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ASSET MANAGEMENT, LLC

synergy **guide**

Cycles

The Financial World of Déjà Vu

One of the most important lessons of investing is that markets move in cycles. Good times are followed by bad times, followed by good times and so on. Within business cycles are sector cycles, within business cycles, sector cycles, within sector cycles are geopolitical cycles. Furthermore, there are seasonal cycles, presidential cycles, and more.

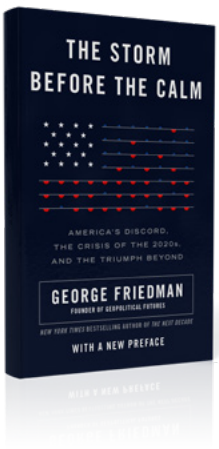
"... insofar as cycles are meaningful, all science that has been developed in the absence of cycle knowledge is inadequate and partial. Thus, if cyclic forces are real, any theory of economics, or sociology, or history, or medicine, or climatology that ignores non-chance rhythms is manifestly incomplete, as medicine was before the discovery of germs."

"THE CASE FOR CYCLES" BY EDWARD R DEWEY

first published by the Foundation for the Study of Cycles in the magazine Cycles in July 1967.

Cycles are a series of events that regularly repeat in the same order. They can be found throughout the natural sciences from biology to climate, hydrology, physics and much more. Human nature often seems hardwired to cycles, with trends moving from one extreme to the opposite.

Geopolitical analyst George Friedman, in his recent book *The Storm Before the Calm*, maintains that today's political hostility, riots and turmoil are the result of the intersection of two major cycles in American history. The first, an 80-year institutional cycle, results in a dramatic change in the way political and social institutions work and the relationship between state and federal governments. The second, a 50-year socioeconomic cycle, results from deep social and economic dislocation and dramatically changes social relationships and economic policy. The 2020s are unique in the history of the U.S. in that both cycles turn over in the current decade.



80
YEAR
institutional cycle

50
YEAR
socioeconomic cycle

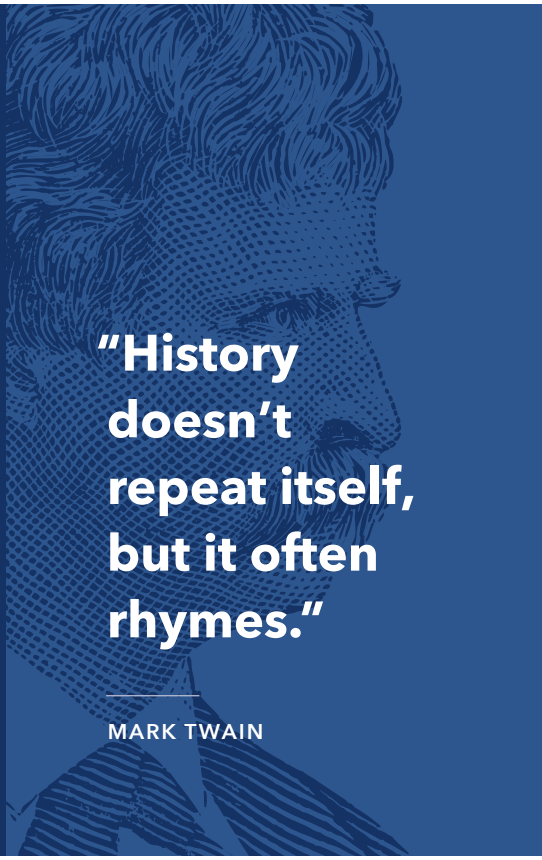
Accepting the cyclical nature of financial markets is the first step to building investment strategies for long-term success.

This time is not different. The cyclical nature of financial markets assures that good times will be followed by bad times.

Cycles seem to inevitably repeat, but not necessarily in the exact same pattern. Duration and severity will vary. Technology may turn leaders into laggards.

Cycles offer the opportunity for both loss and profit.

The study of cycles gives us a window, albeit sometimes a murky one, into the future.



"History doesn't repeat itself, but it often rhymes."

