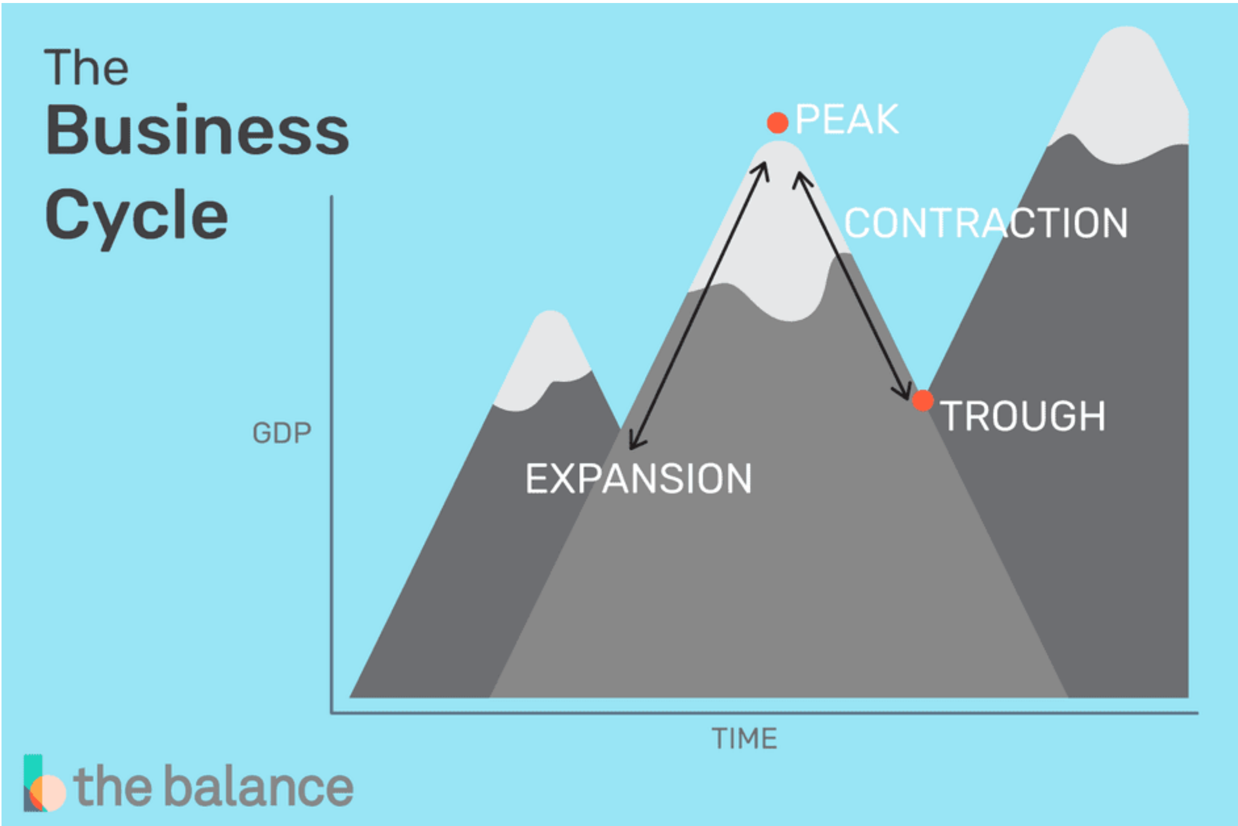
The Business and Stock Market Cycles



The business cycle is the natural rise and fall of economic growth that occurs over time. The cycle is a useful tool for analyzing the economy. It can also help you make better financial decisions.

The stock market cycle operates the same way as the business cycle.

Stages

Each business cycle has four phases. They are expansion, peak, contraction, and trough. They don’t occur at regular intervals. But they do have recognizable indicators.

- An expansion is between the trough and the peak. That's when the economy is growing. The Gross Domestic Product, which measures economic output, is increasing. The GDP growth rate is in the healthy 2 to 3 percent. Unemployment reaches its natural rate of 4.5 to 5 percent. Inflation is near its 2% target. The stock market is in a bull market. A well-managed economy can remain in the expansion phase for years. That's called a Goldilocks economy.The expansion phase nears its end when the economy overheats. That's when the GDP growth rate is greater than 3 percent. Inflation is greater than 2 percent and may reach the double digits. Investors are in a state of "irrational exuberance." That's when they create asset bubbles.
  The peak is the second phase. It is the month when the expansion transitions into the contraction phase.
  The third phase is a contraction. It starts at the peak and ends at the trough. Economic growth

weakens. GDP growth falls below 2 percent. When it turns negative, that is what economists call a recession. Mass layoffs make headline news. The unemployment rate begins to rise. It doesn’t happen until toward the end of the contraction phase because it's a lagging indicator. Businesses wait to hire new workers until they are sure the recession is over. Stocks enter a bear market as investors sell.

The trough is the fourth phase. That's the month when the economy transitions from the contraction phase to the expansion phase. It's when the economy hits bottom.