Investing Using the Business Cycle

Presented by Paul Martin

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Goals for presentation

- Learn the characteristics of each phase of the business cycle
- Examine how changes in the business cycle affect the performance of different sectors in the equity markets
- Examine how changes in the business cycle affect the performance of different asset classes (stocks, bonds, and cash)

Fidelity study on sector performance

- Fidelity analyzed 3,000 of the top U.S. companies ranked by market capitalization and their performance through economic cycles from 1962-2016.

- This presentation is based on the Fidelity report. All figures, unless otherwise indicated, are from the Fidelity report.

Source:
"The Business Cycle Approach to Asset Allocation"
Authors: Lisa Emsbo-Mattingly, Dirk Hofschire,
Fidelity Research 2020
https://institutional.fidelity.com/app/proxy/content?literatureURL=/953042.PDF
https://www.fidelity.com/viewpoints/investing-ideas/sector-investing-business-cycle

Business cycle phases

- Distinct phases can be identified by changes in the rate of growth in economic activity, increasing or decreasing of corporate profits, credit, inventories, and employment.

- Business cycles are not uniform – ranging from 2 to 12 years.*

- Between 1945 - 2020 there have been 12 cycles with average length of 6.25 years.*

Four Phases of Business Cycle

1. Early (Bottom)
2. Middle (Rising)
3. Late (Top)
4. Recession (Falling)

*Source: NBER analysis of business cycles since 1854
https://www.nber.org/cycles.html

Recent peak and trough dates 1980 to present

Turning Point Date	Peak or Trough	Announcement Date with Link
February 2020	Peak	June 8, 2020
June 2009	Trough	September 20, 2010
December 2007	Peak	December 1, 2008
November 2001	Trough	July 17, 2003
March 2001	Peak	November 26, 2001
March 1991	Trough	December 22, 1992
July 1990	Peak	April 25, 1991
November 1982	Trough	July 8, 1983
July 1981	Peak	January 6, 1982
July 1980	Trough	July 8, 1981
January 1980	Peak	June 3, 1980

Source: NBER
https://www.nber.org/cycles.html

Early-cycle phase

- Most robust performance with the top 3000 stocks averaging a total return of more than 20% per year with an average duration of roughly one year.
- “Rising tide lifts all boats”
- Beta-driven: beta exposure tends to be rewarded
- Excess liquidity from fiscal and monetary stimulus
- GDP, industrial production, and incomes begin to pickup
- Inventories are low and sales pickup
- Corporate restructurings, deleveraging, balance sheet repair, and reduction in corporate defaults.
- Low interest rates and steep yield curve

Sector performance in early phase

- Consumer discretionary, real estate, industrials tends to outperform - benefiting from low-interest rates and increased borrowing.

- To a lesser extent, financials and technology also benefit for the same reasons.

- Outperforming industries: apparel, autos, business supplies, construction, construction materials, consumer goods, entertainment, printing and publishing, recreation, restaurants, hotels, retail, rubber and plastic products, and textiles

Sector performance in early phase

Economic sensitive sectors – like industrials, information technology, and materials – also do well, rallying in anticipation of a pick-up in economic recovery.

- In tech, semiconductor and semiconductor equipment stocks are boosted by renewed expectations for consumer and corporate spending.
- Materials: containers and packaging benefit from rising trade activity

Sector performance in early phase

- Defensive industries, like utilities and communications services, typically underperform.

- Energy lags because of weak inflationary pressures.

- Consumer discretionary has beaten the market in every one of the early cycle phases.

