

This essay will discuss a number of issues which contribute to stock market cycles, generally; and will present information about the current level and recent trends in the stock market, aiming to connect the current performance to the cyclic contributors.

Market influences

Markets rise and fall for a variety of reasons, with some factors encouraging investment and others discouraging it. In general, a healthy, growing economy and a stable political situation provide an environment in which stock markets gain value. Similarly, a period of rising interest rates may give the bond markets a boost, and a period of political and economic uncertainty may drive money into short-term cash equivalent investments, such as U.S. Treasury bills.

As with any other commodity, supply and demand are the greatest contributors to the price of a stock at any given time, but there are a number of other factors which can generate more long range cycles or "fluctuations". The Web site "Path to Investing" (2006), presents information about the following factors that influence market cycles:

- **Asset class styles**
    - Each of the traditional asset classes — stocks, bonds, and cash — tends to produce its strongest returns under different market conditions than the other asset classes do. Stock and bond markets react differently to some of the same factors. Positive impacts on stocks, such as interest rate or tax cuts, for example, can have a concurrently negative impact on bond markets; conversely, certain factors which may be beneficial to bond markets, such as interest rate or tax increases, international conflicts, pending elections, high unemployment, or a tight money supply, will often have an adverse effect on stocks.

  - Stocks often shine when corporate earnings are strong and financial markets are expanding. Yet this same environment frequently has the opposite effect on bonds, so that they provide lower than average returns. On the other hand, bond returns often rise in a period when stock values drop. That may happen when interest rates go up or when corporate earnings do not meet investor expectations.

- **Corrections**
  - Sometimes stock prices stabilize and do not move noticeably up or down for a period of time as brief as a few weeks or as long as several years. And sometimes prices drop rather suddenly before they recover and begin to move higher again. If the major market indexes drop 10%, the drop is considered a correction.
  - Corrections tend to be cyclical, sometimes occurring one a year and sometimes only once or twice in a decade. Typically, the market has rebounded relatively quickly after these events, sometimes even regaining lost ground within a few months.
- **Investor Sentiment or Psychology**
  - The markets, especially stocks, can drift far from both the current economic and fundamental valuation pictures. Fear and greed are two significant forces that can drive stock and bond prices to extremes.
  - During the technology bubble of the 1990s demonstrated that investors can drive markets beyond reasonable values. A speculative bubble is a period when stock prices rise to unsustainable levels, driven primarily by investor optimism. When the bubble bursts, as it did with technology stocks in early 2001, investors sell and prices drop dramatically. Past evidence demonstrates that stock prices overall

eventually readjust to levels that are more in line with their actual value — and more in line with historical norms.

- Rumors or speculation and current events can greatly influence the market. While investors and analysts decide whether a stock is worth buying by examining the financial health and profit history of a company, they also look at how news events can influence stock prices by their effect on supply and demand.

- **Cyclical investments**
  - Cyclical behavior is not limited to the markets as a whole, or even to specific asset classes. Certain individual stocks follow predictable patterns, as stocks prices in specific sectors of the economy do. These recurring fluctuations are determined by how closely a specific sector or investment's performance is tied to what is happening in the overall economy.
  - Cyclical stocks typically flourish in good economic times and suffer during downturns. Airline stocks, for example, tend to lose value when business and pleasure travel is cut back and their corporate earnings fall. But when the economy recovers, earnings tend to rise and the stock prices tend go up. On the other hand, defensive, or countercyclical stocks, in industries such as utilities, drugs, healthcare and food, are often more resilient in recessions and stock market slides — at least theoretically — because demand for their products and services continues.
- **Secular Cycles**
  - The stock market has demonstrated longer-term secular bull and bear cycles. Secular cycles are extended periods with a common trend. In the stock market,

these secular cycles are driven by trends in the Profit-to-Earnings ratio.

- **Industry Factors and Outside Forces:**
  - Richard Weiss (2006), Chief Investment Officer for City National Bank, writes that different events outside a company's control can move the company's stock price up or down. Industry factors that drive stock prices include earnings or sales growth, new product releases, leadership changes, or legislation. World events, new competition, government policy changes, natural disasters, or weather can also affect stock prices.
- **Macroeconomic Factors**
  - Economic indicators such as interest rates, inflation rates, trade balance and currency movements also help determine where the markets are, as well as where they are headed in their cycle.

