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Last Week's S&P 500 Index: -1.4%

Stocks and the economic cycle

Key takeaways

- Having an understanding of where we are in the economic cycle helps investors understand what asset classes and sectors are likely to outperform.
- Early in a new cycle, we recommend leaning toward those asset classes and sectors that are most likely to benefit from continued recovery.

Last week we discussed our recommendation to lean toward cyclical sectors of the stock market and away from those sectors that are more defensive. But maybe we were putting the cart before the horse as numerous questions arose asking where we are in the economic cycle and how or why certain sectors tend to outperform or underperform the S&P 500 Index at any given point. We will attempt to address that this week.

The first thing to realize is no two economic cycles are exactly alike. They may “rhyme,” but each has its own set of unique characteristics. It is also worth noting that the economy is different than it was 30 or 40 years ago in that manufacturing and producing “things” makes up a much smaller percentage of the overall economy, which has shifted toward services and digitization. As an example, the Technology sector now makes up nearly 26% of the total market capitalization of the S&P 500 while the Industrials sector makes up only about 9%. Another important thing to think about is the amount of government stimulus that is currently being pumped into the economy to increase everything from consumer and business spending to funding initiatives in the Health Care and Energy sectors. That’s trillions of dollars that will help push economic growth to robust levels this year and likely next as the pandemic eases.

While it is important to have a long-term investment outlook, what happens to equities as the economy moves forward over a six-to-18 month tactical period can add or subtract value (returns). When taking a look at your portfolio, know where you stand in terms of sector exposure and weightings. Are you overly concentrated in more “defensive” sectors that are less sensitive to the ebb-and-flow of the economy? That probably isn’t a good idea early a new cycle as the economy recovers and investors are seeking more risk. That is a prime reason why we are currently rating the Utilities and Consumer Staples sectors as most unfavorable. Investors tend to hide in these defensive sectors since consumers use their services and products whether the economy is good or bad. These sectors are typically favored late in a cycle as growth slows.

But we are early in a new cycle now, and the economy has quickly rebounded from the deep pandemic-induced recession of last year. For us, that means we want to lean toward asset classes and sectors that should continue to benefit from the rebound. U.S. small caps and emerging market equities along with sectors such as Industrials, Materials, and Financials all benefit from improving consumer and business demand, lower unemployment, and large amounts of government fiscal stimulus. We currently rate these asset classes and sectors as favorable, to a large extent because we are early in a new post-recession economic cycle.

Understanding where we are in the cycle helps investors focus on those asset classes and sectors that are most likely to benefit from the economic environment that lies ahead over the next six to 18 months.

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