The Importance of the Business Cycle

Newsletter – April 2018

"The term 'business cycle' is imprecise. Economic fluctuations affect everyone, not just businesses, and they are, unlike astral cycles, anything but regular"

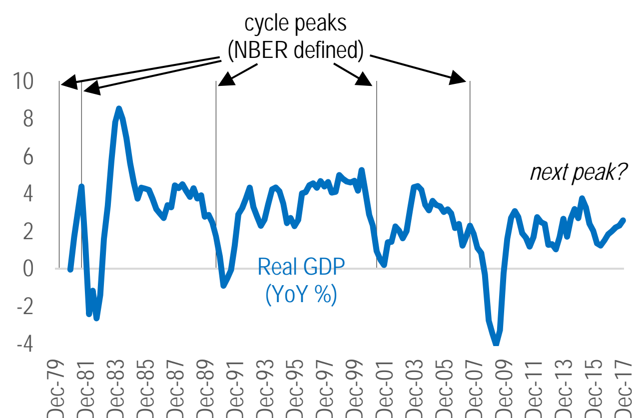
-Kevin Hassett, Economist/Author, Chair of the Council of Economic Advisers

Most industry practitioners view two consecutive quarters of negative real GDP growth as indication of a recession. The National Bureau of Economic Research ("NBER") explicitly states that this is not their definition, and instead provides one that is a bit more ambiguous: *a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales*. Irrespective of the definition, the beginning of a recession represents the peak of a business cycle. From this peak, a typical business cycle goes through a recessionary period followed by a recovery, or expansionary period, until it reaches another peak. Peak-to-peak (or alternatively trough-to-trough), therefore, would represent a full business cycle. Where we are in this cycle has major ramifications for both the general economy and capital markets.

Even after they occur, pinpointing business cycle turning points is difficult and subjective. In fact, NBER formed a Business Cycle Dating Committee composed of highly regarded economists from prominent universities, who collectively determine when the cycle turned, typically about a year after the turning point occurred. If establishing these turning points after the fact is so difficult, then predicting them before they occur must be downright impossible. Paul Samuelson, the first American to win the Nobel Prize in Economics, astutely quipped, "The stock market has forecast nine of the last five recessions". The objective for our latest newsletter, therefore, is not to predict precisely when the cycle will turn. Instead, our goal is to focus on what happens at the very end of a cycle, and then more importantly, assess how high yield has typically behaved relative to other asset classes once the cycle has turned.

We will explore economic factors, interest rate factors, and high yield specific factors that are all closely tied to the business cycle to see what we can learn; i.e., are there clear warning signs that cycle is peaking, or has peaked, or are we simply in the later stages of a typical growth cycle? From there, we will evaluate the historical performance of high yield, equities, investment grade credit, and treasuries following previous business cycle peaks.

Chart 1: Business Cycles
National Bureau of Economic Research



Economic Factors

Charts 2, 3, and 4 highlight unemployment, loan growth, and a leading economic indicators index, respectively, along with business cycle peaks. The unemployment rate typically declines gradually in the latter half of the business cycle—the expansion/growth phase—and then spikes rapidly just prior to the business cycle turning point. We have not observed a trough in this cycle yet but we are nearing levels of prior cycle troughs. Corporate loan growth accelerates in the expansion phase of a business cycle, and then Fed tightening and more stringent lending standards cause a deceleration in corporate lending near the turning point. The pace of decline is normally dictated by the severity of the credit contraction that is typical of end-of-cycle recessions. The Leading Indicators Index typically climbs during the growth phase of the business cycle and then peaks and begins to decline prior to the turning point of what becomes an economic contraction. This is unsurprising given that this is precisely what this index was designed to accomplish. In sum, each of these economic indicators currently exhibit signs that we are in the late stages of the cycle, perhaps the very late stages, but we have not yet observed an indication of a turning point for what ultimately will be called the next recession.

Past performance is not a guarantee or a reliable indicator of future results.