Current Market levels and Recent Tends:

Is growth back? The Motley Fool seems to think so. According to a recent article on the MF website (Beyers, 2006), a survey of leading investment managers conducted by the Russell Investment Group says the current growth rally will expand and continue into 2007. And Fidelity Magellan manager Harry Lange says growth isn't just good, it's cheap. "I am still convinced that this is the place to be, and if anything over the year, I have been adding even more to growth stocks," Lange told Reuters in a recent interview.

"The buyers have come back, saying this economy is resilient, let's not sell off too much here," said Jay Suskind, head trader at Ryan Beck & Co., in a recent interview with the Associated Press (Read, 2006), noting that traders are looking ahead to economic data to be released during the week ending November 17th. Those reports "should give direction on how the economy looks going forward, and that will create hopefully some certainty in the marketplace," he said.

The cycle slowdown during mid-2006 produced bullishness in the bond market. Bullish sentiment surrounding falling long-term yields is being demonstrated currently by a surge in the net long futures and options positions of Treasury bond speculators. As well, conditions surrounding the stock market currently appear quite favorable. Profits are growing three times faster than the level of long-term bond yields.

This optimism would seem to be due to several factors, claims Mark Sellers (2006), writing in Financial Times.

- First, the valuation on the S&P 500 index has fallen for three years in a row even though stock prices have risen.
- Second, the Fed has done a good job of controlling inflation and telegraphing its thoughts on this subject to market participants. This has increased investor confidence in Fed policy, says Sellers, theoretically lowering the “risk premium” built into stocks. If investors do not have to worry about runaway inflation, the yield on stocks should be higher, thereby removing significant worries about inflation and p/e ratios.
- And finally, American corporations today have the best balance sheets in recent history. Debt-to-equity ratios are quite low by historical standards, free cash flow has soared, and many management teams are operating their businesses for cash flow rather than raw earnings growth. Corporations are using their cash to buy back stock, so simple supply-demand theory would conclude that with fewer shares outstanding across corporate America, and slowly rising investor demand for those shares over long periods, the aggregate p/e ratio should rise. Gordon Fowler (2006), chief investment officer of

Glenmede Trust Company in Philadelphia, notes that the S&P 500's forward price-to-earnings ratio is a reasonable 15.9, even though earnings are at cyclical highs.

- There has also been market reaction to the recent elections; however, according to *Money Week* (2006), the initial aftermath of the vote came not from the currency markets, where the economy's performance and Fed rate policy dominates sentiment, but from the bond market. Bonds rallied on the strength of the Democrats' apparent desire to get to grips with the country's fiscal deficit. In particular, they seek to curtail Republican attempts to keep dividend, capital gains and high income tax cuts alive, and from a less certain outlook for international trade.

Conclusion:

Stock market rallies are followed by spurts in bond yields, followed by stock market pullbacks producing a decline in bond yields, leading to another stock market spurt. Currently the stock market is recovering from its fifth temporary sell-off of the recovery, writes Dr. James Paulson (2006) of Wells Capital Management. Since the bull cycle began in early 2003, says Paulson, a similar cycle has been repeated over and over, and new cycle highs in the stock market should be forthcoming. It is encouraging that in each of the previous four short-term stock market declines, the Standard & Poor (S&P) 500 index eventually rallied to new cycle highs. Should that pattern continue, it could be expected that it will rally again before year's end.

References:

Beyers, Tim (2006). Let the Rally Begin; *Motley Fool- Mile High*; 14 November edition. Retrieved 14 November 2006 from http://www.fool.com/news/commentary/2006/commentary06111408.htm

Fowler, Greg (2006). Market Heading into a Seasonally Strong Period; *Wall Street Journal - MarketBeat*; 13 November edition. Retrieved 14 November 2006 from http://online.wsj.com/article/marketbeat.html

Money Week (13 November 2006). What will Democrat Gains Mean for Markets? Retrieved 13 November 2006 from http://www.moneyweek.com/file/21440/what-will-democrat-gains-mean-for-markets.html

Paulsen, James W, Ph.D. (2006, September). Economic & Market Perspective; Newsletter of Wells Capital Management Group; ppg 1-16

Read, Madlen (2006); Stocks Rise on Economic Data; *Forbes*; 14 November edition. Retrieved 14 November 2006 from http://www.forbes.com/home/feeds/ap/2006/11/14/ap3173806.html

Sellers, Mark (2006); For Now, Stocks Are Your Best Option; *Financial Times*; 10 November edition; Retrieved 12 November 2006 from http://www.ft.com/cms/s/35e94ae8-6d68-11db-8725-0000779e2340.html

Weiss, Richard (2006). What Drives the Markets? Retrieved 27 September 2006 from http://www.cnb.com/wms/insights/What_Drives_the_Markets.asp