Basic Economic Concepts I

Business Cycles

There are four phases of the business cycle. The business cycle is a naturally occurring rise and fall of economic activity. You must know the order of the phases. The order is expansion, peak, contraction, trough. The National Bureau of Economic Research (NBER) determines business cycle stages.

Expansion

Expansion is also called recovery. This phase follows a trough. It is characterized by an increase in economic activity. There are many different clues to look for in an economic expansion. Keep in mind that not all expansions will see all signs. Generally, in an expansion employment picks up, consumer spending returns, consumer sentiment is positive, businesses begin placing new orders, inventory increases, bank lending grows, GDP increases, temporary staffing increases, new car sales are strong, the stock market rallies, and shipping increases.

Peak

This is the top of the expansion. It occurs when businesses have reached their productive capacity and they cannot produce more goods. The peak is the month when the expansion turns into a contraction. Peak always occurs after a recovery. Peak precedes a contraction, always. The peak is generally not determined until after the economy has begun to contract. Some signs of the peak of an economic peak activity include the height of employment, height of production, and height of consumer spending.

Contraction

Following a peak begins the contraction. Often one of the first signs of a coming contraction is an inverted yield curve, with the interest rates on long-term treasuries lower than mid-term treasuries which are lower than short-term treasuries. With an inverted yield curve the highest yield is found in the short-term treasury. Some of the signs seen in a contraction include an increase in unemployment, a decrease in consumer spending, a decline in production, a decrease in GDP, loss of consumer confidence (sentiment), temporary staffing decreases, new car sales decline, the stock market declines, credit card debt and late payments both increase, and new home starts decrease.

Trough

The end of the contraction, recession, or depression as the case may be, is seen with a trough. A trough occurs when economic activity hits the lowest point, and prices hit a floor. The trough is the month when the economy transitions from the contractions to the expansion phase.

Recession

A recession is defined as at least two consecutive quarters of decline in GDP. A recession is a broad contraction of the economy.

Depression

A depression is defined as at least six consecutive quarters of decline in GDP.

Types of Industries

In general, there are four types of industries: growth, defensive, cyclical, and countercyclical.

Growth
Growth industries represent opportunities for clients to experience appreciation. They are high risk stocks. Growth industries represent an opportunity for your client, but also significant risk.

Characteristics of stocks that represent growth industries include:
- Companies that have low to no earnings
- Companies that pay low to no dividends (not a good source of income for investors)
- Companies that have high price earnings ratios
- Volatile stock prices

Defensive
Defensive industries are those that resist market cycles.

Defensive industries include:
- Alcohol
- Tobacco
- Pharmaceuticals
- Oil and gas, and
- Public utilities

Cyclical
Cyclical industries are those that do well during an expansion and will contract during a contraction. Industry. Cyclical industries are highly sensitive to business cycles and inflation trends.

Cyclical industries include:
- Steel
- Heavy equipment
- Capital goods (home appliances), and
- The auto industry

Countercyclical
Countercyclical investments are viewed by many investors as "safe havens" during an economic downturn. Countercyclical industries expand during a contraction and contract during an expansion.

Countercyclical industries include:
- Gold, and
- Mining stocks

Monetary and Fiscal Policies

There are two main ways the United States attempts to control the economy; through the use of fiscal and monetary policy.

The government manages the business cycle through the use of fiscal policy.

Fiscal Policy

Congress and the President are in charge of fiscal policy. Fiscal policies include changes in tax laws and budgetary changes.

Taxation

Changes to tax rules are an example of fiscal policy. Estate tax exclusion amounts vary from year to year.

Budgetary

The federal government, just like any business, has income and expenses. The government creates revenue in the form of taxes collected and has expenses in the form of government programs, both domestic and foreign. Changes to the federal budget are another example of fiscal policy.

The Federal Reserve

The Federal Reserve also attempts to manage the business cycle. The Federal Reserve uses monetary policy.

Monetary Policy

Monetary policy includes the policies and procedures used by the Federal Reserve to stabilize and guide the economy.

Open Market Operations

The Federal Reserve is in charge of the buying and selling of U.S. government securities.

During an economic contraction, the Fed will engage in a policy of buying U.S. government securities through a process called quantitative easing. When the Fed buys these securities, they inject cash into the economy with the hope of encouraging consumer spending.

During a period of inflation, the Fed will engage in a policy of selling U.S. government securities through a process called quantitative tightening. When the Fed sells these securities, they are taking cash out of the economy, with the hope of reigning in inflation.

Reserve Requirements

Another tool of the Federal Reserve is the reserve requirements for member banks. Reserve requirements are the amount of cash a bank must have on hand in cash. The Federal Reserve does not change the reserve requirements frequently, it is more used as a tool of last resort.