Chart 2: Unemployment
US Unemployment Rate, Seasonally-Adjusted

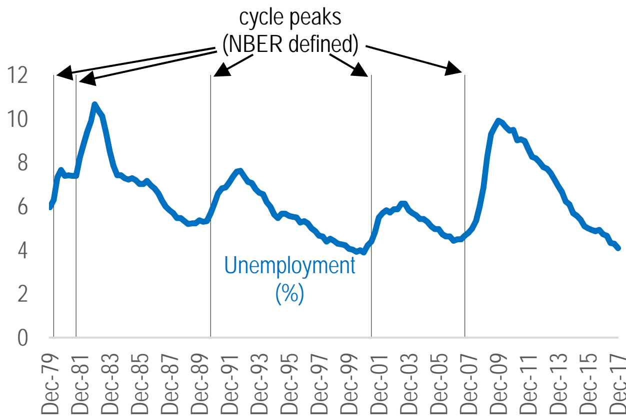


Chart 3: Loan Growth
Total Outstanding Commercial & Industrial Loan Growth

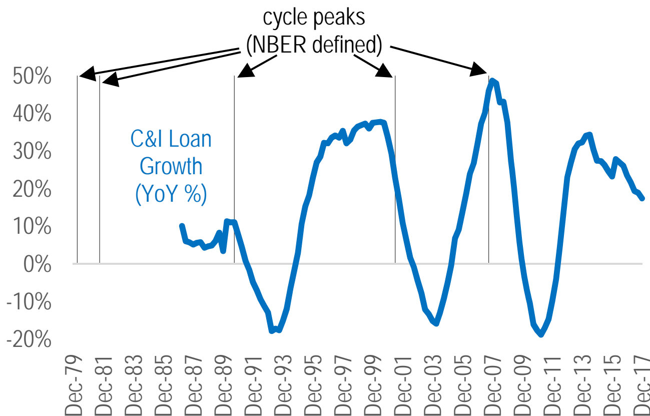
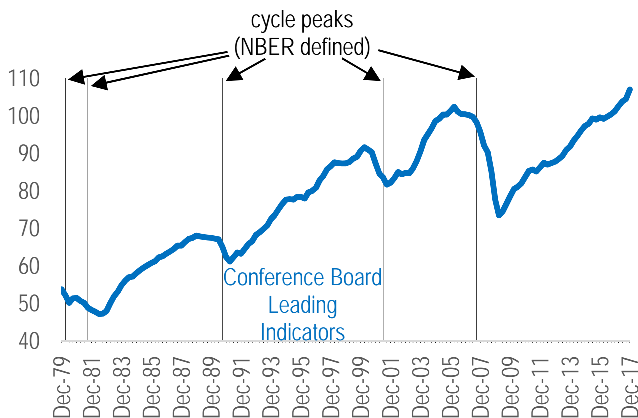


Chart 4: Leading Economic Indicators
Conference Board US Leading Index, 10 Economic Indicators



Interest Rate (and related) Factors

Charts 5, 6, and 7 highlight inflation, the Fed Funds Rate, and the Treasury yield curve, respectively, along with cycle peaks. During the latter half of the business cycle (the expansion phase), inflation typically accelerates and the Fed combats this by raising rates, which results in a flattening of the yield curve. This strains lending, as we observed in Chart 3. Often the yield curve flattens until it becomes inverted, which has been one of the best recession indicators around. Similar to the economic factors we observed, these interest rate related factors also depict a cycle in the later innings, but we have yet to observe a warning sign that suggests the peak is imminent in the near term.