MARK TWAIN

Russian economist Nikolai Kondratiev, using data from the late 1700s through 1920, identified three phases in an average 50-year cycle: expansion, stagnation, recession. His work was published in 1925 in the book *The Major Economic Cycles*. Unfortunately, it earned him a sentence to a Soviet forced labor camp and eventual death for what Joseph Stalin took as criticism of the planned Soviet economy. According to Kondratiev, the stagnation phase is characterized by a lack of good investment opportunities that leads to low interest rates and lowered credit standards, which creates a speculative boom and high debt levels, followed by a crash and financial crisis.

The pendulum ultimately swings too far resulting in every period of expansion followed by a period of adjustment.

The economic or business market cycle drives the equity market, with a variation on the cyclical theme. Equity markets tend to anticipate the business cycle, changing direction before the underlying business cycle. How can investors successfully predict the future? The answer is they can't. But they can study cycles and the trends that make up the cycles

3

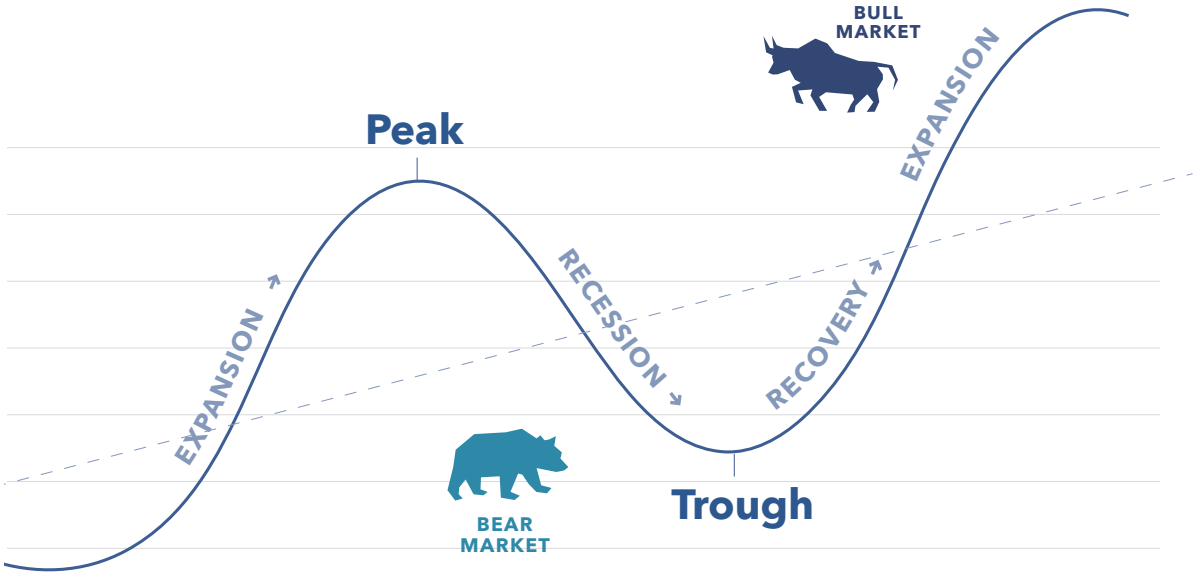
PHASES
in an average 50-year cycle

1. Expansion

2. Stagnation

3. Recession

to change the odds of a correct decision from that of a coin toss, to a knowledge-based expectation that the cycle is beginning to move into the next phase.



Recessions were once considered a natural part of the business cycle. Political aversion to recessions and use of government policy to minimize the potential for a serious recession may be distorting the business market cycle. Many analysts, however, believe it merely pushes the adjustment down the road, when a bigger recession than what was prevented occurs. Tension builds within the cycle until it peaks and reverses direction.

Among the earliest studies of cycles in the financial industry were those of rice traders in Japan. Lacking a defined currency, taxes were collected in the form of rice, making it an important trading commodity. One of the most successful rice traders of the 17th century, developed a tool known today as "candlesticks," which were widely used by Japanese traders by the late 19th century and are still used by technical analysts today.

Among the earliest studies of cycles in the financial industry were those of rice traders.

Each candlestick shows price change over a period of time. The body of the candlestick depicts open and close prices with green indicating a gain in value; while red indicates a loss for the period. The lines above and below the body show the high and low prices for the period.