If the economy was in a recession, the Fed could lower the banks' reserve requirements, allowing the bank to lend more money out, since they now are required to have less cash on hand. This is an example of loose monetary policy.

If the economy is in an expansion and the rate of inflation is higher than the Fed desires, the Fed could choose to raise the reserve requirements for banks, requiring the bank to have more cash on hand, which lowers the cash available to be lent out, reigning in inflation. This is an example of tight monetary policy.

Interest Rates

Interest rates are the cost associated with borrowing money. They affect everything from student loans, to auto loans, to mortgages, consumer credit, and the interest paid on debt securities.

Lowering interest rates is done to spur the economy out of a contraction. Lowering interest rates is considered expansionary monetary policy (accommodative/easy money).

Raising interest rates is done to fight inflation.

Federal Funds

The federal funds rate is the most sensitive indicator of interest rate direction. It is the interest rate changed by a member bank to another member bank for an overnight loan to meet the reserve requirement. The Federal Reserve sets a target range for the federal funds rate, but the market sets the actual rate since it is not a loan from the Fed. On March 16, 2020, the Fed set the target range for the federal funds rate at 0-0.25%. In January 2008, the target for the federal funds rate was 3.5%, but by year's end, it was 0.25%.

Discount Rate

The discount rate is set by the Federal Reserve. It is the rate that the Federal Reserve will lend money to a member bank from their "window" for a short-term loan, typically 30 days (in 2020 they extended this loan time period to be up to 90 days). In May 2020, the discount rate was 0.25%. In January 2008, the discount rate was 4.75%. By the end of 2008, the discount rate was only 0.5% (50 basis points).

Prime Rate

The prime rate is an interest rate that is not set by the Federal Reserve. The prime rate is set by commercial banks themselves and can vary from bank to bank and from region to region. A commercial bank's best business client would receive a loan and be charged the prime rate. Banks will adjust prime as the Federal Reserve adjusts the target for the federal funds rate and the discount rate. In May 2020, prime was around 3.25%. In January 2008, the prime rate was approximately 6.98%, but by year's end, it was 3.61%.

Expansionary Policy (Loose)

Expansionary policies are those that are designed to nudge the economy out of a contraction. Expansionary policies include lowering the federal funds rate and discount rate as well as lowering banks' reserve requirements. Buying U.S. government securities in the open market would also be expansionary monetary policy. Expansionary monetary policy puts money into the economy and/or makes money easier to get. All of the expansionary policies are designed to stimulate spending.

Contractionary Policy (Tight)

Contractionary policies are designed to rein in inflation. Contractionary policies include raising the federal funds rate and discount rate, as well as raising banks' reserve requirements. Selling U.S. government securities in the open market would also be contractionary monetary policy. Contractionary monetary policies are designed to make money harder to get and/or pull money out of circulation. All of these contractionary policies are designed to tame the flame of inflation.

Principal Economic Theories

Macroeconomic theories attempt to explain and predict economic activity, as well as provide solutions for economic issues within our economy.

Keynesian Economists
Keynesian economists believe that lower levels of taxation and higher government spending can get the U.S. out of recessions.

Classical Economists
Classical economists believe that the less government regulation, the better, a laissez-faire approach. They believe in the efficiency of free markets to generate economic development.

Monetarists
Monetarists believe that the quantity of money in circulation determines overall price levels and economic activity and can be used to help the U.S. rise from a recession.

Supply-side Economists
Supply-side economists believe that economic growth can be most effectively created by lowering taxes and decreasing regulations.

Yield Curves

There are various yield curves. The one the examination is concerned with is the yield curve of U.S. government securities, beginning with the 1-month treasury bill, through the 30-year treasury bond.

Normal
With a normal yield curve, the yields increase as the time to maturity increases. The lowest yields are found on the short-term debt and the highest yields on the treasury bonds. A normal yield curve is also called a positive yield curve.

Flat
With a flat yield curve, all of the yields are about the same.

Inverted
In an inverted yield curve the lowest interest rates are on the long-term debt and the yield on the short-term debt is highest. An inverted yield curve is also called a negative yield curve. A negative yield curve is often a precursor to an economic contraction. An inverted yield curve can be the result of high current demand for money relative to supply. It may also be caused by a sharp increase in short-term interest rates, with the expectation that they will come down in the near term.

Remember the relationship between interest rates and yields. If interest rates go up, yields go up too! If interest rates go down, yields go down too!

Credit Spread

The difference between the yields of U.S. treasuries versus corporate debt of the same maturity is called the credit spread (yield spread). It is measuring the additional cost corporations must bear to borrow money in the current market. The bigger the difference is, the worse it is. A widening of the yield spread often signals rough times ahead. If the yield spread should narrow, this is generally a welcome sign of positive economic activity ahead.