ABOUT INVESTING

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A short guide to economic cycles

Each season of the year gives us an idea of what to expect from the weather and how to prepare. What's harder to predict are the exact conditions on any given day or the best moment to put away your summer or winter clothes until the seasons turn again.

If you think of an economy as the weather for investors, then an economic cycle represents the rhythm of its seasons. Each usually has four main stages: peak, contraction, trough and expansion. But unlike the seasons, economic cycles typically run over years rather than months and the length of each stage can vary significantly.

1. Peak: this is when an economy hits a high point following an expansion stage. This change is often only clear when looking back after the period and events that took place.

2. Contraction: growth in the economy is going down. For investors, contraction tends to mean lower returns and more ups and downs in prices (volatility). It may take longer to achieve your investment goals than at other times.

3. Trough: the contraction comes to an end before the economy starts picking up again. Like the peak, it's often only clear afterwards.

4. Expansion: the economy is on the up again, recovering from its contraction and growing towards another peak.

Santander Asset Management

Like weather forecasters, investment experts use their professional skills and experience to predict when economic cycles might turn through their different stages. For example, we're widely thought to be due for a peak in the current global economic cycle, following an expansion phase that began after the financial crisis of 2008.

Signs that a peak may be coming can include economic growth beginning to slow down, the potential for inflation beginning to build (leading to rising interest rates) and a sense that the profits companies are making have gone as high as they can for now.

Beyond the peaks and troughs, central banks and governments may take action to try to shorten the length or reduce the impact of contraction phases, or to keep expansion phases going for as long as they reasonably can. Major political events like Brexit, or the forming of a new government with policies that potentially signal a big change in financial direction (as happened in Italy last year), can have an influence on the economic cycles of the countries or regions most affected by them too.

The Brexit effect ...

Many forecasts have been made about the effect Brexit might have on the UK economy, including whether it will trigger a contraction and send the country into recession. So far, its defining feature has been uncertainty and we predict that will continue for some time.

Leaving the EU is just the first stage in a process, with negotiation of trade deals still to come. As global investors hold back to see how the dust settles, some would argue the UK market now looks undervalued, bringing potential opportunity for those prepared to be patient, stay diversified and take the risks involved. We can never be certain of an upside. There's always the risk things go the other way and you get back less than you put in.

Having an awareness of economic cycles may help you prepare for the prevailing investment conditions, but that doesn't make it easier to predict with accuracy how individual investments will perform. Diversification remains important whatever the season.

By spreading your money across different investments, if some don't do well, you could still have money in others that are putting in a stronger performance. It's that balancing effect that helps smooth your investing journey and keep you on track towards your goals.

Investing in a fund can help you to cover both angles. Unless you're in a fund that simply tracks an investment index, professional fund managers will take their analysis of the economic cycle into account in the decisions they make about where to invest. They will also diversify the fund's investments to help meet its objectives.

In much the same way as there's always a chance of rain on a Bank Holiday, investment values can always go up and down, and there will always be the risk that you get back less than you put in. But understanding economic cycles can help you keep perspective on your progress over the longer term, through the harder times as well as the good.

Let’s be clear!

Investment terms explained

Diversification: Spreading your money across different investments to help manage risk.

Index: A way of tracking the overall performance of a basket of individual investments of a similar type. For example, the FTSE 100 index tracks the performance of shares in the 100 largest companies by market value on the London Stock Exchange.

Inflation: Measures the increase in price of selected goods and services in an economy over a period of time.

Volatility: The extent to which the value of an investment fluctuates over time.