Analyzing Relative Sector Performance

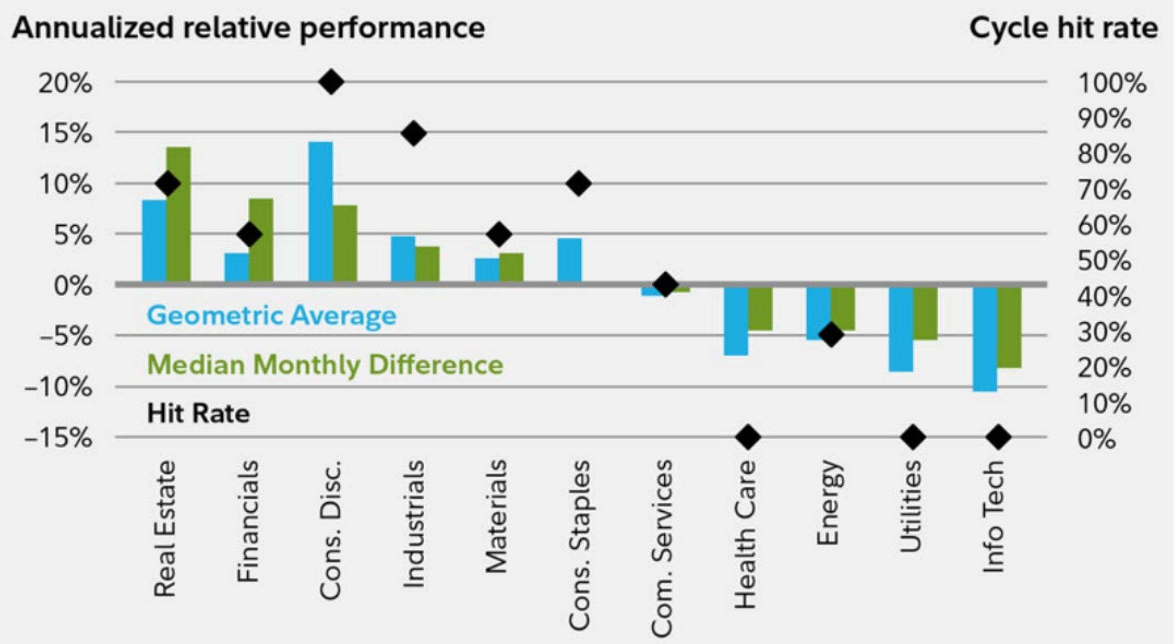
- **Average Performance:** Calculates the (geometric) average performance of a sector in a particular phase of the business cycle, and subtracts the performance of the broader equity market.

- **Median Monthly Difference:** Calculates the difference in the monthly performance of a sector compared with the broader equity market, and then takes the midpoint of those observations.

- **Cycle Hit Rate:** Calculates the frequency of a sector's outperforming the broader equity market over each business cycle phase since 1962.

Sector performance in early phase

Sectors that have performed well in the early cycle are interest-rate sensitive and economically sensitive sectors



Includes equity market returns from 1962 through 2016. Returns are represented by the top 3000 US stocks ranked by market capitalization. Sectors as defined by GICS. Source: Fidelity Investments (AART), as of March 31, 2019. **Past performance is no guarantee of future results.**