Chart 5: Inflation

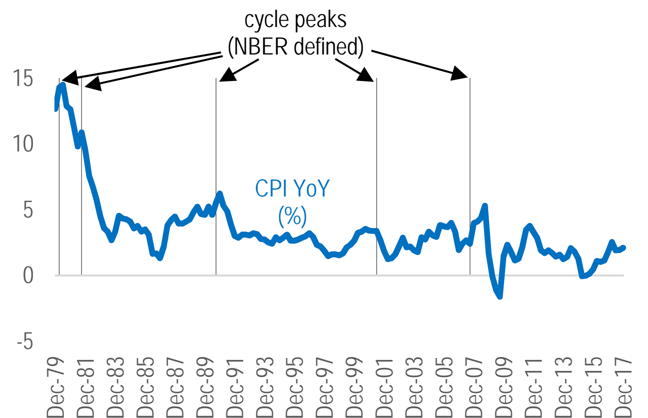


Chart 6: Fed Funds Rate

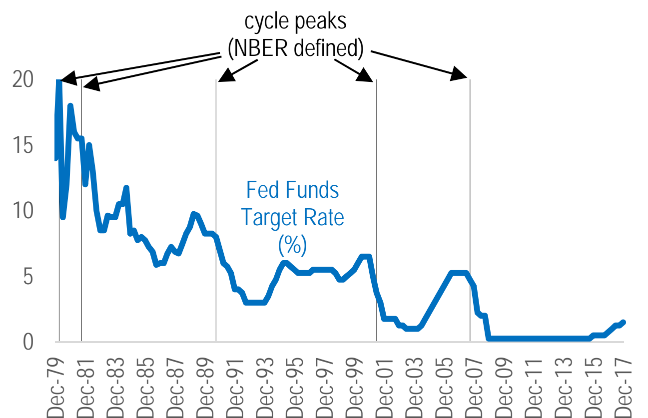


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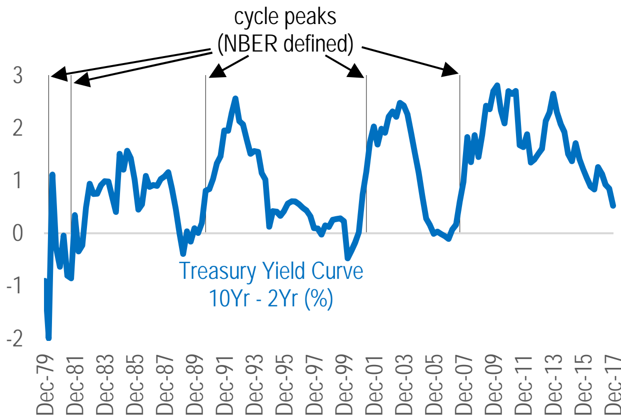
Chart 7: Yield Curve



High Yield Market Factors

Charts 8, 9, and 10 depict various high yield characteristics alongside business cycle peaks. The information goes back to 1986 when we first have decent data. In the first two long cycles that ended in 1990 and 2001, respectively, defaults and spreads were good coincident indicators of the business cycle (Charts 8 and 9). Spreads led the cycle, tightening dramatically in the early phases of the expansion. This transitioned into a relatively tight range for spreads and defaults with absolute levels well below the long term mean. As the cycle neared its peak, spreads and defaults accelerated higher and the cycle rolled over into a contractionary period. The most recent cycle that NBER defines as beginning in late 2007 exhibited similar patterns except defaults and spreads accelerated after the cycle peaked. We view this particular cycle as somewhat unique. While the previous cycle endings were classic demand contractions, the Global Financial Crisis was an extreme contraction in both severity and speed, which developed from a crisis of confidence in the financial system.

Chart 10 highlights recovery rates for unsecured high yield debt. There are two features that are important to recovery rates as it relates to the business cycle. First, these recovery rates are measured from pricing of defaulted debt 30 days after the bankruptcy is declared. As such, they are not true recovery rates but proxies for debt pricing after the dust settles one month after a filing. Second, the prices reflect an array of factors that reflect credit conditions at any point in time: risk appetite for distressed credit, ease of restructure financing, financial leverage, residual valuations, etc. This series does a reasonable job of forecasting the end of expansions but is not perfect. For example, like the other market indicators, it was late in predicting the end of the most recent cycle. It also incorrectly predicted a cycle end in 2015 due to the severity of the metals, mining and energy contraction.

In sum, none of these market driven indicators signal an end to the current cycle.

