COURSE: INVESTMENTS |CHAPTER 12

MACROECONOMIC AND INDUSTRY ANALYSIS

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Chapter Purpose

This chapter explains how broad economic conditions and industry characteristics influence company earnings, interest rates, security prices, investment risk and portfolio performance.

What it influences

- Company earnings
- Interest rates
- Security prices
- Investment risk
- Portfolio performance

Macro focus

- Business cycles
- Inflation and interest rates
- Monetary and fiscal policy
- Exchange rates
- Economic indicators

Industry focus

- Industry analysis
- Industry life cycle
- Competitive forces
- Sector rotation

The macro-to-micro funnel: broad economy narrows to industry, then to the individual company.

Learning Objectives

By the end of this chapter, students should be able to:

- Explain top-down investment analysis
- Identify major macroeconomic variables
- Explain GDP and economic growth
- Describe the business cycle
- Explain inflation and its investment effects
- Explain interest-rate effects on securities
- Explain monetary and fiscal policy

- Analyze exchange-rate effects
- Interpret major economic indicators
- Explain industry analysis
- Describe the industry life cycle
- Apply competitive-industry analysis
- Explain sector rotation
- Connect macro and industry analysis to investment decisions

What Is Top-Down Analysis?

Top-down analysis begins with the broad environment and moves toward individual securities.

Step 1 — Analyze the economy

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Step 2 — Analyze industries

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Step 3 — Analyze companies

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Step 4 — Select securities

Why Start With the Economy?

The economy influences

- Consumer spending
- Business investment
- Interest rates

- Corporate profits
- Employment

- Inflation
- Exchange rates

Economic conditions affect the investment opportunities available to firms and investors.

Economy Before Company

You own the best hotel in town

Excellent management, strong reputation, well-maintained property.

But the environment changes

- Tourism collapses
- Income falls
- Travel restrictions increase

Even a good hotel may struggle.

> ***Company performance depends partly on the environment in which it operates.***

Why the Global Economy Matters

Modern businesses may depend on international connections far beyond the domestic market.

- **Foreign customers**
- **Imported materials**
- **International finance**
- **Global supply chains**
- **Foreign currencies**
- **Commodity prices**

Investors should not analyze only the domestic economy.

Global Economic Linkages

A slowdown in one major economy can affect:

- Exports
- Commodity prices

- Exchange rates
- Global demand

- Investor confidence
- Capital flows

Key principle: markets are increasingly interconnected.

What Is GDP?

Gross Domestic Product (GDP) is the total market value of final goods and services produced within an economy during a specified period.

A major measure of economic activity

Industrial production

Services output

Consumption

Why GDP Matters to Investors

Economic growth can influence

- Sales
- Earnings

- Employment
- Tax revenue

- Investment spending
- Credit demand

Generally, rising GDP growth may support stronger corporate revenues — but effects vary across industries.

Nominal vs Real GDP

Nominal GDP

Measured using current prices. Includes the effect of price changes.

Real GDP

Adjusted for changes in the general price level. Reflects volume of output.

For economic-growth analysis, investors often focus more on real GDP growth.

GDP Growth Rate

Conceptually:

$$\text{GDP Growth} = (\text{GDP}(t) - \text{GDP}(t-1)) \div \text{GDP}(t-1) \times 100$$

Example

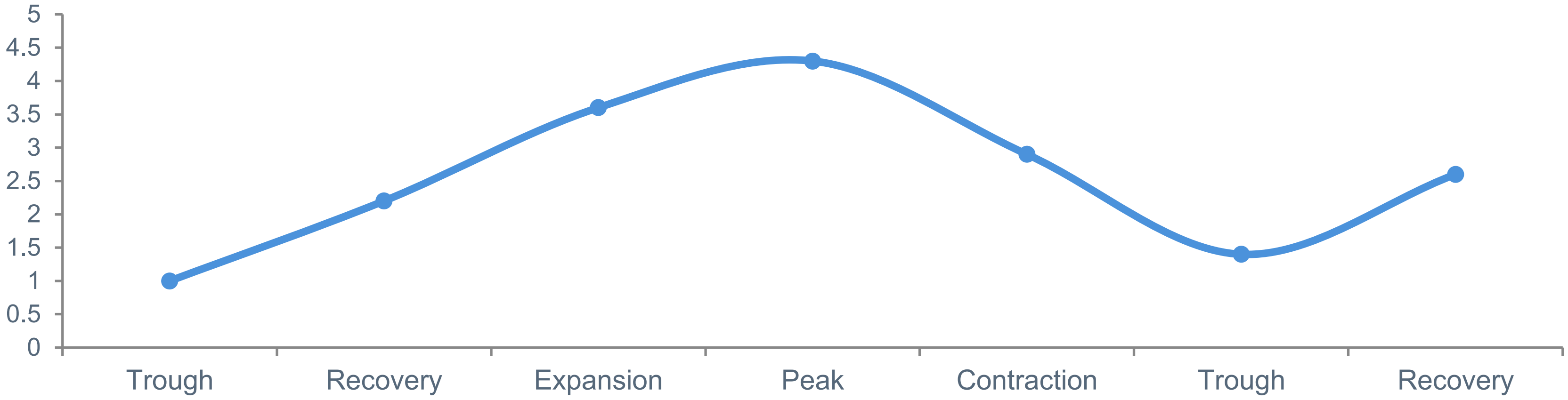
- Previous GDP = ETB 1.00 trillion
- Current GDP = ETB 1.08 trillion

