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The Economic Cycle

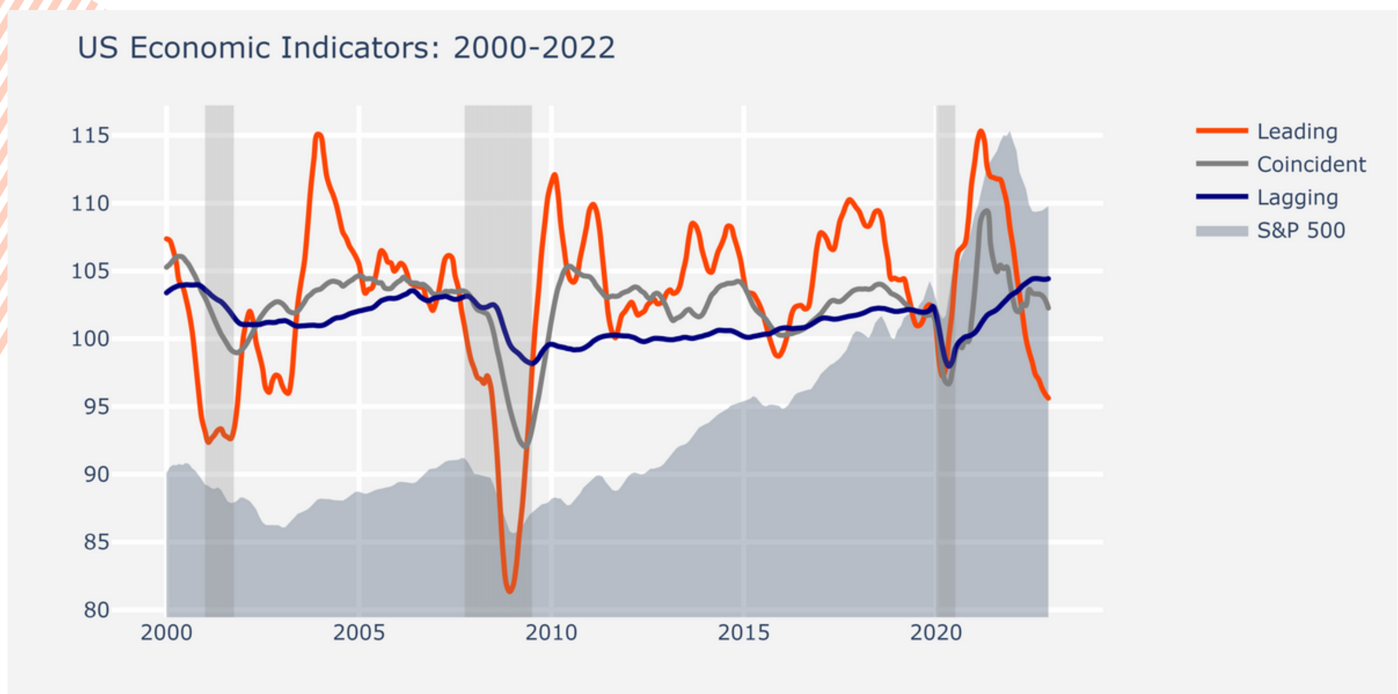
by Garrett Nel

2022 was historically not the best year for investors, with many impediments to economic growth. A war, rising prices and recession fears have weighed on asset returns worldwide resulting in the S&P 500 ending the year with a loss of almost 20%. Many investors may still be uncertain about what the future holds as they cautiously consider what a potential global recession may imply for their portfolio. Luckily a new year has come around, and a good way to start 2023 as an investor is to consider the context of where the market is and to revaluate where it is going.

Economic growth in most countries accelerates and contracts in a cyclical manner around a general upward trend. During times of strong economic growth, the economy of a country may grow faster than its average rate, while at a later stage growth may slow down to below the average rate, or even become negative for a certain period—this is what is known as a recession. However, it is important to note that this behaviour is still a cycle, i.e., recessions are usually followed by periods of stronger growth.