Chart 8: High Yield Default Rate
Trailing 12-Month Default Rate, Par Weighted

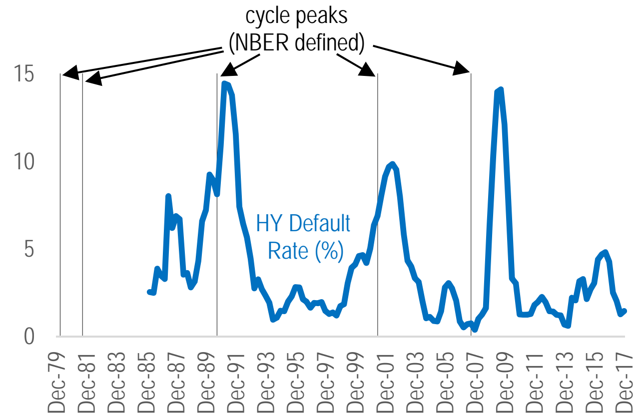


Chart 9: High Yield Spread Over Treasuries

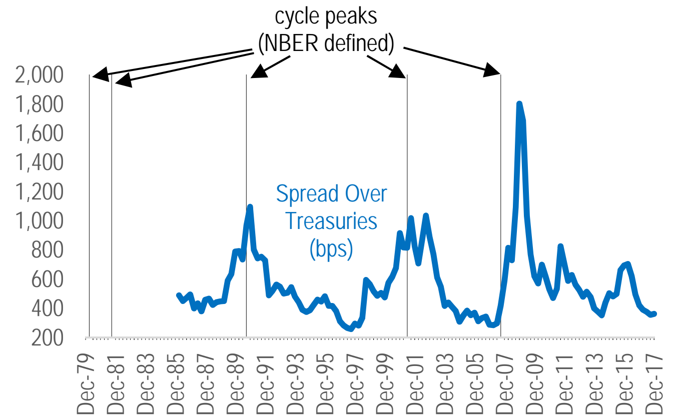
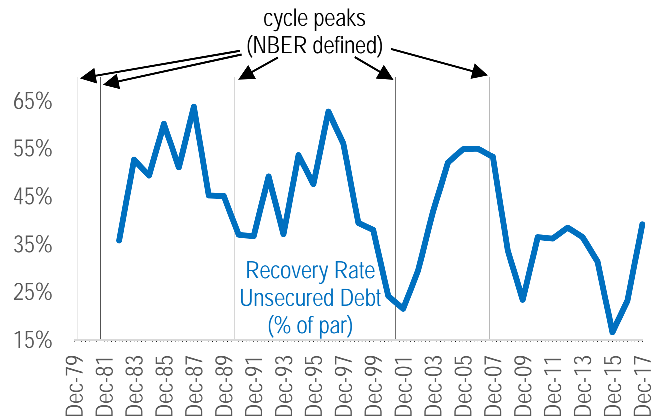


Chart 10: Post Default Recovery Rate



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Summary of Factors

Table A summarizes the findings from Charts 2 through 10. The economic and interest rates factors depict a current environment consistent with the latter part of the business cycle but shows no clear signs that the cycle will turn in the near term. While monetary policies have tightened modestly, recent fiscal stimulus could prolong the current cycle. In any case, it appears as though we are in the late innings (perhaps very late innings) but the end of the cycle could still be a ways off.

Table A: Summary of Factors

Factor	Late in Cycle	Turning Point	Recent/Current
Unemployment	Falls	Troughs	Falling
Loan Growth	Mixed	Plummets	Decelerating
Lead Indicators	Rises/Plateaus	Peaks	Rising
Inflation	Rises	Peaks	Unclear
Fed Funds	Rises	Peaks	Rising
Yield Curve	Flattens	Inverts	Flattening
Defaults	Varies	Spikes	Declining
Spreads	Varies	Spikes	Declining
Recovery Rate	Declines	Troughs	Increasing

Turning Points and Performance

Next, let's explore how high yield has performed relative to other major asset classes once the cycle has turned. Chart 11 shows the cumulative performance of four major asset classes since 1986, highlighting the three most recent business cycle peaks.

