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# Investment cycles – why do they matter?

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Like a circle in a spiral, like a wheel within a wheel,
Never ending or beginning, on an ever spinning wheel.
As the images unwind, like the circles that you find,
In the windmills of your mind.

A. Bergman, M.Bergman, M.Legrand, The Windmills of Your Mind

## Key points

- Cyclical fluctuations in investment returns are particularly important for investors. Most take their lead from economic developments but are magnified by swings in investor sentiment.
- Of particular importance are the long-term cycles driven by waves of innovation and the 3- to 5-year business cycle. Right now we are still in the upswing phase of the business cycle, but still in the context of the weak and constrained phase of the long-term cycle.
- Investors ignore cycles at their peril. Periods of poor returns invariably give way to periods of great returns and vice versa.

## Introduction

I have always loved the lyrics to The Windmills of Your Mind. Nature is full of cycles. Whether it be the cycle of day and night, seasons, tides, weather cycles from the almost weekly cycles of cold fronts that regularly blow across south east Australia to the longer La Nina and El Nino cycles, fertility cycles, birth and death, etc. But they are also endemic to economics and investment markets. Some are regular, some just rhyme. Despite attempts to end or subdue them via economic policy and regulation the cycle lives on. As the Australian financial economist Dr Don Stammer constantly reminds us: there's always a cycle. Usually when we declare investment cycles dead they come back to bite us.

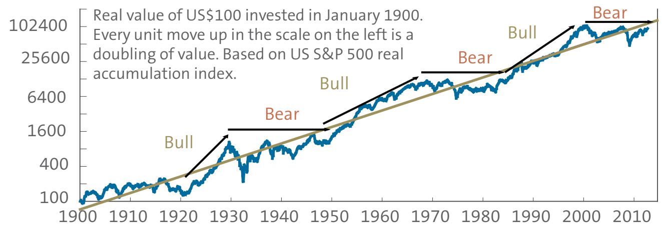
Investment cycles sometimes bring much joy, but also angst to investors. But what are they? What causes them? And why do investors need to be aware of them?

## Cycles within (investment) cycles

Cycles in investment markets refer to swings between good and bad returns. They usually take their lead from fundamental economic/financial developments but tend to be magnified by waves of investor optimism and pessimism. There are three cycles of particular relevance to investors:

**The long-term or secular cycle** – share markets go through long-term or secular bull and bear phases, often lasting between 10 to 20 years. This is most clearly evident in the US share market and illustrated by the following chart. It shows the cumulative real value of US$100 invested in 1900. Secular bull markets – or 10- to 20-year periods where the trend in shares is up – can be seen in the 1920s, 1950s and 60s, and the 1980s and 90s. In between in the 1930s and 1940s, 1970s and over the last decade are secular bear markets – which are long-term periods where shares have poor and volatile returns.

**Long-term bull and bear phases in US shares**



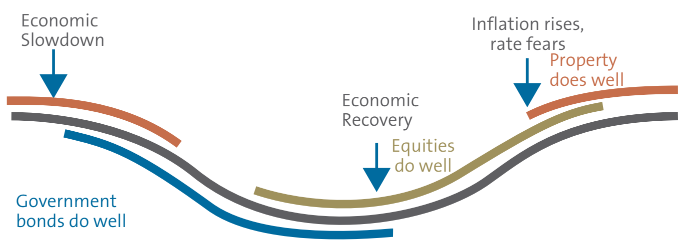

Source: Global Financial Data, AMP Capital

Secular bull and bear phases are arguably related to what have become known as Kondratiev waves, named after Russian economist Nikolai Kondratiev who identified them and received the death penalty for his conclusions as they didn't align with Stalin's view of things. Kondratiev waves take their lead from waves of technological innovation. Starting back in the 1780s, water power, textiles and iron drove the first industrial revolution; steam, rail and steel drove the second industrial revolution; electricity, chemicals and the internal combustion engine drove a third Kondratiev wave into the 1920s; petro chemicals, electronics and aviation drove a fourth wave in the post World War II period; and then the IT revolution drove a fifth wave more recently. The last three of these were associated with secular bull markets in the 1920s, the 1950s and 60s, and the 1980s and 90s.

At the end of each long-term upswing, share markets reached overvalued extremes and investors had become excessively exposed as optimism that good times would roll on forever reached extremes. This left investors and shares vulnerable as economic excesses such as too much debt (1930s and 2000s) and excessive inflation (1970s) became overwhelming giving way to economic weakness and secular bear markets. The most recent secular bear market began in 2000 with the tech wreck, corporate governance scandals, a bursting of credit and housing bubbles and public debt concerns, and it has been in play ever since, even engulfing Australian shares from 2007.

**The business cycle** – this is the most well-known economic cycle and has a duration of 3 to 5 years. It tends to relate to the standard economic cycle where after a few years of economic expansion, inflation or other imbalances start to build which results in monetary tightening, which leads to a downturn in economic growth or recession made worse by the need to cut back inventories, then falling inflation and monetary easing which then sets the scene for the next expansion. This can be referred to as a Kitchin cycle, named after Joseph Kitchin who first identified it. It tends to underpin a 3- to 5-year cycle in investment markets with the stylised link between share markets, property and sovereign bonds and the business cycle shown in the next chart. Shares tend to lead the business cycle – bottoming several months before an economic trough and topping before an economic downturn. Property markets tend to be more coincident.