Result

Growth = 8%

What Is the Business Cycle?

Economic activity does not normally grow at a constant rate. It tends to move through repeating phases.



Phases: expansion, peak, contraction, trough, recovery.

Expansion

During expansion

- Production rises
- Employment improves
- Consumer spending increases

- Business investment rises
- Corporate profits may improve

Potential beneficiaries may include cyclical industries.

Economic Peak

At or near a peak

- Growth may be strong
- Capacity utilization may be high
- Inflation pressure may increase
- Interest rates may rise

> ***Investors may begin anticipating slower future growth.***

Contraction

During contraction

- Economic activity declines
- Sales may weaken
- Unemployment may rise

- Profits may decline
- Credit conditions may tighten

Cyclical companies may be particularly exposed.

Trough and Recovery

At the trough

Economic activity is relatively weak.

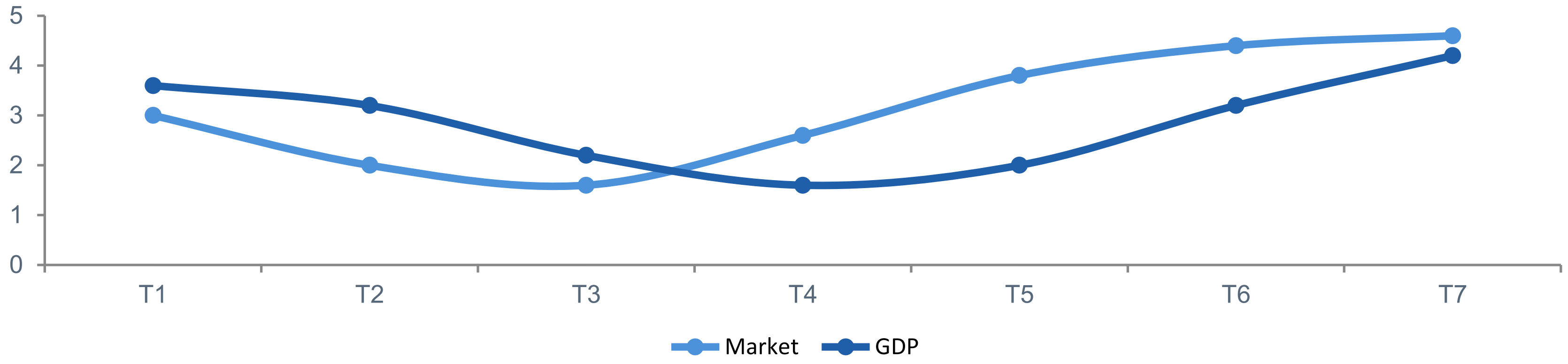
During recovery

- Demand begins improving
- Production rises
- Business confidence improves
- Earnings expectations may increase

Markets may react before economic data fully recover.

Markets Are Forward-Looking

Security prices reflect expectations about the future — the market line tends to lead the GDP line.



> ***Markets may rise before recovery is official — and decline before a recession becomes obvious.***

Cyclical Industries

Cyclical industries are strongly affected by economic conditions.

- Construction
- Automobiles
- Travel
- Luxury goods
- Capital equipment

During expansion

Demand may rise strongly.

During recession

Demand may decline sharply.

Defensive Industries

Defensive industries tend to experience relatively stable demand across economic cycles.

- **Basic food**
- **Utilities**
- **Essential healthcare**
- **Basic consumer products**

Why? Consumers still need many of these products during downturns.