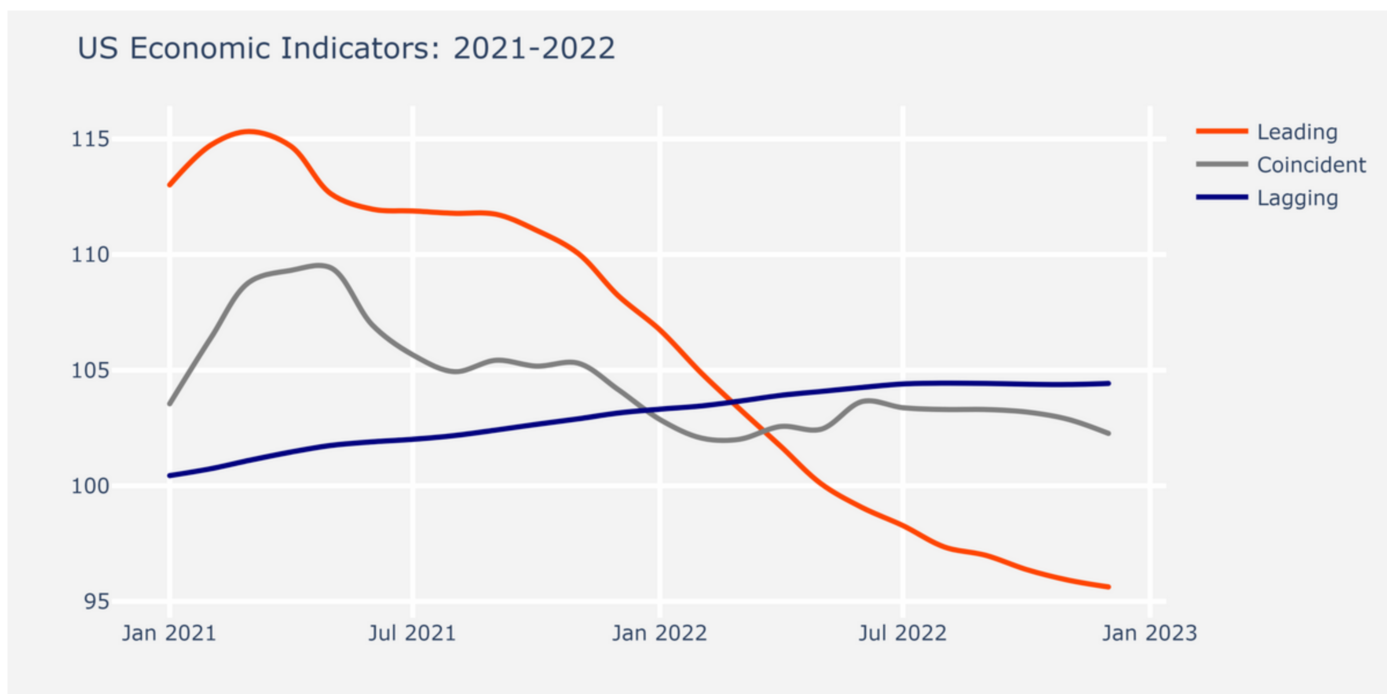
It is not difficult to understand the relationship between economic growth and investment growth. Purchasing a security gives the investor a right to some of the underlying entity's cashflows—the size or certainty of which would be correlated to the strength of the economy. With that in mind, the question becomes: where are we in the economic cycle going into 2023, and where could its trajectory take us?

To answer this question, it is useful to consider economic indicators, of which there are three groups: Leading, Coincident and Lagging indicators. As their names would suggest, each of these give an indication of economic conditions but are sensitive to its movements on different time scales. This behaviour is useful because, in conjunction with each other, they may give an indication of changes in the cycle. The graph below depicts the three composite economic indicators for the world's largest economy, the US, which has a strong impact on the rest of the global economy.



During economic downturns, notice that the Leading indicator falls first, followed by the Coincident indicator, and then the Lagging indicator—this is especially evident in the period following the 2008 Financial Crisis. It is important to note that the grey Coincident indicator represents current economic conditions using figures such as GDP, personal income and industrial production, which is the component that individuals are concerned about when discussing the "economy". The periods during which the US experienced recessions are shaded in grey and matches up with what the indicators would suggest.

Although markets are related to economic growth, they are not perfectly correlated. In fact, a component of the leading indicator consists of equity performance. Clearly one cannot use the Coincident indicator to make inferences of Leading indicator performance. In reality the connection between asset performance and economic conditions, is that investors value assets according to their assumptions on future economic conditions—this creates the "leading" effect in this indicator and is a common theme in all components of the leading composite. Thus, one should not wait for underlying economics to recover before investing, as the investor may miss out on the start of the boom cycle. The following graph zooms in more closely on the economic indicators over the last two years.



When considering where we currently are in the economic cycle, the indices considered seem to confirm the expected economic slowdown to come. The Leading indicator is clearly below its average, and the Coincident indicator seems to be approaching a downturn. However, it is noticeable that the rate of decrease in the Leading indicator is slowing down, i.e., it is approaching a possible reversion. This implies that, although there may be a recession in the future, the markets may already be looking past it as has been the case in previous recessions.

Going forward, investors with an eye on economics should keep in mind the leading-lagging disconnect between market returns and economic conditions. Although it cannot be said with certainty that a rebound in markets are due shortly, it is a likely possibility if current conditions prevail. A turn-around in economic climates as a whole would only serve as a confirmation that equity markets have already turned around, at which point valuable gains may already have been missed by overly cautious market participants. Recessions and the fears surrounding it may still be prevalent topics going into 2023, but the wise investor would keep the important underlying market relationships in mind.

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