Perpetual knowledge bank series: tightening cycle

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A tightening cycle occurs when central banks implement a cycle of interest rate hikes. This course of action is usually undertaken to slow down overheated economic growth, to constrict spending in an economy, or to curb inflation when it is rising too fast. By boosting interest rates, a central bank increases the cost of borrowing and effectively reduces its attractiveness.

Typically, easy or 'loose' monetary policy and consumer confidence push stock prices up and GDP higher because growth in borrowing and spending translates into growth in transactions and incomes. A central bank will then consider tightening financial conditions. For example, Baby Boomer spending played a large part in driving the US inflation of the 1970s that led to the Volcker tightening cycle. Closer to home, the RBA took the cash rate to 6.75 percent in 2007 as part of a tightening cycle to combat the inflation resulting from an economic boom.

For investors, the prospect of a tightening cycle should not be alarming, and any selloff may indeed provide an attractive entry point into the market. Slower economic and earnings growth, exacerbated by tighter fiscal and monetary policy, suggest a more defensive approach, which could mean considering high-quality, large-cap stocks.