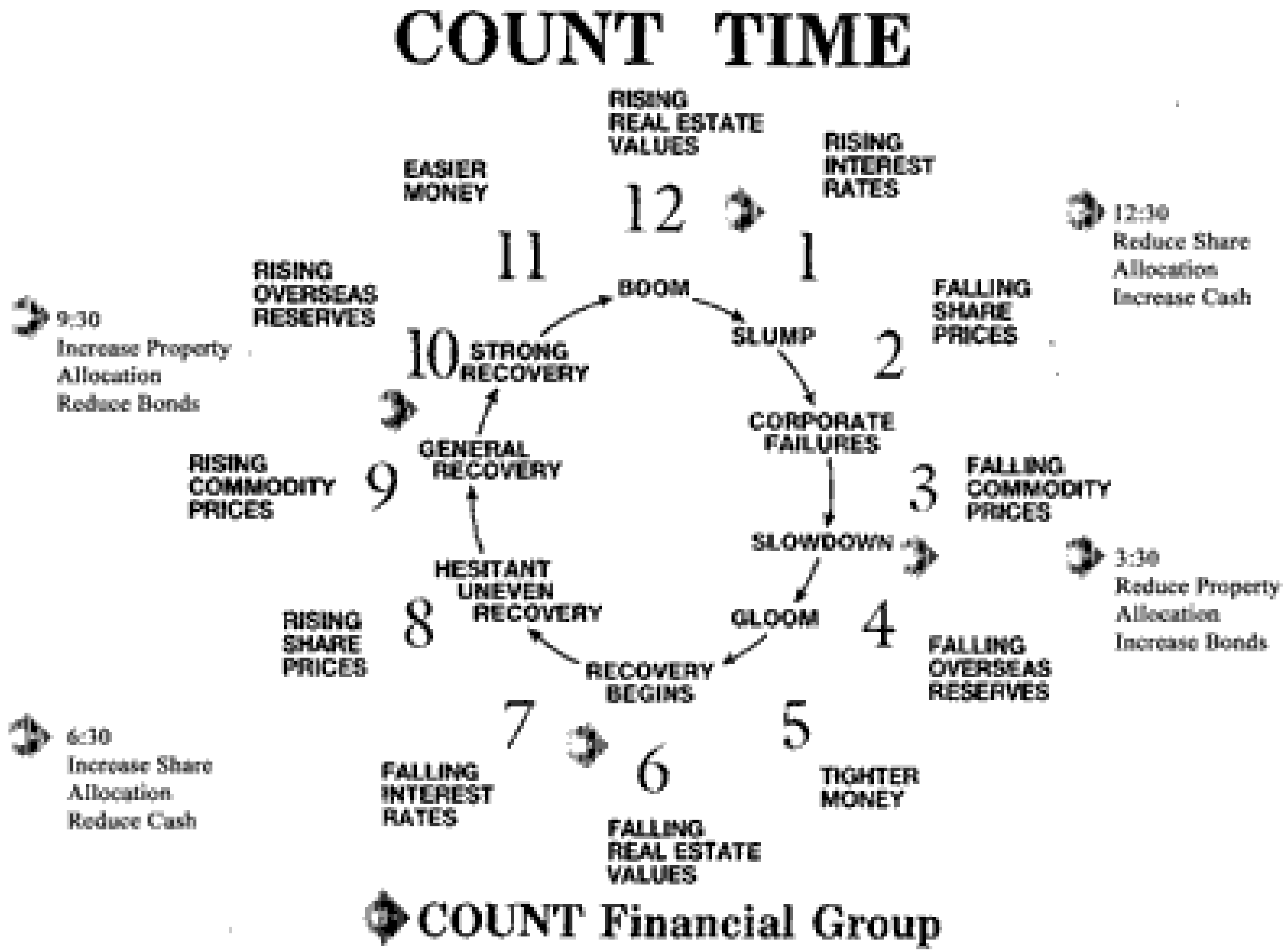
The Economic Clock – Everything Goes in Cycles!



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What Is The Economic Clock?

The economic clock, pictured above, demonstrates that as an economy moves through its economic cycle there is a time to buy certain types of investments and possible a time not to buy. Notice that I don't say 'sell', because one of the most important investment habits to develop is a long-term investment horizon.

The economic clock is not a signal about what to buy to quickly become wealthy. Rather, it identifies that the return a particular investment will generate depends on what time it is in the economic cycle.

For example, if it was two o'clock then neither share or property is likely to be the best investment option.

To understand the process of the economic clock, let's go through one full cycle.

The Six O'Clock Recession

Recessions mark the peak of a downward swing in an economic cycle.

A recession is defined as a period of two or more successive quarters of decreasing production. Production is usually measured in terms of Gross Domestic Product (GDP), so in layman's terms, any two consecutive periods of negative GDP will constitute a recession.

Recessions are characterised by high unemployment, caused by employers shedding staff as production levels fall, cutting profitability and the need for labour.

With less employment comes a drop in the average weekly earnings and with fewer dollars to spend, consumers demand less, resulting in even lower consumption.

Historically Australia has entered a period of recession every seven to nine years with our last recession in 1990.

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Recovery 'Till Midnight

A recovery from recession begins with increased government spending (known as fiscal policy) and control of interest rates (known as monetary policy).

More spending on government projects increases the demand on private sector businesses, which in turn look to employ more staff to cope with increased production needs. Lower interest rates prompt businesses to borrow and invest in capital projects.

