Where We Are in the Business Cycle – And the Surprising Places That Will Make You Money

It's human nature to complicate things – to make them more convoluted than they need to be.

The stock market – investing – is a case in point.

If you want to succeed – to make money in stocks – you just need to ask (and answer) a single simple question.

What time is it?

Look at the "cycles" the stock market and the economy go through over and over again. Where are we at that particular moment? In other words: What time is it?

As a veteran investor and trader, I've worked my way through countless economic and market cycles. So many, in fact, that I've lost count. (Just like I've *intentionally* lost count of my birthdays.)
As I showed you in a recent ***Inside TradeSmith*** column, I'm constantly studying those cycles and asking the "What time is it?" question.

But I've also learned how relatively easy it can be to answer that "time" question – with some help from *TradeSmith's* deep tool kit.

Today I'm going to demonstrate how you can use those tools to answer that question, and to spotlight some of the moneymaking opportunities I see right now.

4 Phases of the Business Cycle

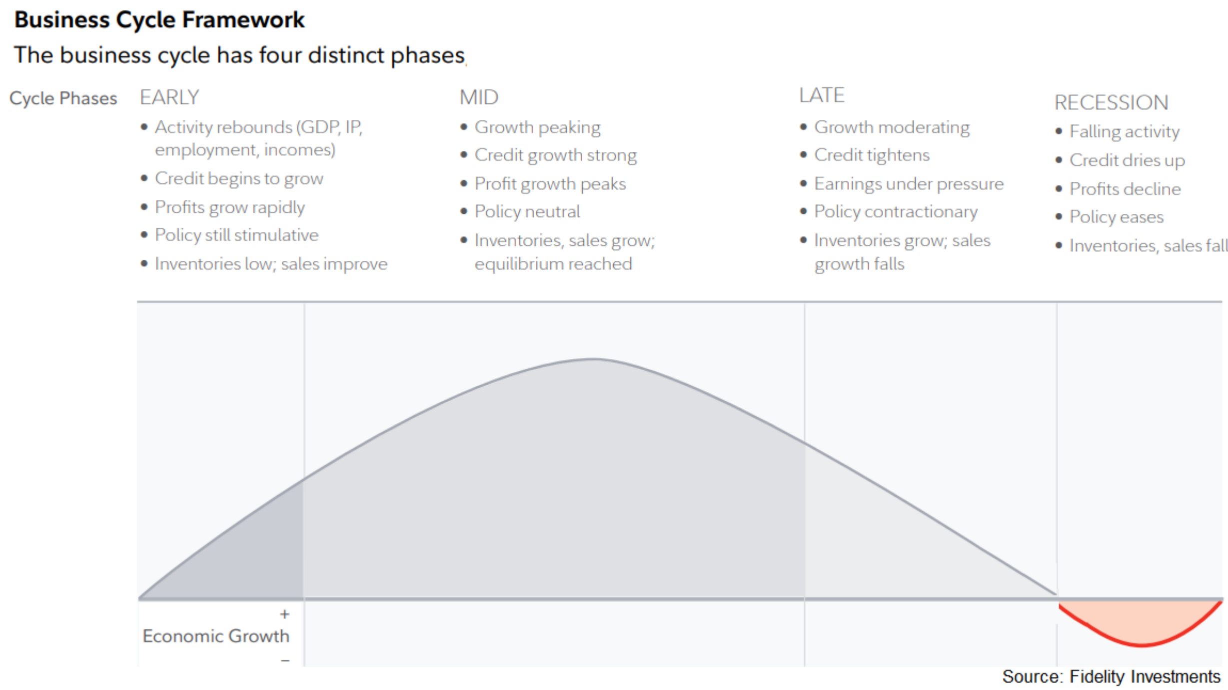
As you know from previous insights, our ***Trade Cycles by TradeSmith*** timing models are based on historical patterns for individual stocks – *and* for the overall market.

