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Independent Financial Consulting

The Stock Market Cycle vs the Business Cycle

The stock market is a highly sophisticated mechanism designed to bring together buyers and sellers. To make good investment decisions, it's important to understand the basics of how the stock market interacts with the business cycle. Let's look closer.

Although both the stock market cycle and the business cycle are products of a capitalist economic system, the two cycles are not the same. The business cycle reflects the ups and downs of the economy, which is generally measured by metrics such as wages, the unemployment rate, and inflation. The stock market cycle reflects investor expectations of future corporate earnings. Both cycles are continually updated as new information arrives to the participants.

The stock market leads the business cycle by an average of 8-12 months based on historical data. This means the stock market peaks about 8-12 months prior to the economy peaking on the upside after which it turns negative. On the downside, the stock market hits bottom about 8-12 months prior to the depth of economic productivity after which it turns positive. Each cycle lasts approximately 5 years (60 months): 48 months up and 12 months down. These data suggest that over time, the stock market presents an excellent opportunity for accumulating wealth.

The relationship between the stock market cycle and business cycle is far from exact. The actual lead time on both the upside and downside is only known after the fact. Before the fact, it is impossible to tell how long or how short the relationship is between the two cycles. The problem is that analysts do not know where we are at any point in time due to noise in the data. Even if the data were totally accurate, different pieces of data do not arrive all at one time. For example, we don't have an accurate measurement of the unemployment rate for months after the fact and even then, noise in the data could mean a reported unemployment rate of 3% is somewhere between 2.5% and 3.5%, or even greater.

The reason the stock market leads the business cycle is because it is a discounting mechanism. Stock investors are continually evaluating how current domestic and global economic events affect future corporate earnings. Different investors view world events through different eyes and thus, arrive at different conclusions. It's

this disagreement between buyers and sellers that causes some investors to be optimistic while others are pessimistic. The result is volatility as investors process incoming information according to their unique perspective. This is especially true when the world is so chaotic, as it has been lately.

Any attempt to outguess where the stock market is going ahead of time in such a frenzied environment is nothing short of guesswork. Justin and I do not engage in such a speculative venture but instead, focus our attention on your individual risk tolerance and adjust your portfolio quarterly to reflect that risk. Our bet is that over time, the stock market will give a fair return to patient investors. Historically, that return has been around 8-10 percent. We expect to achieve this historical return for the clients who are willing and able to withstand the associated risk. We know how to adjust the expected return up or down via diversification across multiple asset classes for clients who do not want or need the risk related to equities.

We welcome your comments and questions. Please do not hesitate.
All the best, Ron and Justin