Perspectives

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The Business Cycle Diaries

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Even the casual observer of market dynamics is likely aware that the world economy appears to be on uneven footing. Elevated price levels, increasingly restrictive monetary policy, and geopolitical turmoil have plagued securities markets during the first half of the year and are now dampening expectations for global GDP growth going forward. Given this myriad of macroeconomic challenges, many investors are now assessing the possibility of a prolonged slowdown in economic activity for both the United States and the rest of the world. The aim of this newsletter is to gauge the extent to which the global economy is at risk of such a downturn by examining the state of the current domestic business cycle, inferring its likely next stage, and reviewing which asset classes and investing styles tend to be the most attractive during each phase of the cycle.

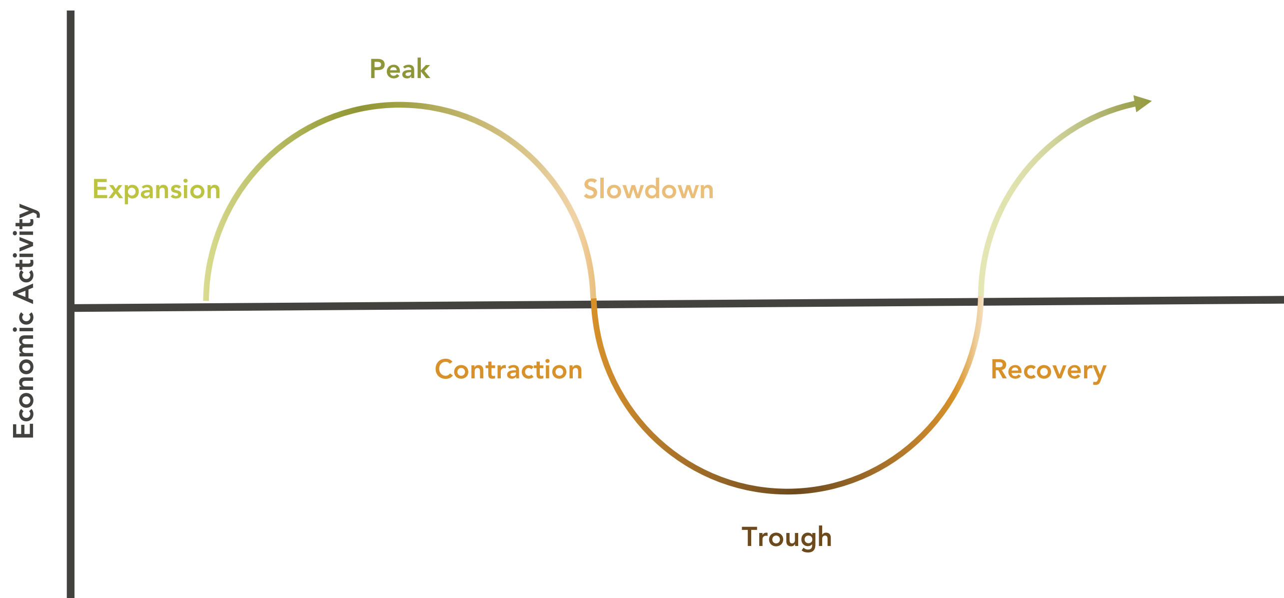
THE BUSINESS CYCLE

As opposed to market cycles, which relate exclusively to asset prices, business cycles refer to the fluctuation of economic activity due to changes in aggregate demand and exogenous shocks. A typical business cycle is comprised of four stages:

- Expansion
  Expansionary periods are typically marked by positive and increasing GDP growth and a narrowing output gap, as well as accommodative fiscal and monetary policy. Additionally, variables like employment, wages, and demand are typically robust during this interval.
- Slowdown
  A slowdown will occur after an economy achieves maximum growth, at which point prices of financial assets and consumer goods typically peak. The hallmarks of economic slowdowns include slowing GDP growth and elevated levels of inflation, which lead to declining demand and tightening by central banks.

