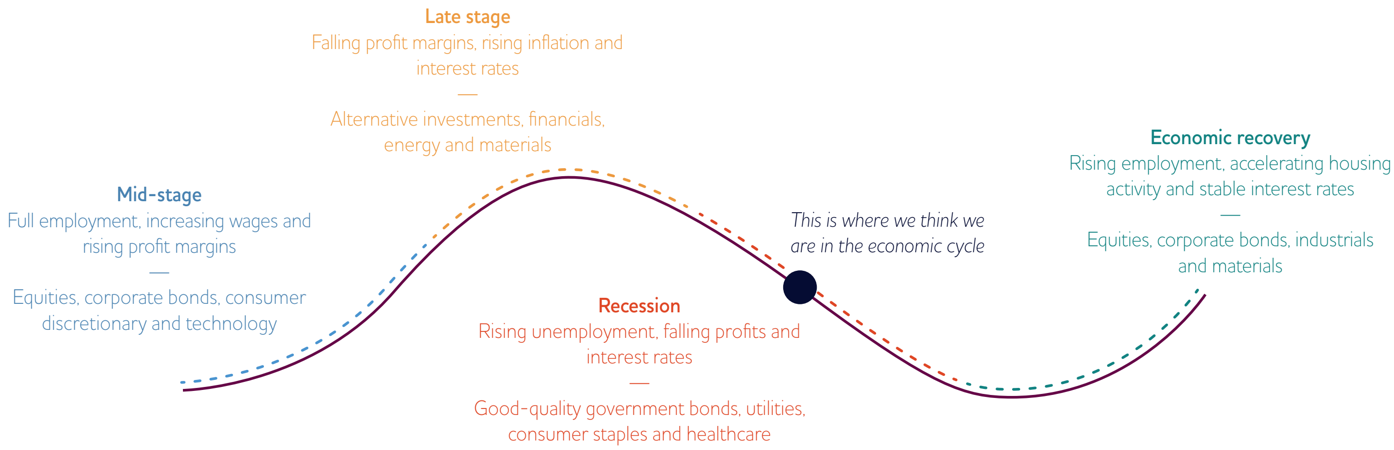
As demand for consumer goods increases, businesses ramp up production and grow their profits. They hire more workers and invest in capital to expand their operations. With this increasing demand for goods and services, prices also begin to increase (inflation). Unemployment remains low, the stock market performs well and investors are confident.

2. Late stage. The economy reaches a maximum rate of growth, signalling the end of expansion. As consumer demand increases, businesses may reach a point where they are no longer able increase their supply to meet it without increasing their capabilities. They may have to pay higher wages (because there are less unemployed people available to hire) and production costs, which they pass on to consumers by raising prices.

As inflation builds, the economy starts to overheat due to too much activity. The highest point of activity is where production and prices have peaked and there is no more room for growth. This stage is usually characterised by higher inflation, which central banks attempt to cool by increasing interest rates. In raising rates, they make it harder for consumers and businesses to borrow, which slows their spending.

Figure 1: Different assets for different environments

The global economy and financial markets tend to move through a cycle over multiple years, with different types of investments and industry sectors performing best at each stage.



Source: Omnis Investments.

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3. Recession stage. After reaching a peak, the recession phase of the economic cycle begins. It's the period when economic activity is shrinking, unemployment rates rise and inflation begins to fall (this does not mean that prices fall but that the rate at which prices are rising slows). Consumer spending and corporate profits begin to fall. The value of shares also tends to drop as investors move their investments into safer assets such as government bonds and cash.

When GDP growth turns negative for more than two quarters, the economy is usually considered to be officially in a recession. Businesses may be forced to lay off employees, the unemployment rate increases and prices stop increasing. If employment and output have been falling for a while, the government may step in to stimulate a recovery.

4. Economic recovery. The good news is that recessions don't last forever. After the economy has contracted, it eventually meets a trough and begins to recover. Government policies to boost the economy start to bear fruit and demand for goods and services begins to rise again. People become more positive about investing and spending, and employment and production starts increasing. The demand for shares tends to rise, because investors believe they offer better returns than government bonds.

As the economy begins to improve, businesses that had cut back during the recession start to ramp up again. To meet the rising consumer demand, production increases, leading to business growth, more jobs, higher salaries and an increase in the size of the economy. Declining GDP starts to turn positive and the economy begins a transition to the mid-stage and the economic cycle repeats.

Where are we in the cycle today?

