How to Read The Winds of Change

Like the weather, the economy has its seasons. But the economic seasons aren't exactly like those of the calendar. For starters, the phases of the economy, or business cycle, tend to be of unequal duration. (Happily, the periods of growth historically have lasted longer than the periods of decline.) It is often difficult to tell, until months later, when one phase is over and another has begun. Overall periods of growth can contain temporary stretches of decline, and vice versa. And complete cycles have lasted from eight months to as long as eight years. Keep in mind, as well, that past performance does not guarantee future trends and results.

There are, however, some trends that historically have indicated which economic season is blowing toward us or is already upon us. Let's examine a few of these indicators, along with their effects on typical retirement plan investments.

A slowdown might be on the way if inflation is up and several powerful economic weather-makers are down. These include auto sales, housing starts (the total number of building permits issued) and durable goods orders (the total dollar value of all goods that have a useful life of three years or more, such as electrical machinery). In response to one or more of these downward trends, the Standard & Poor's 500 and other stock market indexes sometimes start to fall three to six months *ahead* of a recession.

You might be in a recession when the nation's total value of goods and services, known as the Gross Domestic Product (GDP), declines for two consecutive quarters, or half a year. (In a depression, collapsing businesses and severe unemployment bring the economy to a prolonged slump.)

A recovery might be in the air if industrial production (the total output of factories, mines, and gas and electric utilities), durable goods orders and the GDP stop going down and begin to rise. The S&P 500 or other financial market indexes sometimes start to rise three to six months *ahead* of a recovery.

You might be at a peak when the GDP is up by almost 6%. What kinds of investments historically flourish in each economic season? Bond funds, which increase in market value as interest rates and inflation decline, have usually done well going into a recession, when the Federal Reserve usually lowers interest rates to get the economy growing again.

Stock funds have often done well toward the end of recessions, in anticipation of better economic weather. They also may rise during the start of a recovery, at the start of a peak or whenever low interest rates and low inflation take a smaller bite out of corporate profits.

With this information in mind, you may be tempted to try to predict the economic seasons and move your retirement money around to take advantage of expected weather fronts. However, betting your retirement funds on your forecasting talent (when even the best professional economists are often wrong) and on your ability to move your funds at precisely the right moment is extremely risky.

What may be less risky is believing that the economy, even with its ups and downs, will continue to grow over the long haul, because that's what the overall trend has historically been since World War II. That's why it's best to develop a diversified portfolio and stick with it. In the short run you may miss some chances for profit, but in the long run you may ride some very favorable winds.

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