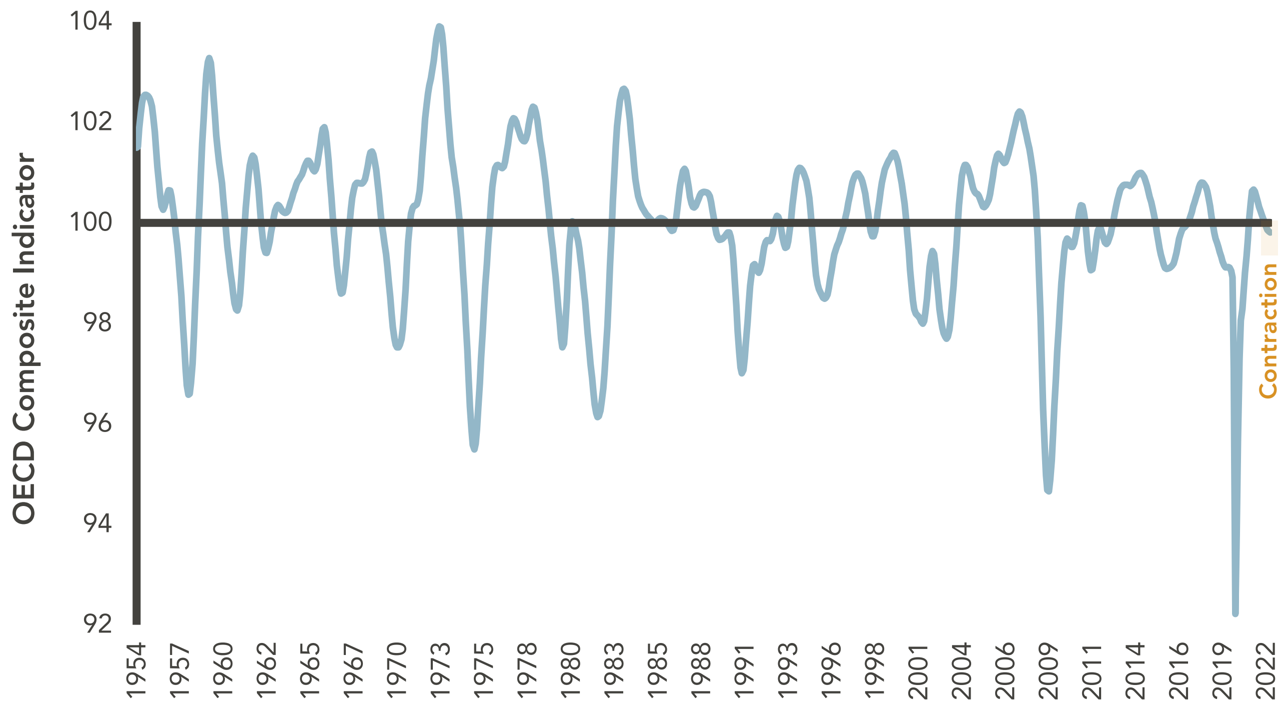
- Contraction
  Declining economic activity, high rates of unemployment, and low lending activity are all indications of a contraction. This stage culminates in a trough, at which point growth has bottomed out and economic variables hit their lows.
- Recovery
  Economic sentiment begins to brighten during periods of recovery, with both monetary and fiscal policy typically at their most stimulative during this stage. Consumer demand, lending, and investment typically increase during a recovery, while unemployment declines.

