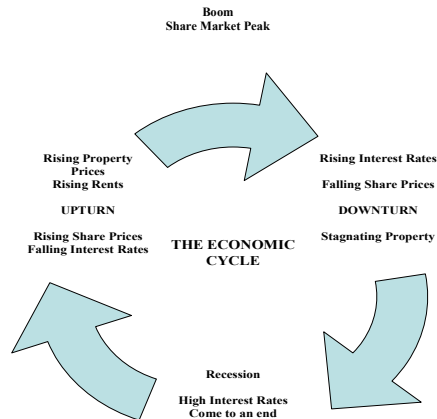


# THE ECONOMIC CYCLE



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How often do we say 'If only I had known that was going to happen', when looking back on our financial decisions. Economic Cycles are a reality of life and an understanding of these can help people in the decisions they make. They are linked very much to the mass psychology of the people, which tends to be a reason as to why we have a roller-coaster type of cycle. This in itself is a warning to be careful who you listen to, when making financial decisions that will affect you and yours for many years to come. Also never ignore your own 'gut' feelings, particularly if the rumble down in the bowels comes with a warning.

I last wrote an article about the Economic Cycle two years when we were in a very different part of the cycle. Then I talked about finance companies failing, real estate slowdown and business failures or retrenchment. These things have come to pass. I believe that this Recession will eventually result in lifestyle habit changes. Our current culture tends to be 'we want it all now and let's borrow against everything to get it'. I think that we are at the beginning of a shift toward a more savings orientated culture and that this recession is the agent of that change. One of the problems to counter this theory is the incessant advertising and urging by banks, finance companies and retail outlets to spend, borrow, spend, which appeals to human weakness and comfort zones. These marketing programmes make out they can help you when all they want is to help them; you are just a number.

An economic cycle has four broad steps or features. However, this is only a basic template, as these steps never unfold in exactly the same way. Also we tend to often have cycles within cycles where a Recession can be much more pronounced, even going as far as a Depression. Similarly the highs of booms in the share and property markets can be more pronounced in different cycles. The way to recovery from a Recession will depend on many factors world-wide, so that no one solution provides a 'fix-all': Nevertheless, as night gives way to day, Recessions never last forever.

## The Steps of an Economic Cycle

### The Recession

Historically, the cycle repeats itself every seven to nine years. Similarly a bigger cycle range can happen every seventy to ninety years, hence the likening of the current Recession to the Great Depression of the 1930's.

The start of a Recession is characterised by high interest rates, lack of consumer confidence and business failure. Businesses are forced to minimise wastage and improve efficiency and productivity. As the economy improves, companies quickly realise those improvements as increased profits. The Share market begins to rise, heralding the start of the Share market cycle. Note that there can be false starts. A number of commentators believe the current recovery is a false start and there is still a rocky road ahead. If this happens then it is likely that the Recession would turn to Depression.

### **The Share market Cycle**

Improved company performances mean investors regain their confidence. This confidence is backed by investors pouring more money into shares accelerating the increase in share values.

The market gains momentum and we then get to a point where all that investor activity and optimism outpaces gains due to good company performances. Share prices get expensive and are not supported by asset backing or earnings. Then oops, there is a reduction in share values, politely called a 'market correction', or when really bad, despairingly called a 'crash'.

This signals the start of the real estate cycle.

### **The Real Estate Cycle**

In recent times the cyclical effect of this has become very apparent. Property increases in popularity as an investment vehicle when people get nervous about share market fluctuations. Also property seems more 'real'. A net positive migration flow helps fuel property prices.

Because property purchases are funded primarily by borrowing, the demand for funds increases. This ultimately fuels the rise in interest rates and subsequently inflation. Hence this rapid growth of the real estate market cannot be sustained once interest rates rise to a level that dampens any enthusiasm for borrowed money.

We are at a point now with interest rates where we have seen the lowest and stop-start rises now lie ahead. Historically NZ borrowing interest rates have averaged close to 7.5% over the last thirty years. Only the longer term rates are above this mark at present, with shorter term and floating rates well below this level. There is now a reasonable expectation that interest rates will increase gradually to peak again around the end of 2011 or into 2012. In that time the OCR could be expected to rise 2.5%.

Unlike the share market, the property market stabilises at the close of a real estate cycle – rather than crashing. This stabilisation of values marks the beginning of the fixed interest cycle.

### **The Fixed Interest Cycle**

Evidenced by boring but steady returns. This is really tortoise stuff (as in the tortoise and the hare). The share market is quiet, interest rates are high and people are put off new property investment. The banks attract investors with their high interest rates and in reality these high rates are propelling us toward another recession or downturn.

The cycle then repeats itself all over again. If we all had long memories, I doubt there would be such a short span between cycles, but then we would be enveloped by longer periods of pessimism or optimism.

### **It is infallible?**

The cycle is not an exact science. It does happen. It is subject to many variables which could make it 'wobble' somewhat, accelerate or delay its effects. It is however a strong guide as to what is likely to happen as certain conditions take place in the market. Sometimes part of the cycle will be weak and sometimes very strong as evidenced by recent years of both share trading and the real estate market. It is perhaps a classic example that history does repeat itself.

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