Dow Theory, developed by Charles Dow in the 1880s, was one of the first cyclical trading strategies to be commonly used in the U.S. Because transportation stocks dominated the market of the time, Dow created the Dow Jones Transportation Index, consisting of eleven transportation-related companies, to track market cycles. (By 1896,

transportation stocks were no longer dominating the market, resulting in the creation of the Dow Jones Industrial Index.) Dow explained his theory in a series of editorials in the *Wall Street Journal*, which he co-founded.

Dow Theory maintains that Bull and Bear markets cycle through three stages. Bull market phases include (1) Accumulation as prices rise and volume increases, (2) Public Participation as retail and average investors join in, and (3) Excess, when experienced investors begin to exit the stock while public participation continues to grow. Bear markets cycle through (1) Distribution as news of the market or investments decline begins to circulate, (2) Public participation as average and retail investors begin existing positions, and (3) Panic or despair when selling continues at scale.

Bull market cycles

1. Accumulation
2. Public Participation
3. Excess

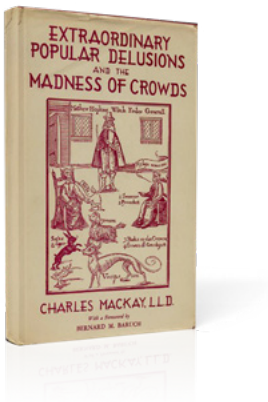
Bear market cycles

1. Distribution
2. Public participation
3. Panic / despair

The Dow Theory phases are reflected in another well-known cycle:

The Investor Sentiment Cycle

People and their reactions have changed little over the history of financial markets. The observations of Charles Mackey in *Extraordinary Popular Delusions and the Madness of Crowds*, published in 1841 still hold true today. The **Mississippi scheme**, the **South-Sea Bubble**, and **Tulipmania** are repeated in the **railroad bust** of 1894, the **Nifty Fifty crash** of the 1970s and the **dot com bust** of 2000.



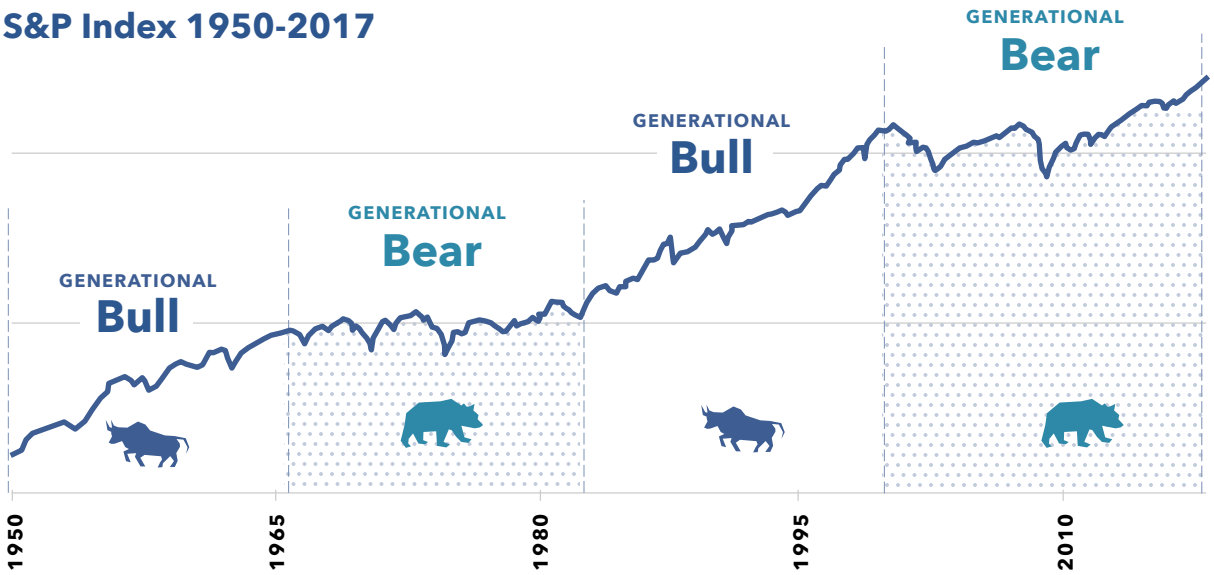
A typical chart of the S&P 500 Index over time shows a "mountain" image, with the market growing at an increasing speed. The problem with the image is that real people don't invest for 70-year timeframes. With luck you might have a 30-year investment time frame, but most likely the bulk of your investment dollars will fall within a 20 to 25-year time span. When you look at the market using a logarithmic scale, long-term cycles of bull and bear markets that can span an entire generation's investment years emerge. Depending on when an investment is made, a relatively static portfolio could do very well or stagnate for years.

