Investing in Cyclical Stocks

Description

A cyclical stock is one whose underlying business is more sensitive to economic trends and cycles. In general, when the economy is going through a recession, as we saw during the COVID-19 pandemic, cyclical stocks tend to perform poorly. Conversely, when the economy picks up, cyclical stocks tend to rebound, performing better as the economy gets stronger.

Like other types of stocks, cyclical stocks can have a valuable place in your investment portfolio, as they thrive during periods of expansion. If you're thinking about buying some cyclical stocks, here's what you should know about investing in them.

What is a cyclical stock?

Cyclical stocks tend to move with the overall economy. That is, if the economy expands, cyclical stocks tend to expand with it. Likewise, when the economy contracts, or goes through a recession, cyclical stocks tend to lose their value.

The reason is that the underlying business of a cyclical stock usually sells products and services that consumers don't need, but want. Leisure, luxury, travel, entertainment, and retail: these are all cyclical industries that rely heavily on disposable income. When people have money to spend, when the economy is performing well and growing, they typically buy more non-essentials.

The reverse is true, too: as the economy retracts, people are tighter with their budgets, and the companies that sell non-essentials experience a rapid decline in sales and revenue.

Investors often see cyclical stocks as more volatile than non-cyclicals (also called "defensive" stocks), since they experience significant price movements during periods of economic weakness.

But the volatility of cyclical stocks isn't always negative: during periods of economic strength, cyclical stocks can outperform the market, bringing investors hefty gains that non-cyclical stocks don't often achieve.

What are some examples of cyclical stocks?

Because Canada has a strong selection of bank, financial, and materials stocks, we have a fair number of cyclical companies. To help you get a good grasp of cyclicality, here are three well-known companies that follow economic cycles.

1. Suncor Energy

Oil stocks in general can be extremely volatile, and **Suncor Energy** (TSX:SU) is no exception. In a robust economy, consumers are more inclined to travel and buy gas, whereas in a weaker economy, they're less likely to travel by car or air. That makes Suncor Energy more cyclical than, say, utility companies, which people almost always need.

2. Air Canada

Air Canada (TSX:AC) is the largest international airline in Canada, but that doesn't protect it against cyclicality. Consumers are less inclined to buy airline tickets when their budgets are tighter. Likewise, during strong economic periods, consumers will travel more by air.

3. Magna International

Magna International (TSX:MG) is an auto parts maker whose revenue depends on the sale of cars. While people will always buy cars, whether the economy is strong or weak, they are usually less inclined to buy *new* cars during tough economic times. When such times occur, Magna International typically sells fewer parts, and therefore makes less revenue, and experiences a decline in the value of its stock.

Which industries are cyclical?

In general, an industry is considered "cyclical" when it depends heavily on a consumer's disposable income for revenue. Here are just a few examples:

- **Airlines and hotels:** For many consumers, travel isn't a necessity. It's a luxury. When times are good, people are more willing to purchase airline tickets and pay for hotel rooms. Of course, the converse is true, too. As the economy contracts, people don't have money to travel, and these companies often suffer a loss in revenue.
- **Automakers:** You may think of your car as a necessity. And, in truth, for many people, cars *are* a necessity. But that's not to say consumers will purchase new cars during a recession. The reluctance to take out car loans during lean times—the willingness to drive beaters or older models until the economy gets better—makes auto stocks cyclical.
- **Banks:** During recessions, banks often lose money. For one, interest rates are typically lower, which hurts a bank's ability to earn revenue. You may think low interest rates would draw more consumers to banks, but the reverse is true: during lean economic times, consumers are less likely to borrow money, which makes bank products—like mortgages, credit cards, and

loans—less profitable.

- **Restaurants:** People have to eat, true, but they don't have to eat at restaurants. When the economy is strong, consumers are less hesitant to spend money at restaurants, whereas recessions often force them to buy only what they need at the grocery store.
- **Retail:** Retail stocks are a mixed bunch, but, for the most part, they are cyclical. The only retail stocks that aren't cyclical are those that sell products that people actually need. For example, **Costco** is a retailer that performs fairly well during recessions, as people still have to buy food.
- **Textiles and apparel:** Again, consumers are more hesitant to spend money on clothes, not to mention luxury clothes and apparel, when the economy is weak.
- **Technology:** Like retail, tech stocks tend to be more cyclical, though there are exceptions. For the most part, however, consumers are less inclined to buy new smartphones and the latest gadgets when they're stressed about money.

What are the pros and cons of cyclical stocks?

Perhaps the biggest advantage of cyclical stocks is their ability to grow immensely during strong economic periods. While, true, these same cyclicals can contract during recessions, the gains that you can earn during the booms might make the investment worthwhile.

Cyclical stocks might encourage you to try your hand at timing the market, which is almost always a losing battle. Recessions aren't easy to predict—most of the time, we can only name recessions in retrospect—and you might sell your cyclicals before a true economic bust happens.

Should you buy cyclical stocks?

Cyclical stocks are ideal for those investors who have a high risk tolerance. Because cyclicals can be volatile, you would do well to combine them with non-cyclical stocks. That way, you might have downside protection when the economy starts to falter.

If you do want to buy cyclical stocks, the best time to buy them is at the beginning of an economic boom, or on the upward path after a recession. For instance, now might be a good time to buy certain cyclical companies that were negatively impacted by COVID-19, as many are starting to grow once again. That said, it's impossible to time the market. No one knows what will happen tomorrow, whether it will be a boom or a bust, so if you're going to buy cyclicals, you should buy them because you believe in the value of the company, not because it's the "right time."

If you're new to investing, you might want to buy shares in an exchange-traded fund (ETF) that tracks an index of cyclical stocks. In this way, you don't have to handpick individual stocks: with a single share, you'll get a basket of stocks, which will give you diversification, as well as take the heavy load of selecting stocks wisely off your shoulders.

TICKERS GLOBAL

1. TSX:AC (Air Canada)
2. TSX:MG (Magna International Inc.)
3. TSX:SU (Suncor Energy Inc.)

PP NOTIFY USER

1. cleona
2. metienne
3. tmfbwelch

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