Chart 11: Cumulative Performance

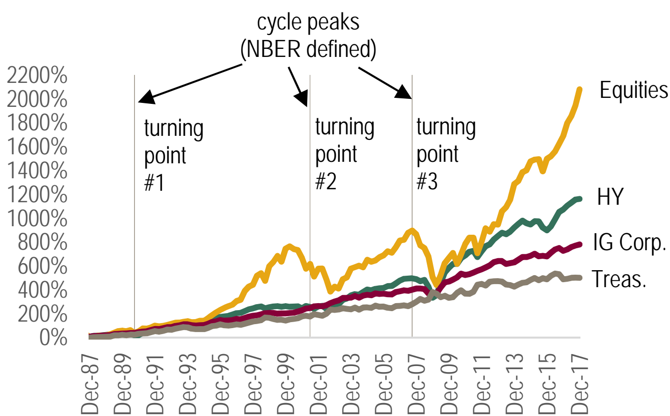
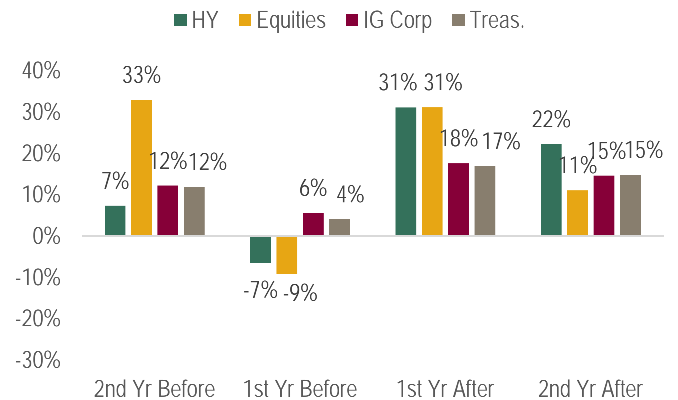


Chart 12 highlights the performance of these same asset classes before and after turning point #1—the 1990 cycle peak. We are going to discount the results of this particular period because it was such a brief and moderate recession that recovered quickly. While we would like to believe that the high yield market could return more than +30% and then another +22% in the years after a business cycle peak, a pragmatist would justly classify this as an anomaly.

Chart 12: Turning Point #1 (3Q 1990)
Performance Before and After Turning Point



Charts 13 and 14 show performance before and after turning points #2 and #3, respectively. These represent more severe recessions and the results are more intuitive. It shows that in the first year after a peak in the business cycle, high yield and equities declined while investment grade corporates and treasuries fared better. The decline in high yield was modest; however, and the recovery was rapid as can be seen by the return generated in the second year after a cycle peak.

Chart 13: Turning Point #2 (1Q 2001)
Performance Before and After Turning Point

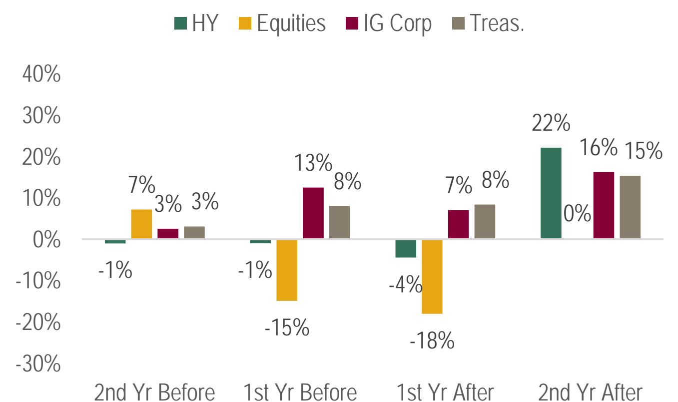


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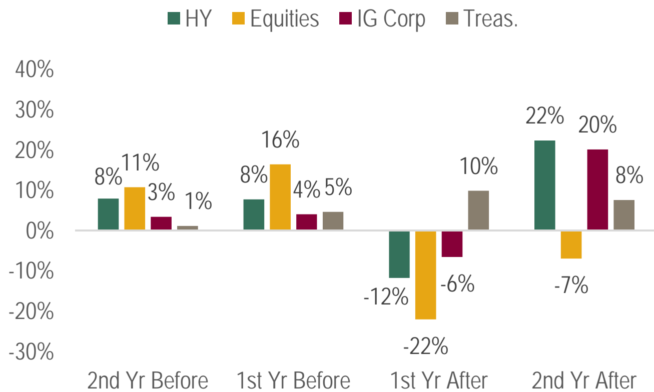
Chart 14: Turning Point #3 (4Q 2007)
Performance Before and After Turning Point



Even if we ignore the data from turning point #1, we venture that some readers find the modest decline of high yield following cycle peaks surprising. Charts 15 and 16 explore these two periods in greater detail. As highlighted in the charts, high yield performance troughed a little more than 1 year after the cycle turned, which was similar to equities. From there, the high yield market recovered rapidly—more so than equities. Chart 17 averages the two periods.

