



A Market Cycle Primer

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Like many things in life, the securities markets have cycles. Unfortunately, market cycles may be erratic and nearly impossible to predict. A market peak or valley may not be obvious until several months after it happens. So it's important to understand the various cycles and how they affect you as an investor.

No investment is immune

Every asset class – stocks, bonds, money market, real estate – falls victim to cyclical patterns. But different classes usually move in opposite directions. So, when stocks rise in value, bond prices may decline or remain the same. Of course, this isn't always the case.

The same holds true for asset subclasses. For example, large-cap stocks may rise in value at the expense of small-cap stocks or vice versa.

How it happens

What's going on in the world economically and politically may encourage or discourage potential investors and, as a result, affect the markets. Typically, stock and real estate markets do well when the economy is growing. Tax and interest rate cuts, a high employment rate, political stability, and increased corporate profits also generally mean rising stock values.

The opposite can be true for bond markets, which, for example, may do well during times of political uncertainty. Moderate inflation, international

conflicts, a volatile stock market, and a tight money supply often are a boon to bond markets.

Markets react to economic and other conditions in a number of ways:

♦ Corrections . . .

A sudden drop of 10 percent in the major market indexes, such as the Dow and the S&P 500, is considered a *market correction*. After a correction, stock prices tend to more realistically reflect a company's growth and earnings potential. As an investor, you may not be happy about the decline in stock values that a correction brings. Keep in mind, though, that the market often rebounds quickly after a correction.

♦ Crashes . . .

But what happens if the market *keeps* dropping? A sudden drop in stock values of 20 percent or more over a short period of time – accompanied by widespread selling – is known as a *market crash*. The U.S. experienced two major crashes in the twentieth century: a 23% fall over two days in 1929, and a 22.6% one-day fall in 1987.

♦ . . . and Bubbles

And then there's the *speculative bubble*. A bubble occurs when overly optimistic investors drive stock prices to unsustainable levels. Many experts place the late 1990s in this category.

When the bubble bursts and investors begin to sell, stock values plummet. Although it may take a long time and there's no guarantee it will happen, stock prices generally readjust to levels that more accurately reflect their values.

The good news is that the aftermath of a bubble may offer long-term investors an opportunity to buy good-quality stocks at bargain prices.

Another kind of cycle

Investments in certain economic sectors typically experience predictable ups and downs because their performance is closely tied to what's happening in the economy. So-called *cyclical stocks* do well in a strong economy and suffer during an economic downturn. Airlines, housing, and automobile manufacturing are examples of cyclical industries.

Stocks in industries such as pharmaceuticals and utilities are more apt to weather an economic downturn. Why? Demand for their products and services generally isn't tied to the economy.

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