TYPICAL INVESTMENT SPAN:

20 TO 25 YEARS

Break down the generational bear or bull market, and smaller cycles emerge where opportunities emerge to capture the majority of the up trends and avoid the majority of the down trends.

S&P Index 1950-2017



A active investor can even step away from the broad market action to look at trends resulting from cyclical human behavior.

Mark Hulbert, editor of the *Financial Digest*, tracks the performance of investment newsletters that use active trading strategies. From his years of data, he maintains that seasonality cycles have often been the most accurate investment approach. Seasonality strategies are based on the historical pattern of equity markets to rise from January until a high point around the beginning of May. The second upswing for the year is often a strong rally that begins in late October and continues through the end of the year. It doesn't happen every year, but the consistency of the trend helps put odds on the investors' side. From this behavior comes the market adage "*Sell in May and go away.*"

"Sell in May and go away."

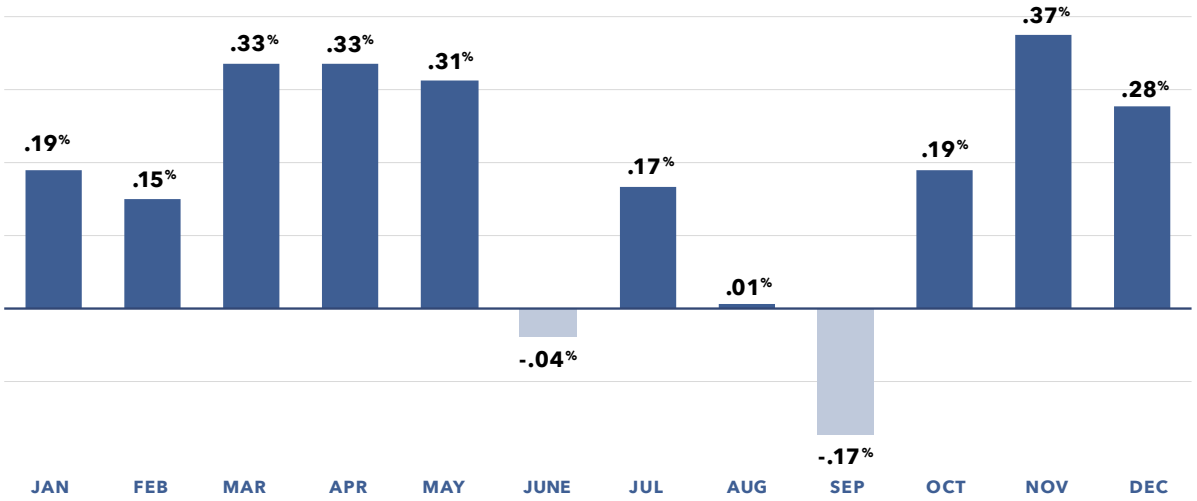
– MARKET ADAGE

These two graphs below contrast periods from 1950-2017 and 1986-2022. While the best performing months show changes, the overall trend remains the same, with the months from June through September underperforming.