Chart 15: Turning Point #2 (1Q 2001)
Cumulative Performance After Turning Point

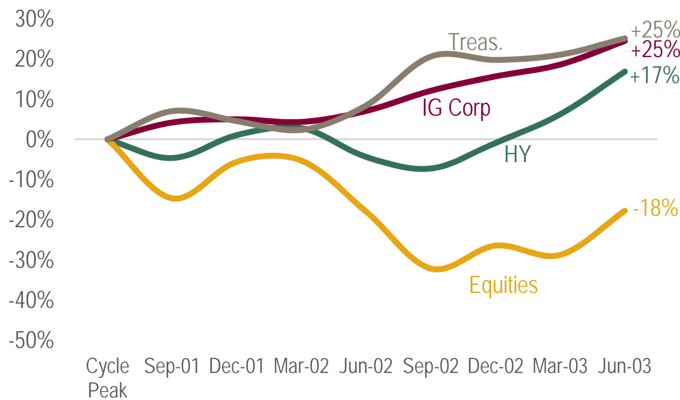


Chart 16: Turning Point #3 (4Q 2007)
Cumulative Performance After Turning Point

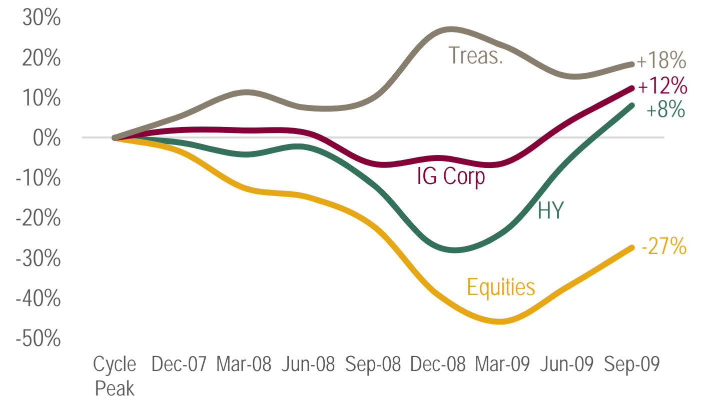
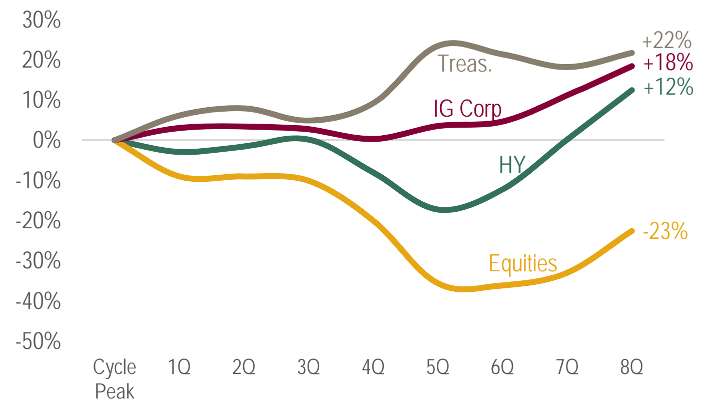


Chart 17: Turning Points #2 and #3 (average)
Cumulative Performance After Turning Point



Charts 18 and 19 depict high yield spreads over these same two periods, which unsurprisingly, show a peak in spreads slightly more than one year after the cycle peak. Chart 20 averages the two periods.

Chart 18: HY Spreads After Point #2 (1Q 2001)

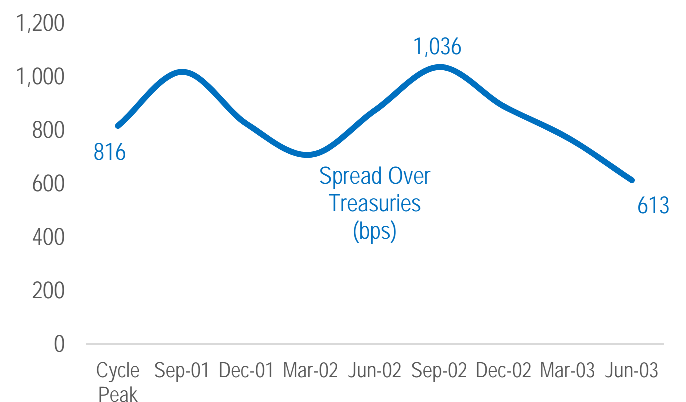


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Chart 19: HY Spreads After Point #3 (4Q 2007)