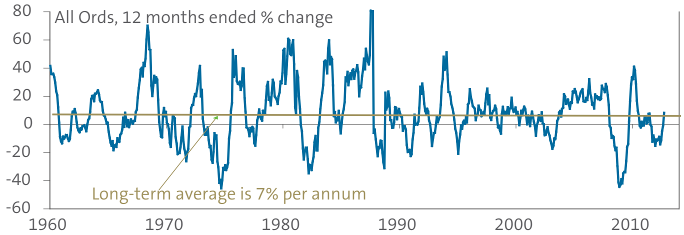
**The standard 3- to 5-year investment cycle**




Source: AMP Capital

In terms of actual share market fluctuations, the 3- to 5-year investment cycle is evident in the swings in rolling 12-month changes in Australian share prices. See the next chart.

**3- to 5-year investment cycle swings in Australian shares**




Source: Global Financial Data; AMP Capital

Overlaying the 3- to 5-year business cycle there is also some evidence of an 8- to 10-year cycle that relates to credit, resulting in every second business cycle being more extreme and ending in recession. It arguably drove the more extreme downturns we saw in the mid 1970s, early 1980s, early 1990s, early 2000s and late 2000s.

**Short-term sentiment cycles** – within the 3- to 5-year investment cycle there are also short-term swings (weekly, monthly) between overbought and oversold for things like shares and currencies driven by sentiment, but which relate to the tendency for economic and profit data to run through hot and cold periods particularly relative to market expectations. They often give rise to what is commonly referred to as corrections in share markets.

## Some observations

There are several points to note regarding investment cycles:

- No two cycles are the same but they do have common features being usually set off by economic developments (e.g. a pick-up in growth or a significant technological innovation) accentuated by swings in investor sentiment. As such while history doesn't repeat it rhymes.
- There are cycles within cycles – just like in the windmills of your mind. For example, even though US and global shares have been in a long-term secular bear market since 2000, there have still been investment cycle swings up and down in economies and share markets.
- Obviously when several cycles going in the same direction combine the impact can be huge. For example, a business cycle downturn in 2000 coincided with an end to the secular boom of the 1980s and 1990s resulting in 50% falls in global shares over the 2000 to 2003 period.
- Despite various attempts to smooth them out (via Keynesian or Monetarist economic policies) or declare them dead (e.g. as a result of the decline in the relative importance of manufacturing) cycles live on.
- Cycles can be self limiting as economic downturns lead to lower inventories, pent-up demand and lower interest rates which sow the seeds of recoveries and share slumps result in cheap shares which entice bargain hunters and sow the seeds of a new bull market.
- Finally, investment cycles provide immense opportunities for investors to vary their asset allocation dynamically through the cycle, e.g. buying more shares into cyclical downturns and reducing exposure into upswings. But to do this successfully requires an acceptance that timing is not going to be perfect and of the need to be contrarian, i.e. buy when everyone else is selling and sell when everyone else is buying.

## Where are we now?

Right now our assessment is that we are still in the upswing phase of the investment cycle. Numerous uncertainties remain – the US fiscal cliff, Spain, China, etc – which will result in volatility, but none of the normal excesses that signal a downturn in the investment cycle are in place. There has been no economic boom, investment is low in the US and Europe, inflation is low, the private sector has been focused on reducing debt and share markets are not expensive. This suggests the investment cycle upswing has more to go.

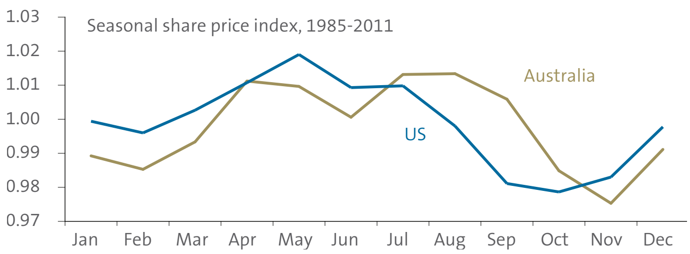
However, we likely also remain in a long-term secular bear market. While it's now long in the tooth having started in 2000 globally, debt reduction and less business-friendly governments suggest it may have a bit further to go yet.

## Other cycles of relevance

**Political cycles** – these are less relevant in countries with an irregular political cycle like Australia. However, the US has a precise four-year federal political cycle and this has given rise to a fairly regular pattern that sees below-average returns in the first two years after an election but well above-average returns in the third year (as the President seeks to stimulate the economy to help his parties' re-election) and to a lesser degree in the fourth year. Right now we are in the fourth year of the US presidential cycle, so this warns of more sub-par returns for the next two years. The trouble is the pattern has been thrown out by the global financial crisis in recent years.

**Seasonal patterns** – There is also a well-known seasonal pattern in shares that sees strength from November - reflecting the ending of US tax loss selling, a wind-down in new equity raisings, New Year cheer and the reinvestment of bonuses - continue after a brief pause around February into mid-year before weakness from around May to October. This year the weakness was loaded into May.

**The seasonal pattern in US and Australian shares**




Source: Thomson Reuters, AMP Capital

Right now were entering a period of seasonal strength.

## Concluding comments

Being aware of investment cycles, and how they influence ones' investment psychology, is of critical importance for investors. Markets won't stay bad forever and vice versa.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