Understanding business cycles and their impact on asset classes

Here's a quick guide on how to identify the phases and what to do with your funds during which period.

The recent inversion of the yield curve (a rare scenario when the short term yields are higher than long term yields) has been a talking point as a precursor of transition of business cycle from a prolonged growth era to a looming recessionary period. Well, what goes up must come down – and business cycles are possibly no exception to this rule. Economies often fluctuate in cycles – recovery, expansion, peak and recession. And this is repeated over time.

There are many factors which influence the investment markets and impact returns on investments. Business cycle change is perhaps one of the most influential factor among these, as the cycle changes represent the state of economic growth (whether expanding or contracting), corporate earnings (profits and job impact), credit cycle (ease of borrowing) and inflation (price changes).

This article aims to explain the different phases of a business cycle and their impact on asset classes.

What are business cycles?

Like two extreme sides of a day (midday to midnight), a business cycle has two extreme states (peak, represented by economic activity in full bloom and trough, represented by recession). To account for smooth transition, the entire business cycle can be divided into four stages.

Unlike market cycles, which are largely driven by sentiments and hence shorter, business cycles typically last longer between five to 10 years.

Peak (key outcome – slower growth rate)

This phase occurs when the economic activity has peaked and growth begins to moderate. While growth is still positive, it starts to slow down in terms of pace of growth. Corporate earnings and profit margins start to get compressed due to tighter labour market, rising wages, costs, interest expenses and continued inflationary pressure. This leads to a slowdown of business momentum. This also results in tightening of the credit market making it difficult for corporates to access continued credit growth.

Recession (key outcome – contraction)

Post the period of peak economic activity, businesses start to slow down, as a result, start to freeze pay, reduce hiring or even embarking on layoffs resulting in higher unemployment rate, which, combined with lower wages results in decreased consumer spending.

Expansion (generally conducive for most asset classes)

Expansion phase is generally the best times for different asset classes and cyclical sectors. Investors still prefer equity asset classes in comparison to fixed income due to higher income / yield being generated.

Recovery (Equity and reit over fixed income)

Recovery is the best period due to accommodating monetary and fiscal policies and strong momentum for corporates and consumer spending. Sectors representing discretionary and expansive spends tend to do better e.g. technology, consumer discretionary, industrial and financial.

Moving forward

Four stages of the business cycle

Who’s up, who’s down

Asset class performance in different cycles

<table>
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<tr>
<th>BUSINESS CYCLE</th>
<th>EQUITY</th>
<th>FIXED INCOME</th>
<th>OTHER ASSET CLASSES</th>
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<tr>
<td>Peak Shift from equity to fixed income</td>
<td>Sectors which are non-discretionary or which benefit from high inflation tend to do well e.g. healthcare, materials, consumer staples, utilities and energy.</td>
<td>While this period is conducive for bond yields, the yields start to come off. It’s a good time to start allocating more towards quality grade bonds.</td>
<td>This is a good period for commodity sector including gold as prices are high, creating healthy gains.</td>
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<tr>
<td>Recession Fixed income over equity</td>
<td>Recession phases generally yield negative returns for equity asset classes as business tends to slow down with negative sentiments.</td>
<td>Possibly the best time for fixed income investments as investors tend to look for safe assets and risk off approach. It is good to be in quality fixed income i.e. investment grade bonds versus high yield bonds and even treasuries as safe havens. Look for long duration during this time.</td>
<td>This is generally a negative period for commodity returns as demand and price start to fall and inventories are high, and have not fallen in line with the drop in sales. Real estate tends to underperform.</td>
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<tr>
<td>Recovery Equity and reit over fixed income</td>
<td>Recovery is the best period due to accommodating monetary and fiscal policies and strong momentum for corporates and consumer spending. Sectors representing discretionary and expansive spends tend to do better e.g. technology, consumer discretionary, industrial and financial.</td>
<td>Due to moderate inflation and rising but benign interest rates, fixed income tends to do well. Together with bonds, this period is good for high yield bonds as credit becomes strong on account of strengthening corporate balance sheet and margins. It’s good to start reducing the duration of the portfolio.</td>
<td>This marks a good time period for real estate and commodity sectors as momentum picks up.</td>
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<td>Expansion Generally conducive for most asset classes</td>
<td>Expansion phase is generally the best times for different asset classes and cyclical sectors. Investors still prefer equity asset classes in comparison to fixed income due to higher income / yield being generated.</td>
<td>This period is good for both high yield and investment grade bonds at the back of continued credit growth.</td>
<td>Commodity and gold continue to hold up during this phase.</td>
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Source: CFA