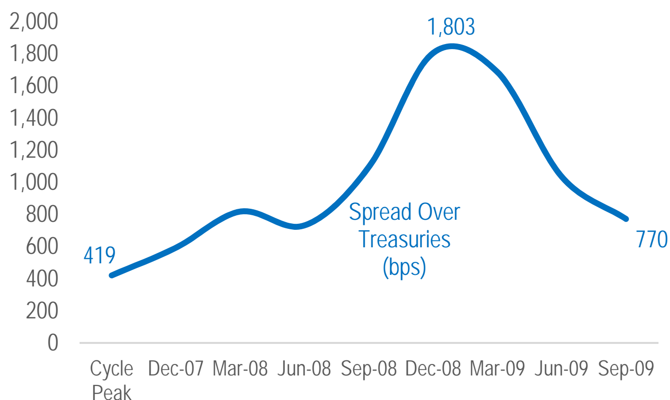
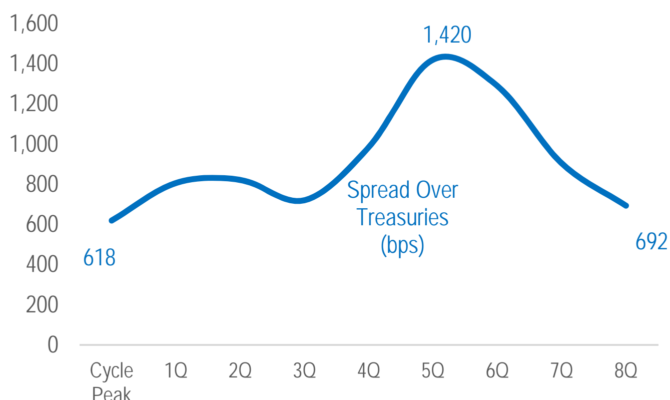


Chart 20: HY Spreads After Points #2 and #3 (average)



Summary

Historically, the high yield market has experienced relatively few years of negative performance. The exceptions have generally occurred following a peak in the business cycle, which is why we believe it is so important to evaluate where we are in the cycle. This newsletter highlighted many factors that either affect, or are affected by, the business cycle. The factors that have done a good job of providing warning signs historically, are generally signaling that we are late in the cycle but not dangerously close to a peak. Predicting turning points in the economic cycle with precision, however, is impossible. If we are close to the peak, we are somewhat reassured by high yield market performance that followed prior peaks. Drawdowns have been modest and/or short-lived as the market recovered quickly following a brief cleansing period. Also, while these stretches can be taxing, they often present some of the best long-term valuation opportunities for credit pickers. So while we do not long for a rapid market tightening, we acknowledge that such periods are short-lived and often laden with opportunities for diligent, patient credit investors.

Hotchkis & Wiley High Yield Research

All investments contain risk and may lose value. Investing in high yield securities is subject to certain risks, including market, credit, liquidity, issuer, interest-rate, inflation, and derivatives risks. Lower-rated and non-rated securities involve greater risk than higher-rated securities. High yield bonds and other asset classes have different risk-return profiles and market cycles, which should be considered when investing.

Data reference to "High Yield" refers to the ICE BofAML US High Yield Index, "Equities" S&P 500, "IG Corp" ICE BofAML US Corporate, and "Treas." 10-Year Treasury Note. Charts 1-17: National Bureau of Economic Research (NBER); Charts 1-7, 9, 11-20: Bloomberg. Along with NBER and Bloomberg - Chart 1: Bureau of Economic Analysis; Chart 3: FDIC; Chart 4: Conference Board; Chart 6: Federal Reserve; Chart 7: US Treasury; Charts 8, 10: JPMorgan; Chart 9: Credit Suisse, BofA Merrill Lynch. Table A: All of the above.

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