Market analysts believe the beginning of the recovery phase is an excellent time to invest in the stock market. Companies which survived the recession will be efficient and well placed to obtain higher earnings from growth in target markets resulting in higher share prices and bigger profit distributions.

Share prices move through a period of gradual increases as the hour hands pass between six o'clock until about eleven o'clock when those who have missed out on the stock market gain start buying leading to more aggressive market highs. A frenzy begins which marks the beginning of the end of the recovery cycle, which peaks when the economy is booming.

Just before midnight a phenomenon known as 'the greater fool theory' begins. The greater fool theory suggests that no matter what price an investor pays for a share, someone (the greater fool), with less education and less understanding of the market, will buy it at a higher price. Eventually the price rises to a figure when the greatest fool buys because s/he cannot find anyone to buy it at a higher price. When the greatest fool buys the market has reached its peak and is set for a correction.

You know you are in the 'great fool' period when you hear that investors with little or no knowledge of the fundamentals of investing believe they can't lose

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Midnight Boom Before The Impending Correction

Just as the greatest fool has purchased articles appear in the media about how wonderful the stock market is and how the good times are never going to end. In recent times stockbrokers coined the term 'new economy' stocks only to see traditional economic theory pierce the hype and bring stock values down.

Well before the clock strikes midnight the wise investors have exited stocks and are looking for the next opportunity. They have left because they understand that there is likely to be a correction in the market, since share prices cannot be justified by traditional stock valuation methods, such as asset backing per share or earnings multiples.

As investors leave the market, supply (sales) become higher than demand (purchasers) triggering a sell off and a slump in share prices. Investors who were too slow (or greedy) are burned, particularly those that have leveraged (via margin lending facilities) and the panic begins as people scream 'sell'.

Property 'Till Three O'Clock

The smart investors that 'got out' at the top move into property with reliable 'bricks and mortar'.

Extra demand in property pushes demand above supply and results in higher prices.

This itself isn't a problem, except that the government sees the economy is overheating and looks to introduce measures to enable a 'soft landing' through increasing interest rates to flatten demand by consumers.

With higher interest rates comes less profit in real estate since most investors have leveraged their property purchases. Rises in interest rates continue until it is no longer viable for purchasers to continue investing in property and soon there are more sellers than buyers. Property prices, like share prices, correct.

There is trouble on the way.

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Decline Back To Six O'Clock

Decline begins as business confidence begins to fall. Investors find little value in either stocks or property and with impending trouble on the horizon fixed interest securities become very popular again.

Lower business confidence means that new capital ventures are postponed.

Less spending and higher interest rates result in lower demand, which results in less production. With fewer sales there is a squeeze on earnings, resulting in profit downgrades; economic rationalisation becomes a hot topic in the boardrooms.

The economy slows to the point where productivity stalls and then declines. When this happens for two periods in a row, the economy is said to be in a recession.

This information has been extracted from the **Wealth Tips Online** web site.

http://www.wealthtipsonline.com.au/innercircle/hotopic1.html

Key Points Noted from Shirlaws Presentation – 4th Feb 2009

- Historically every bull run has lasted around 7 years.
- Average number of months to sell a home in the US reaches 9mths and this triggers an immediate tightening up of credit and slump in the market.
- Stock markets always work 6-12mths ahead of the economy – reflecting what they see coming up in the economy.
- This would tend to suggest that May- September 2009 is going to be really tough for the economy. Note that every sector is different and has it's own context that needs to be considered.
- 3 differences with this recession (when compared to others) – Bank-led, all asset classes dropped in same year, Govt intervention – so the ultimate implications are unknown.
- Analysts predict US market to start to improve approx June 2010. Historically European markets tend to go 6mths ahead of that and Australian markets 6mths after. Depends how fast we move through the Economic Clock.
- Historically during this time, stock markets have lost around 50% of their value from their previous high (approx 6800 was the last high point for the All Ordinaries) , then eventually return to a new high over the bull run years, that is approx 3 times that 'bottom out value'. Historically the market has never fallen below the 'bottom out value' of the previous significant downturn.
- Current view of presenter was that the market has reached approx 85%-90% of possible drop – most of the bad news is now factored in.
- First 18mths/2 years after initial spike up, there seems to be a 'drag' period before a brief and sharp dip followed by a significant rise in the stock markets.
- Economic Clock (current cycle) – as the current government has intervened, injecting a significant amount of money into the market, we will probably not see the very bottom of the current cycle/recession and therefore the extra fat in lots of businesses will not be shed. There are a couple of possibilities, the first is we will bounce back as per previous cycles and only have a relatively short period at the reduced bottom of the cycle, the second possibility is we spend significantly longer at the bottom of this cycle as businesses will be less efficient and therefore it will take longer for the economy to "bounce back".

Key Points Noted from Shirlaws Presentation – 4th Feb 2009

- Each business is placed differently in terms of how the "economic clock/cycle" will impact on them and therefore this should be looked at very closely before any decisions are made relative to this cycle and our current position in it. E.g. depending on the product or services that businesses offer, they may well be growing their business as we head into a recession others (probably the majority) will be shedding the fat.

- Staff turnover tends to be 30% during first 18mths after the rebound (invest in staff loyalty now to minimise this affect).

- The 'Down/Drag/Release/Up' model by Shirlaws encourages a business to 'Build Platform for Growth 'during Down/Drag period (approx 18mths from now) and 'Implement Growth 'as soon as 'Release' point is reached in the cycle – the sharp and sustained rising of the stock market.

- 'Growth Platform' should look at your Positioning, Channels, Functional Areas, Capability, Succession.