Cyclical vs Defensive

Cyclical	Defensive
Sensitive to the economy	Less sensitive
Higher earnings variability	More stable demand
Strong in expansions	Relatively resilient in downturns
Examples: autos, travel	Examples: utilities, staples

Visually: a cyclical earnings wave against a comparatively flat defensive line.

What Is Inflation?

Inflation is a sustained increase in the general price level.

As inflation rises, the purchasing power of money falls

> ***The same amount of cash buys fewer goods and services over time.***

Why Inflation Matters to Investors

Inflation affects

- Real investment returns
- Interest rates

- Company costs
- Consumer purchasing power

- Bond prices
- Valuations

Important: a positive nominal return can still produce a poor real return.

Inflation and Bonds

Higher expected inflation

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Investors demand higher nominal yields

▼

Market yields rise

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Existing bond prices fall

Therefore, unexpected inflation can hurt many fixed-income investors.

Inflation and Companies

Inflation can raise

- Wages
- Raw-material costs

- Transportation costs
- Financing costs

Companies with strong pricing power may be better able to pass costs to customers.

— Pricing Power

Suppose an input cost rises by 20%.

Company A

Can increase prices without losing customers.

Company B

Cannot raise prices; margins absorb the cost.

Company A is better positioned — pricing power can protect profit margins.

Why Interest Rates Matter

Interest rates affect

- Bond prices
- Borrowing costs
- Investment spending

- Consumer credit
- Housing

- Company valuation
- Currency flows

Interest rates are therefore central to investment analysis.

Interest Rates and Bonds

Rates ↑	Rates ↓
Bond prices ↓	Bond prices ↑

The price–yield relationship behaves like a seesaw: one side rises as the other falls.

> ***Longer-duration bonds generally react more strongly.***

Interest Rates and Stocks

Higher interest rates can affect equities because:

- Borrowing costs increase
- Profit may decrease
- Discount rates rise
- Present value of future cash flows falls

> ***Growth companies with distant expected cash flows may be especially sensitive.***

Interest Rates and Business Investment

When borrowing becomes expensive, companies may postpone:

- **Expansion**
- **Equipment purchases**
- **Construction**
- **Acquisitions**

> ***Therefore, higher rates may slow economic activity.***

What Is Monetary Policy?

Monetary policy refers to actions taken by a central bank to influence financial and economic conditions.

Interest rates	Money & credit conditions	Inflation	Economic activity

Transmission path: central bank → interest rates → credit → the wider economy.

Expansionary Monetary Policy

Expansionary policy generally seeks to stimulate economic activity.

Lower policy rates

▼

Lower borrowing costs

▼

More spending and investment

▼

Higher economic activity

Restrictive Monetary Policy

Restrictive policy generally seeks to reduce inflationary pressure.

Higher interest rates

▼

More expensive credit

▼

Lower spending and investment

▼

Reduced demand pressure

Monetary Policy and Markets

Changes in expected policy may affect

- Bonds
- Equities

- Banks
- Real estate

- Exchange rates

Markets often react to expectations before actual policy decisions occur.

What Is Fiscal Policy?

Fiscal policy refers mainly to government decisions regarding:

- Taxation
- Government expenditure

- Budget deficits
- Public borrowing

These decisions affect aggregate demand and economic activity.

Expansionary Fiscal Policy

Examples

- Increased infrastructure spending
- Tax reductions
- Higher transfers

Potential effects

- Higher aggregate demand
- More business activity
- Greater government borrowing

Restrictive Fiscal Policy

Examples

- Spending cuts
- Tax increases
- Deficit reduction

Possible effects

- Lower aggregate demand
- Slower growth
- Reduced government borrowing

Actual outcomes depend on prevailing economic conditions.

Why Exchange Rates Matter

Exchange rates affect firms that:

- Export goods
- Import materials

- Borrow in foreign currencies
- Earn foreign revenue

- Compete with foreign companies

Currency movements act on revenues, costs and debt at the same time.

Currency Depreciation — Exporter

Suppose a domestic exporter earns USD revenue while many of its costs are domestic.

Domestic currency depreciates

▼

Foreign earnings convert into more domestic currency

▼

Reported domestic-currency revenue may rise

Potentially positive — but not always.

Currency Depreciation — Importer

Suppose a company imports fuel, equipment and raw materials.

If the domestic currency depreciates, import costs rise

> ***This can reduce profit margins unless prices can be increased.***

Foreign-Currency Debt

Suppose a company earns domestic currency but owes USD 10 million.

Domestic currency depreciates substantially

▼

Local-currency debt burden increases

▼

Currency risk

Employment

Employment conditions affect

- Household income
- Consumer spending

- Credit quality
- Housing demand

- Business sales

Strong employment can support consumption; high unemployment may reduce demand.