In the same way, the business cycle follows predictable patterns based on the strength or weakness in the broad economy.

The key point is this: Fluctuations in our economy can give you valuable clues about which stocks and sectors should beat or lag the market.

And right now, my sector analysis says that we're not where the "experts" say we are.

Probability analysis – our stock-in-trade here at *TradeSmith* – can help you identify the current phase of the economy and business cycle. And that can point you to the best industries to invest in and stocks to buy during that phase.



Here's a quick business cycle tutorial. There are four distinct phases, as described above in a Fidelity Investments chart.

From left to right they are:

Early-cycle phase: The economy is typically recovering from a slowdown or recession. GDP expands – along with corporate sales and profits. Interest rates trend lower.

Mid-cycle phase: Usually the longest phase of the business cycle, this phase is characterized by positive (but moderating) economic growth and healthy business profitability.

Late-cycle phase: Peak economic growth, rising inflation, higher interest rates, and peak profit margins.

Recession phase: Economic and business activity contracts, profits decline, and interest rates trend lower.

Equity sector relative performance has tended to be differentiated across business cycle phases.
Every business cycle is different, and so are the relative performance patterns among equity sectors. While it is important to note outperformance, it is also helpful to recognize sectors with consistent underperformance. Sector investing can help investors position their portfolios for the next business cycle shift.

Sector	Early Rebounds	Mid Peaks	Late Moderates	Recession Contracts
Financials	+			–
Real Estate	++	–	+	– –
Consumer Discretionary	++		– –	
Information Technology	+	+	–	– –
Industrials	++			– –
Materials	+	– –		–
Consumer Staples	– –	–	+	++
Health Care	– –			++
Energy	– –		++	– –
Communication Services		+		–
Utilities	– –	–	+	++
	Economically sensitive sectors may tend to outperform, while more defensive sectors have tended to underperform.	Making marginal portfolio allocation changes to manage drawdown risk with sectors may enhance risk-adjusted returns during this cycle.	Defensive and inflation-resistant sectors tend to perform better, while more cyclical sectors underperform.	Since performance is generally negative in recessions, investors should focus on the most defensive, historically stable sectors.

Note: The typical business cycle shown above is a hypothetical illustration. There is not always a chronological progression in this order, and in past cycles the economy has skipped a phase or retraced an earlier one. Source for sector performance during business cycle: Fidelity Investments (AART).

Economically sensitive stocks – the so-called “cyclical” sectors – typically perform the best (see above) from the early phase through the mid phase of the business cycle as growth expands.

Here you want to think about consumer stocks, basic materials, and technology leadership.

Meanwhile, more defensive stocks and sectors take the lead as the business cycle transitions from late to recession phase. Typically, this means heath care, utilities, and consumer staples stocks are the leaders.

Since 1962, the stock market has given its best showing in the early-cycle phase – with stocks up more than 20% a year on average.

The market performs worse in the late-cycle phase (average gain of 5%), and typically stocks decline (down an average 8.8%) during the recession phase.

So the key question is this: What time is it *right now* in the business cycle.?

It’s not an easy question to answer: As usual, there are conflicting signals.

We're in a Better Phase

Look, the business cycle doesn't always follow a precise pattern, just as the seasonal stock market cycles don't precisely repeat themselves time and again. However, cycles serve as a very good guide of what to expect next.

At times, the cycle can be cut short. What looks like a coming recession can be a "fake out" as the economy re-accelerates.

Right now, there are plenty of CNBC-type pundits who will tell you there's a recession dead ahead.

Rapidly rising interest rates, an inverted yield curve, and negative leading economic indicators all point to a downturn.

