



The Effect of the Business Cycle on Stock Markets

SZF Capital

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The Effect of the Business Cycle on Stock Markets

- The stock market tends to be a leading indicator of the business cycle, since investors look to other indicators and tend to exit the market at or before an economic contraction and return to the market during recovery.

Sources of the Business Cycle's Impact

- Investor Expectations: Essentially, investors move money based on where they see future profit (or loss) potential. Such movements can then affect the overall market itself, since more dollars entering the market tends to drive stock prices higher.

Sources of the Business Cycle's Impact

- ❑ Inflation expectations are another source of business cycle impact on the stock market.
- ✓ If it is assumed that inflation will rise in the near future (see the sections below), interest rates tend to rise, and this has a negative impact on stock (and bond) prices.
- ✓ Ironically, people look to stocks as an inflation hedge, but stocks actually do poorly during periods of high inflation.
- ✓ Of course, over long periods of time, the return on stocks does beat the general rate of inflation.

Inflation

- ❖ Inflation refers to a general increase in the price of goods and services.
- ❖ This occurs when demand for these items grows faster than the supply.
- ❖ The result is more money chasing fewer goods, and therefore prices increase.
- ❖ Ensuring that your client's investments outpace the rate of inflation over the long haul is one of the major challenges for any investor.

Inflation

- The most important measure of inflation is the Consumer Price Index (CPI).
- The stock and bond markets are very sensitive to changes in the CPI because when inflation rises, purchasing power is eroded.
- The ensuing drop in consumer spending has a negative effect on stock and bond prices.

Inflation

- The rate of inflation tends to increase during economic expansions and decrease during recessions.
- Inflation tends to be moderate during expansions, and high inflation rates tend to hasten the transition from peak to recession.
- Deflation is rare and occurs only during recessions.

Interest Rates

- ❑ **Interest Rates** have an inverse effect on the stock market.
- ❑ Rising rates almost always lead to lower stock prices as the overall market sinks.
- ❑ In this case, few companies will be able to maintain their share price in the face of an unraveling stock market.
- ❑ There are two reasons why the stock market is hard hit by higher market interest rates.

Interest Rates

- ❑ For the macro economy, higher interest rates will lead to slowing economic growth.
- ❑ Slower economic growth impacts the typical corporation with lower sales, revenues and profits.
- ❑ Thus higher interest rates leads to an expectation of lower earnings growth and stock prices adjust downward to reflect the new outlook.

Interest Rates

- ❑ Interest rates also affect stock prices for the reason of opportunity cost.
- ❑ As interest rates rise, the return on alternative investments increases.
- ❑ Yields on bank certificates of deposit, bonds, and other interest bearing assets rises, making the dividend yield of stocks lower in comparison.

Interest Rates

- ❑ Yield sensitive savers may move some of their money out of stocks and into interest bearing assets.
- ❑ Sometimes expected interest rate movements are as important in determining investor behavior as do actual changes in interest rate.
- ❑ If there is a common belief that interest rates will rise in the future, then present stock prices will reflect the expectations and the market will fall.

Market forces

- ❑ **Market forces** represent a critical item in determining a stock's price.
- ❑ If the market as a whole is falling due to a poor economic outlook

- ❑ Or, because institutional investors are engaged in another one of their frequent irrational panics, even the best stocks may not be able to withstand the force of the overall market.

Market forces

- ❑ Or, a strong bull market may lift the prices of the majority of stocks despite constant fundamentals for individual companies.
- ❑ Market forces may also represent a segment of the market.
- ❑ Certain stock groups may become very popular and show tremendous price appreciation simply because investors are trading on momentum.

Market forces



- ❑ In this case, economic and company fundamental are basically ignored in favor of making a rapid capital gain.
- ❑ The most recent example is the mania for Internet stocks that began in 1998.
- ❑ Individual investors known as day traders bid up the prices of Internet stocks to stratospheric levels.



Thank you