Consumer Confidence

Consumer confidence reflects household expectations about income, employment, the economy and financial conditions.

High confidence

May support spending.

Low confidence

May encourage saving and delayed purchases.

Why Investors Use Economic Indicators

Where is the economy now — and where might it be heading?

Indicators are often classified into three groups:

Leading	Coincident	Lagging

Leading Indicators

Leading indicators tend to change before broad economic activity.

- New orders
- Building permits
- Consumer expectations

- Stock-market measures
- Credit conditions

Purpose: help anticipate future activity.

Coincident Indicators

Coincident indicators move broadly with current economic activity.

- Employment
- Industrial production

- Personal income
- Sales measures

They help assess current conditions.

Lagging Indicators

Lagging indicators tend to change after economic conditions have already shifted.

- Some unemployment measures
- Certain interest-rate measures
- Loan delinquency data

They may help confirm existing trends.

Economic Dashboard

Indicator	Possible signal
GDP	Growth
Inflation	Price pressure
Interest rates	Financing conditions
Employment	Consumer strength
Currency	External competitiveness
Credit growth	Financial conditions
Confidence	Future spending

Why Analyze the Industry?

Companies do not operate in isolation. Industry conditions affect:

- Growth opportunities
- Profit margins

- Competition
- Pricing power

- Investment requirements
- Risk

Key question: is this an attractive industry in which to compete?

Industry Analysis Questions

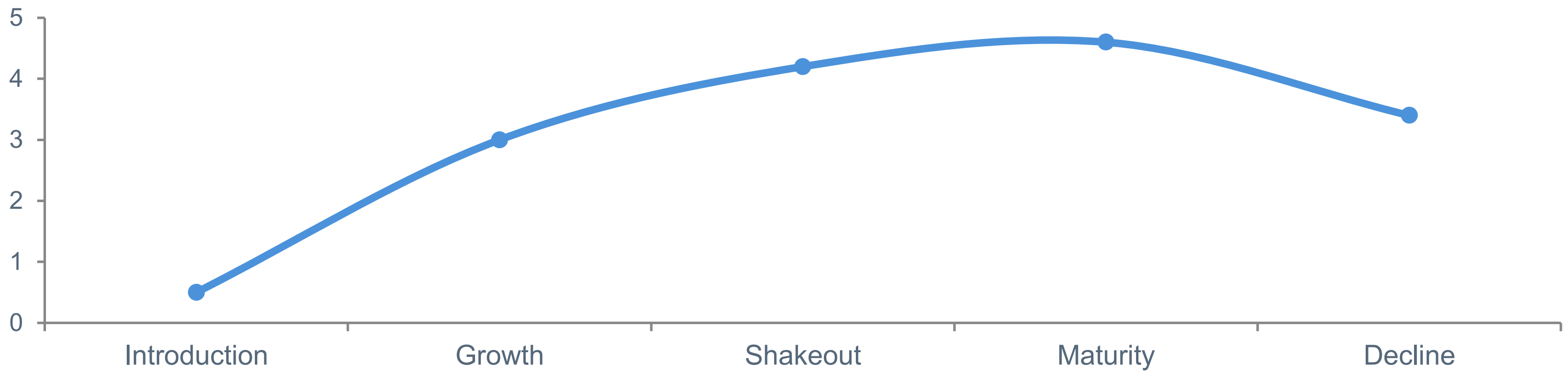
A practical industry checklist:

- Is demand growing?
- How strong is competition?
- Are entry barriers high?
- Are customers powerful?

- Are suppliers powerful?
- Are substitutes available?
- Is technology changing rapidly?
- Is regulation favorable?

Industry Life Cycle

Industries often move through five stages, tracing an S-shaped growth curve.



Introduction Stage

Characteristics may include

- New product
- Low sales
- High uncertainty

- High investment
- Few established competitors

Potential: high opportunity combined with high risk.

Growth Stage

Typical characteristics

- Rapid sales growth
- Increasing demand
- New competitors

- Expanding capacity
- Improving profitability

Investors may focus on the sustainability of growth.

Shakeout Stage

As growth slows:

- Competition intensifies
- Weak firms exit
- Consolidation occurs
- Pricing pressure may rise

Key question: which companies can survive and gain market share?

Maturity Stage

Characteristics

- Slower growth
- Stable demand
- Established competitors

- Strong focus on efficiency
- Potentially higher dividends

Competitive advantage becomes especially important.