Exhibit 1: Business Cycle Stages



In reality, of course, business cycles typically do not unfold as perfect sine waves and charting the course of each cycle can be somewhat subjective. The Organization for Economic Cooperation and Development (OECD) composite leading indicator (CLI) — designed to track the fluctuation of economic activity around a long-term potential level and provide early signals of turning points — is one objective way to map such cycles. Exhibit 2 on the following page examines the trajectory of this indicator, which has a base value of 100, over the last several decades, and helps provide insight into the dynamics of previous business cycles. Any period in the time series above the baseline and increasing is considered to be expansionary, while figures below 100 and decreasing reflect periods of economic contraction. Decreasing values above 100 reflect slowdowns and increasing values below 100 are considered recoveries. It is worth noting that, due to the acute nature of this data, longer periods of expansion and contraction can be interspersed by short periods of any of the four stages. With these nuances in mind, OECD data indicate that the United States and the broader global economy have both recently gone into a contraction.

Exhibit 2: Business Cycles in the United States



Source: Organization for Economic Cooperation and Development, data as of June 30, 2022

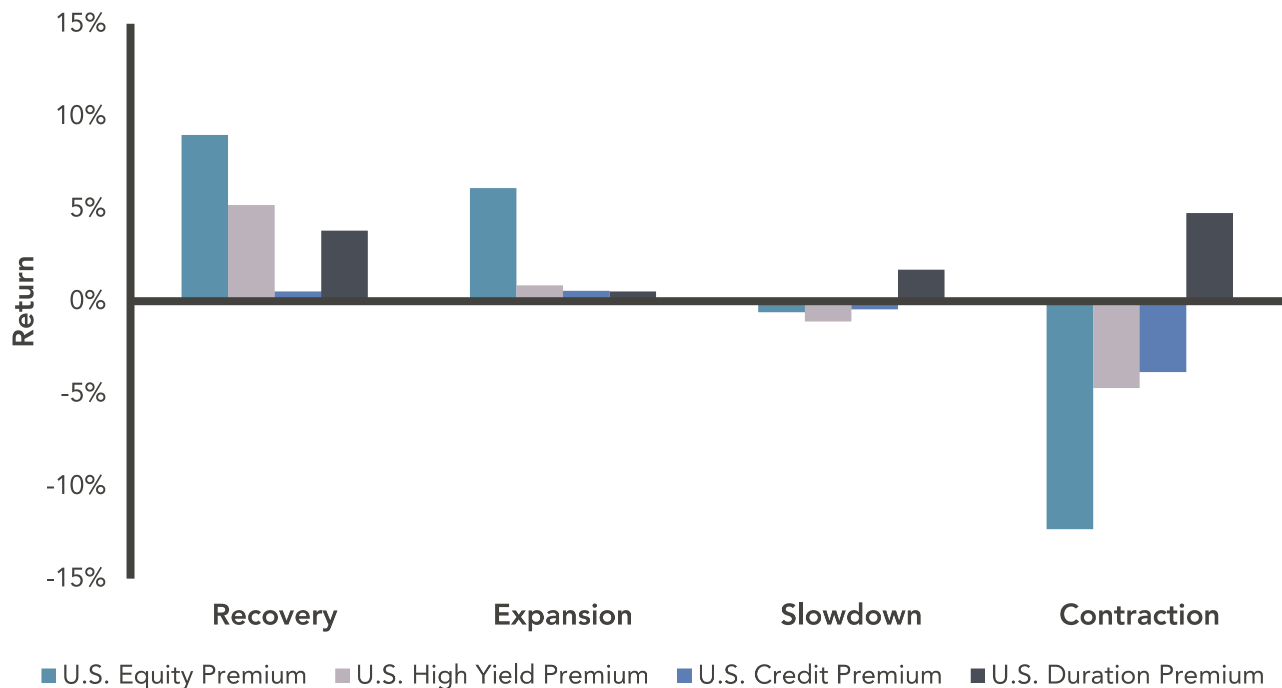
As can be seen in Exhibit 2, each business cycle stage can vary in length due to the sensitivity of the indicator employed. Typically, however, each stage has persisted for an average of 6–8 months, with the longest instances of each ranging 15–21 months.