January 1986 - December 2022

Source: S&P 500 Index Returns, Yahoo Finance

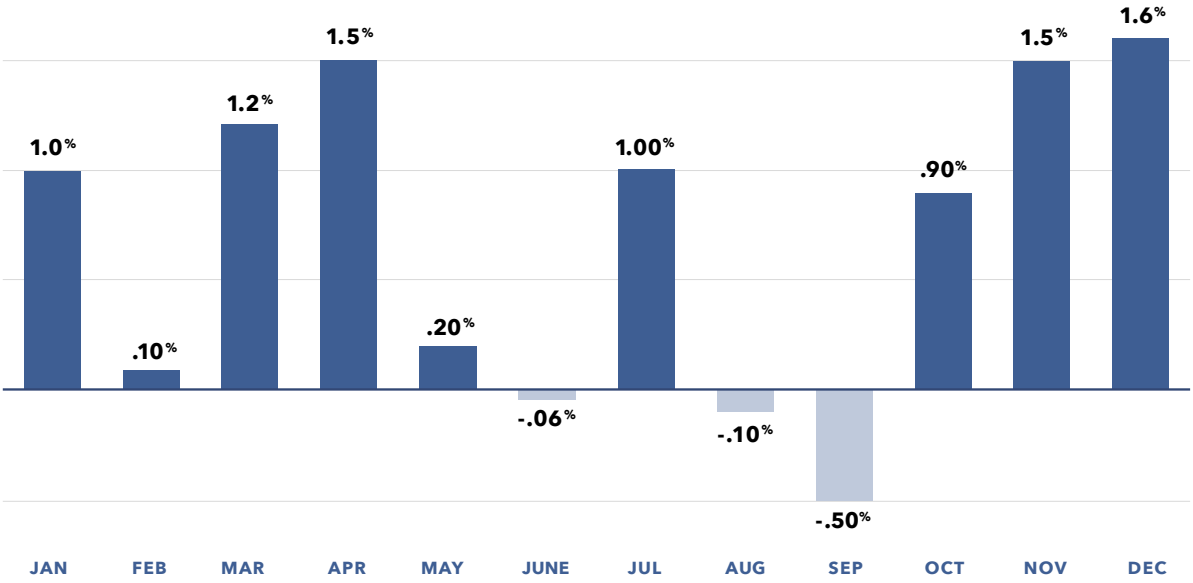
Average Monthly S&P 500 Index Returns



January 1950 - April 2017

Source: Stock Trader's Almanac (2018)

Average Monthly S&P 500 Index Returns



Days matters as well when it comes to seasonality trading. Fridays tend to be the best day to sell stock, particularly before a long holiday weekend. Stock markets tend to rise ahead of an observed holiday.

Another relatively accurate cycle is the four-year Presidential Cycle. In *The Stock Trader's Almanac, 2004*, Yale Hirsch notes that,

"Presidential elections every four years have a profound impact on the economy and the stock market. Wars, recessions and bear markets tend to start or occur in the first half of the term and bull markets, in the latter half.[1]"

The Stock Trader's Almanac 2004, Hoboken, NJ: John Wiley and Sons, (2004): 127

"Thank Joe Biden for Stocks' Bounce—Trump and Obama, Too"

Thank Calendar for Stocks Bounce (Days matter), Season, election cycle have predicted rallies," by Spencer Jakab, Wall Street Journal, January 30, 2023.

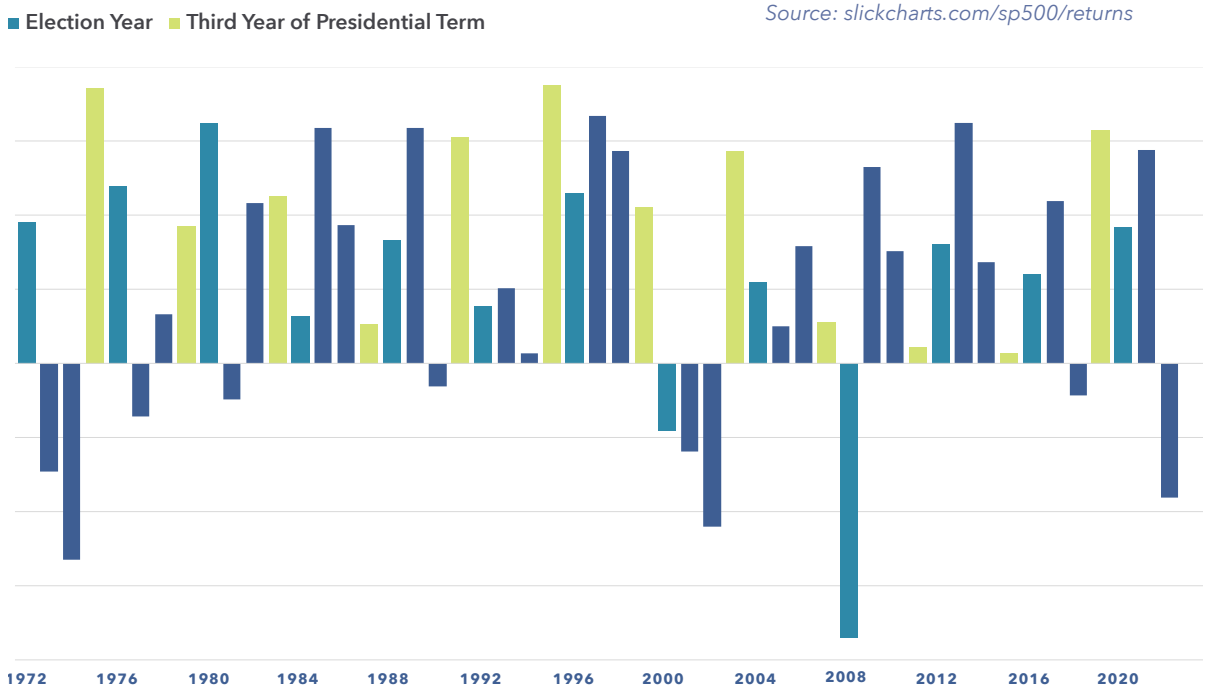
Put together "Sell in May and go away" and the "Presidential Stock Market Cycle," and the return patterns are almost too good to be true.