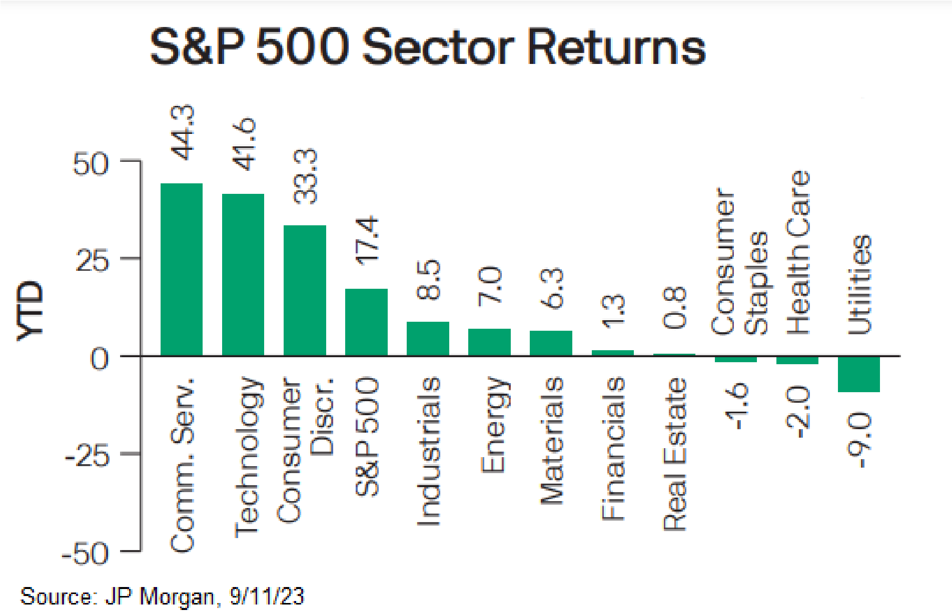
Or do they?

After all, our economy already experienced a significant slowdown in 2022, and the stock market tanked accordingly. Today, however, the economy and corporate profits are expanding again after that 2022 slowdown.

So is it possible that slowdown was "it" for *this* business cycle – meaning we won't get the full-blown recession this time around?

I believe the answer could be "yes, that's a very strong possibility." And it's also possible the current sector leadership in stocks so far this year is telling you so.

Take another look at the typical stock-sector relative performance chart above. Then check out this chart below.



Notice how most of the leading sectors year-to-date are, in fact, the cyclical sectors that typically outperform in an early-cycle phase: I'm talking about Technology, Consumer Discretionary, and Communication Services.

Mind you: This isn't your father's historically conservative communication sector.

The folks at S&P reshuffled the sector index not so long ago. They added more high-growth names – including Facebook-parent **Meta Platforms (META), Netflix (NFLX),** and Google-parent **Alphabet (GOOGL)**.

Old-school and slow-growth telecom stocks like **AT&T (T)** and **Verizon (VZ)** were drastically reduced in sector weighting. As a result, the Communication Services sector is really a slice of "tech-sector lite."

Also, notice that the Top Two sectors just behind the S&P 500 year-to-date are Industrials and Materials … two more early-cycle winners.

Add it all up and you'll see that what's working right now in the stock market is pretty much *ALL* early-cycle stocks and sectors.

These are the exact type of stocks you would expect to lead the market as the business cycle is re-accelerating, not contracting toward recession.

Mike Burnick's Bottom Line: I believe the business cycle may very well have "skipped a beat" recently. And for *my* money, the current sector leadership in the stock market is proof positive.

The economy jumped from near-recession to the early-recovery cycle, but most folks missed it. But our *TradeSmith* Market Outlook indicators got it right.

So, for *your* money, Technology, Consumer Discretionary, Energy, and Industrials are all in the Health Indicator Green Zone. Meanwhile, defensive sectors including Health Care and Utilities are in the Red Zone.

Now that you know which cycle we're *really* in, let's get to work.

Good investing,

Mike Burnick
Senior Analyst, *TradeSmith*

P.S. As always, if you have any questions or concerns, feel free to reach out to me at **emailmikeburnick@tradesmith.com**. While I can't reply personally to every message, I will respond to shared questions in another issue soon. And be sure to include "Inside TradeSmith" in the subject line.