Decline Stage

Possible characteristics

- Falling demand
- Obsolete technology
- Excess capacity

- Price competition
- Industry consolidation

A declining industry may still contain profitable companies — but opportunities become more selective.

Five Competitive Forces

A useful industry framework examines five forces shaping profitability.

Threat of new entrants

Bargaining power of suppliers

Rivalry among existing firms

Bargaining power of buyers

Threat of substitutes

Rivalry sits at the centre; entrants, substitutes, buyers and suppliers press on it from each side.

Rivalry Among Existing Firms

Competition tends to be stronger when:

- Many similar competitors exist
- Industry growth is slow
- Products are undifferentiated

- Fixed costs are high
- Exit barriers are high

Strong rivalry can reduce industry profitability.

Threat of New Entrants

New competitors find entry easier when:

- Capital requirements are low
- Regulation is limited

- Brand loyalty is weak
- Technology is easy to copy

High entry barriers can protect existing firms.

Threat of Substitutes

A substitute solves the same customer need in a different way.

Traditional taxi

The established solution.

Ride-hailing platform

A different solution to the same need.

Substitutes can limit prices, growth and profit margins.

Buyer and Supplier Power

Powerful customers may demand

- Lower prices
- Better quality

Powerful suppliers may demand

- Higher prices
- Better contract terms

Both can reduce company profitability.

Different Industries React Differently

Interest-rate sensitive

- Banking
- Real estate
- Construction

Commodity sensitive

- Mining
- Energy

Consumer sensitive

- Retail
- Tourism
- Automotive

Relatively defensive

- Utilities
- Staples
- Essential healthcare

A sector sensitivity matrix helps map exposure to each macro driver.

What Is Sector Rotation?

Sector rotation is an investment strategy that shifts portfolio exposure among industries based on expectations about the economic cycle.

Early recovery	**Expansion**	**Peak**	**Slowdown**

> ***The business cycle sits at the centre, with sectors positioned around it.***

Simplified Sector-Rotation Logic

Early recovery

- Consumer cyclicals
- Financials
- Industrials

Strong expansion

- Technology
- Capital goods
- Materials

Economic slowdown

- Defensive sectors
- Utilities
- Consumer staples

This is a simplified framework — not a guaranteed trading rule.

Integrated Top-Down Process

- Step 1 — Global economy
- Step 2 — Domestic economy
- Step 3 — Business cycle
- Step 4 — Interest rates & inflation

- Step 5 — Identify attractive industries
- Step 6 — Analyze companies
- Step 7 — Value securities

Investment Decision

Practical Exercise

Scenario

- GDP growth slowing
- Inflation remaining high
- Interest rates rising
- Currency weakening
- Consumer confidence declining

Industries

- A. Luxury retail
- B. Commercial banking
- C. Food staples
- D. Construction
- E. Export-oriented manufacturer

Student tasks

- Which industries may be most vulnerable?
- Which may be more defensive?
- How might rising rates affect banks?
- How might currency weakness affect exporters, and import-dependent firms?
- Which macro indicators should be monitored?
- How would this affect bond investors and sector allocation?

Key Takeaways

- Analyze economy, industry and company together
- GDP is a broad measure of economic activity
- Business cycles run expansion, peak, contraction, trough, recovery
- Markets are forward-looking
- Cyclical industries are more economy-sensitive
- Defensive industries have more stable demand
- Inflation affects purchasing power, costs, rates and valuation
- Interest rates influence bonds, equity values and investment

- Monetary policy influences credit and financial conditions
- Fiscal policy affects taxes, spending and aggregate demand
- Exchange rates affect exporters, importers and FX borrowers differently
- Leading indicators may signal future activity early
- Industry profitability depends on competitive structure
- The life cycle shapes growth and opportunity
- Sector rotation aligns exposure with the cycle
- Top-down analysis links macro to security selection

Economy tells you the environment. Industry tells you the opportunity. Company analysis tells you who may win.

Next Chapter — Chapter 13: Equity Valuation

- Meaning of intrinsic value
- Market price vs intrinsic value
- Discounted cash-flow valuation
- Dividend Discount Model
- Gordon Growth Model
- Multistage dividend models

- Free cash flow valuation
- Price–earnings ratio
- Price-to-book ratio
- Price-to-sales ratio
- Enterprise-value multiples
- Comparable-company analysis

- Growth and value drivers
- Required rate of return
- Sustainable growth
- Valuation sensitivity
- Undervalued and overvalued shares
- Practical equity valuation

Financial statements → cash flows → valuation → investment decision.

THANK YOU

Questions and Discussion

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