CYCLICAL STOCKS

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As individual we all experience ups and downs in our personal and professional life.

Sometimes even an emotional roller coaster ride that you can't quite imagine.

But the ones who show resilience and patience are the ones who can overcome with flying colours.

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In the same way, as the economy goes through numerous ups and downs so does some companies and sectors.

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- These companies who move in tandem to **business cycles** (expansion or recession) are termed as **cyclical stocks.**

- Profits and share prices of cyclical companies tend to follow the up and downs of the economy; that's why they are called cyclicals.

- When the economy booms, sales of cars, air tickets, homes etc tend to increase. On the other hand, cyclicals are prone to suffer in economic downturns.

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Let us consider an example.

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- **Suppose the economy is booming and income levels are rising, then more and more people will be willing to purchase homes. This will result in more construction activity and home prices are also likely to rise. As a result, companies in the business of construction and selling housing properties will see an increase in their profits and share prices.**

- **Contrary, if the economy is slow, less people are likely to invest in the housing market and share prices in the stock market of these construction companies will also suffer in line with lower profits.**

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However, not all businesses are dependent on economic cycles.

Companies operating in the business of basic consumer goods don't get affected since demand for their products and services continue regardless of the state of the economy.

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For instance, if the economy slows down and, as a result, consumer confidence takes a hit, people may postpone or cut expenditure on discretionary spending such as buying a new car, traveling abroad or buying luxury item but they may not cut expenses on essential items such as toothpaste, electricity, healthcare etc.

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Therefore, companies in the business of producing and selling basic consumption goods are least affected by economic cycles. Shares of such companies are termed as non-cyclical or defensive stocks.

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Cyclical stocks can be classified under two categories.

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- **Rate Sensitive Sectors – These are the businesses which are primarily affected by the interest rates prevailing in the economy and thus any contraction or expansion in economy consequently affects them. Auto companies, banks and capital goods fall under this category.**

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- **Commodity Based Sectors** – Earnings and cash flow of these businesses are dependent on the demand & supply of their products/raw materials.

  During expansion, there is increase in demand, resulting in business expansion; whereas in the times of recession, the demand gets subdued, leading to business contraction. Metals, mining, sugar, cement companies etc follow these patterns.

So, how do you identify

a cyclical stock?

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- Before selecting a cyclical stock, it makes sense to pick an industry that is due for a revival. Declining interest rates and growing consumer spending signals towards the economic expansion. Then, in that industry, choose companies that look especially attractive.

- Predicting an upswing can be extremely difficult, especially since many cyclical stocks start doing well many months before the economy comes out of a recession. Buying requires research and courage. On top of that, investors must get their timing perfect.

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- It pays to keep an eye on the business cycle and know where it is and where it is going. For conservative investors non-cyclical stocks many of which also pay good dividends may make more sense while building a portfolio.

- However, keep in mind that this relative safety comes with a price and that is missing growth opportunities in an up market.

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Hope you have understood the concept of Cyclical Stocks.

Thinking of Investment

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