INVESTING THROUGHOUT THE CYCLE

Risk Premia

While each business cycle is unique, there are certain asset class and investment style patterns that are typically present in each of the four phases. Exhibit 3 *(next page)* outlines performance of several domestic risk premia during each stage of the traditional business cycle. It should come as no surprise that securities like stocks and high yield bonds perform strongly during periods of economic recovery given the increase in investor risk appetite, and that Treasury securities, as measured by the duration premium, outperform cash as monetary policy is often loose with below-trend inflation. During expansions, equities continue to outperform, driven by the robust earnings growth and margin expansion characteristic of this stage, while fixed income securities have historically put up only modest positive returns. In periods of slowdown, when economic growth is normally still positive, stock returns are often muted as equity markets begin to anticipate the upcoming contraction phase. Fixed income securities have also faced headwinds throughout past slowdowns given typically tight monetary policy and above-trend inflation. Finally, contractions usually see the worst performance of risky assets amid a decline in economic output and heightened conservatism on the part of investors. As demonstrated in Exhibit 3, defensive assets like long-dated government bonds are often the lone bright spot for market participants amid economic contractions.

Exhibit 3: Average Risk Premia During Various Business Cycle Stages



Source: Bloomberg, data from December 31, 1954 through June 30, 2022. U.S. Equity Premium = S&P 500 Index – 10-year Treasury; U.S. High Yield Premium = Bloomberg U.S. High Yield Index – Bloomberg U.S. Credit Index; U.S. Credit Premium = Bloomberg U.S. Credit Index – 10-year Treasury; U.S. Duration Premium = 10-year Treasury – 3-month T-bill.

Factors

Though the performance pattern of the broad stock market throughout a business cycle is fairly straightforward, it is worth exploring the more nuanced behavior of various equity investing styles during each stage, as seen in Exhibit 4 on the following page. The value and size factors tend to be procyclical, leading during periods of economic expansion and recovery. Conversely, amid stretches of economic slowdown and contraction when earnings and lending activity come under pressure, these styles have historically lagged the broad market. High quality, low volatility, and dividend-paying stocks typically behave in a more defensive manner, displaying a countercyclical performance pattern. The momentum factor can be more difficult to pin down due to the extent to which it is driven by idiosyncratic investor behavior. Still, as the factor is based on a continuation of trends that have persisted in the recent past, it is not unreasonable to expect outperformance during late expansions, as well as underperformance at turning points in the business cycle. Finally, the growth factor has historically outperformed during expansions after initially trailing during recoveries. The data also shows outperformance of the broad market during slowdowns and contractions. While growth is generally expected to outperform in a low-growth environment, the data has been heavily influenced by the recent COVID-19 pandemic, which led to an environment that was highly conducive to outsized gains of long-duration technology-oriented stocks. This period was likely aberrational in nature and may not be indicative of future performance of growth-style equities during future economic contractions.

Exhibit 4: Average Factor Returns During Various Business Cycle Stages Relative to the Broad Market

Source: Bloomberg, data from December 31, 1989 through June 30, 2022; factor returns based on difference between Russell factor indices and Russell 1000 index

CONCLUSION

While the recent reversal in the U.S. business cycle may be cause for concern, it is important to remember that economic contractions have happened throughout history and are natural and necessary parts of each business cycle. Furthermore, these stages are often abbreviated in nature, lasting roughly seven months on average according to OECD data going back to the mid-1950s. So, while it is important to remember that each business cycle is unique, every contraction has been followed by a recovery, and risky assets tend to see a strong resurgence during those periods. While higher-quality and lower-volatility assets can help mitigate the negative impacts of souring economic conditions, it is important to remember that markets are forward looking and timing markets is notoriously difficult. Above all, it is imperative that investors maintain a thoughtful, disciplined approach to portfolio allocation amid the ebbs and flows of economic growth. Marquette will continue to monitor the state of the domestic and global business cycles while assessing the viability of various investment strategies and advise clients accordingly.

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