There are limits to presidential power and to the ability of the party in power to influence the economy. But there is also a strong incentive for individuals in power to do all they can to influence financial markets and the economy to support their party's re-election. Thus, actions that might have a negative impact on the markets are taken early in the term, followed by actions to support strong market prices the nearer the next election. The second year is the worst, and the third is the best, on average.

This thesis seems to fit the Presidential Cycle, which has seen rising stock markets in advance of every U.S. Presidential election since 1952. But the last 20 years show less likelihood that the second year will be the worst year of the president's term, or the third will be the best.

A poor third year tends to result in a change in the Presidential party.

Presidential Cycles 1972-2022



Along with the economic cycles come shifts in public confidence. During the good times, people tend to not want to rock the boat. In difficult times, there is a tendency to look to government for answers. Destroy an economy and dictators rise to power more easily.

The lesson of cycles for investors is the realization that opportunities for profit change, and that the periods of change can span both a relatively long-time period and short periods. Rather than cling to what has been waiting for it to recover, we need to look for investment areas favored by the current cycle. For example: Food manufacturers and retailers are somewhat protected from recessions. While demand for more luxurious or expensive foods may decline, everyone has to eat. Addictive substances such as tobacco tend to be a necessity regardless of costs. Medicine and medical equipment fall under the necessity category and are less impacted by economic cycles, as are utilities. While new construction may languish, repairs and refurbishments expand in tight economies. Frugal nations also have their opportunity to shine.

If we are to look for any lessons on the cyclical nature of economies, it is not to expect quick fixes. Cycles can take time to play out, but eventually economies recover. The key is to limit your losses, keep your capital intact as much as possible and look for opportunities that match

The key is to limit your losses, keep your capital intact as much as possible and look for opportunities that match today's market.

today's market, not the market of five or even ten years ago. Within every long-term cycle have been shorter cycles that offer opportunities for the agile investor.

A prudent investment strategy recognizes that one strategy is not going to excel across all market cycles. The ideal approach is to adapt to the current market cycle and position your portfolio in asset classes with the greatest perceived potential for a given situation. This is why Synergy Asset Management, LLC, offers more than 25 investment strategies designed to help position an investor properly for any part of a market cycle. We want the right offense and the right defense to protect client assets from losses and build wealth across market cycles.

In many ways, our firm functions as the investment advisory firm's Chief Investment Officer, positioning the advisor as their clients' Chief Wealth Advisor. We welcome the opportunity to explain how Synergy facilitates the asset management side of client portfolios providing the advisors with the track record and management capabilities to grow their businesses.

Joseph M. Maas

Chief Investment Officer

CFA, CFP®, ChFC, CLU®, MSFS, CCIM, CVA, ABAR, CM&AA

It all starts with a conversation.

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