During 2021 the UK economy was in the mid-stage. There was full employment, wages were increasing sharply and companies were making good profits. As 2022 progressed, we reached the late stage and growth hit a peak. Companies began to see falling profit margins, high inflation became a problem and central banks started raising interest rates in response.

At the beginning of 2023 we're coming out of the peak of the late stage and heading towards the recession stage. Towards the end of last year, inflation reached a 40-year on both sides of the Atlantic, resulting in central banks increasing interest rates.

While the past few years have felt particularly strange for investors, it's worth remembering that we've just been going through the economic cycle. However, it's been an exaggerated one, mainly due to the impact of the economic shutdown during 2020 and subsequent reopening in 2021. The Ukraine War has also had an impact.

What this means is the speed at which we've travelled through the economic cycle has been faster than usual. Another unusual aspect of this cycle is that we have had an environment of rising inflation with weakening economic growth. Central bank have had to raise interest rates to tackle inflation at a time when economic growth was slowing – and this led to the unusual situation where both equities and government bonds fell for most of 2022.

How did investments perform?

It's worth remembering that markets are forward looking and as such tend to fall before the economy contracts and begin recovering while economies are still in a recession. Let's look back at the last few years.

In line with what you expect from the business cycle, as the economy was growing in 2021 (the mid-stage of the economic cycle) shares and corporate bonds performed strongly. Consumer discretionary sectors (non-essential things that consumers find desirable, like cars, household appliances and luxury goods) also did well, as did technology stocks – particularly US ones such as Apple, Microsoft and Amazon.

As the economy started to slow, the cycle moved into the late stage during 2022. Alternative investments, banks, mining companies and energy started to provide the highest returns.

What's next?

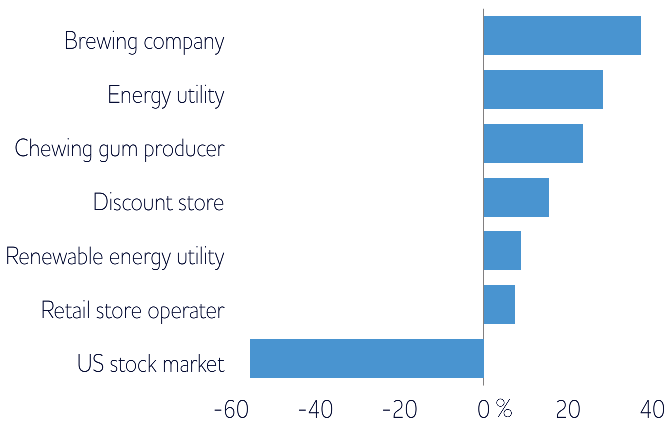
As growth continues to slow and we move into recession government bonds should help protect portfolios from the downturn. Generally, bonds are less volatile and tend to outperform shares during a recession.

Government bonds are considered to be among the safest investments, providing investors with a reliable source of income. Within the stock market, utilities, consumer staples and healthcare stocks could all add value.

Our funds are actively managed by professional teams using their expertise to pick investments, which can help navigate challenging conditions when times get tough. This is because they can select companies that can continue to generate profits through a recession (figure 2). Importantly, all of the Omnis investment managers have an objective to deliver performance through a business cycle (five years).

Figure 2: Not all companies are the same

Even during a recession it's possible to find companies that can outperform the overall market. This chart shows a selection of US businesses in different sectors with share prices that increased during the Global Financial Crisis, while the overall stockmarket fell.



Source: Bloomberg. US stock market is represented by the Russell 1000 Index.

While it may sound odd that some companies can prosper during a recession, we have seen it before during the financial crisis when share prices for some companies rose. For example, there are some industries that remain essential even amid an economic downturn, such as healthcare, utilities and food.

It's just another economic cycle

All economies go through economic cycles, where the pace of growth, incomes and spending fluctuates, although the length and intensity of each phase varies.

It's important to remember that while this economic cycle is more exaggerated than usual, in that we have gone through it much faster than normal cycles, it is following a typical path. GDP and the value of investments will almost inevitably rise when we eventually come out of the recession stage.

Market downturns are always followed by recoveries, so it's important to remain invested when conditions are challenging. An active manager can help manage risk, adjusting your portfolio in response to current market conditions.

Find out more

As always, the best thing you can do if you are feeling nervous about your investments is to stay calm and speak to your financial adviser, who will be able to assess your portfolio against your long-term objectives.

Approved by Omnis Investments on 13 February 2023

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