Mid-cycle phase

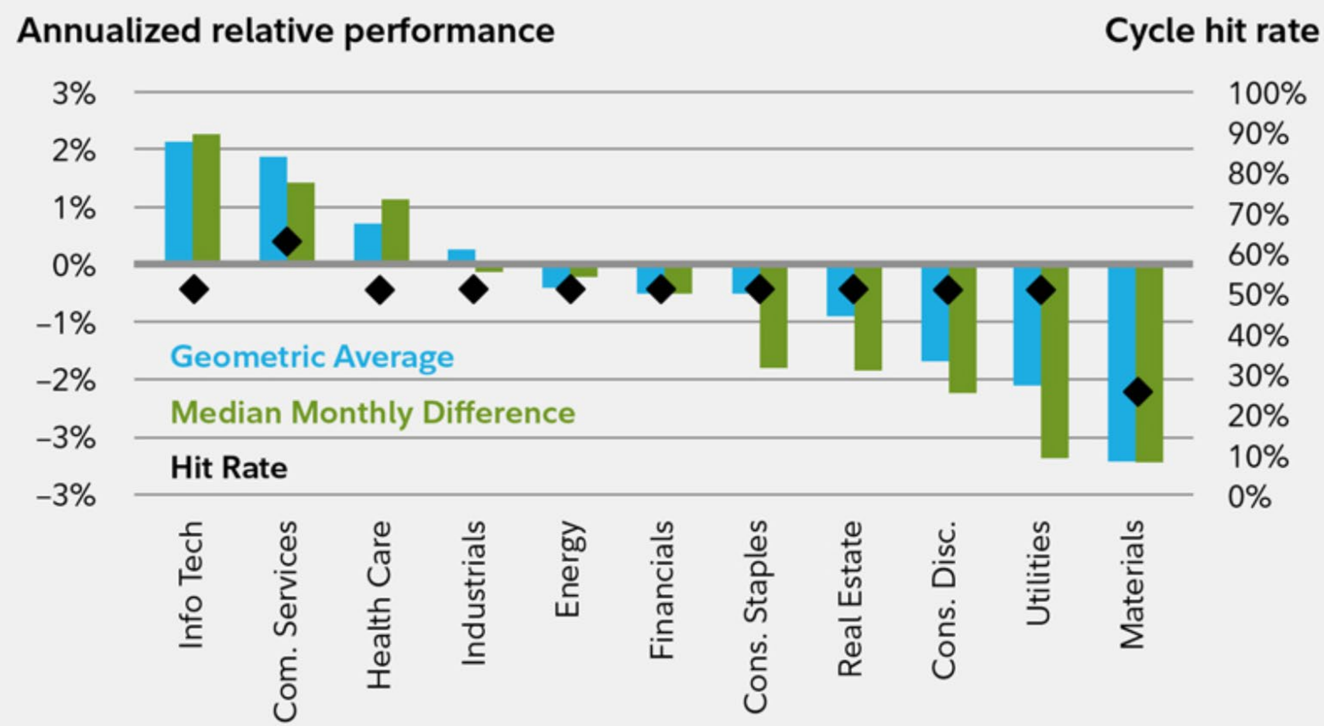
- When the economy exits recovery and enters into expansion.
- Average annual stock market performance is 14%.
- Typically the longest phase in the cycle, with an average duration of 3.5 years
- Mid-cycle phase is when most corrections take place.
- Least sector differentiation because sector leadership rotates quickly due to corrections.
- No sector has outperformed or underperformed broader market more than 75% of the time, and the magnitude of outperformance is modest.
- However, information technology – such as semiconductors and hardware – along with communications services tend to outperform.
- Growth is peaking, credit growth strong, profit growth peaks, policy is neutral. Yield curve is flattening; inflation is moderate.
- Stock selection becomes important – move from beta exposure to alpha driven as corporate winners and losers emerge.
- High quality fixed income performs poorly relative to stocks.

Sector performance in mid-cycle phase

- Information Technology is the best performer.
- Communications Services & Transportation also do well.
- Industrials on a whole tend to underperform, but certain sectors do well, such as industrial conglomerates.
- Utilities and materials lag the most.
- Mid-cycle is when stock selection is most important!

Mid-cycle sector performance

Sector leadership has rotated frequently in the mid-cycle phase, resulting in the smallest sector performance differentiation of any business cycle phase



Sectors as defined by GICS. Source: Fidelity Investments (AART), as of March 31, 2019. **Past performance is no guarantee of future results.**

Late-cycle phase

- Stock market returns weaker than the previous two cycles with an average of 6% total return per year.
- Average duration is 1.5 years.
- Inflationary pressures cause rising raw material costs, which help energy and material sectors outperform.
- Characteristics: deteriorating corporate margins, tightening credit. Inventories build up and sales growth slows. Yield curve is flat or inverted.
- High interest rates, corporate expansions, mergers, acquisitions, and increased leverage as corporate restructuring becomes exhausted.
- Slowing economic growth amidst restrictive monetary policy, tightening credit
- High quality fixed income performance begins to improve.

Late-cycle phase

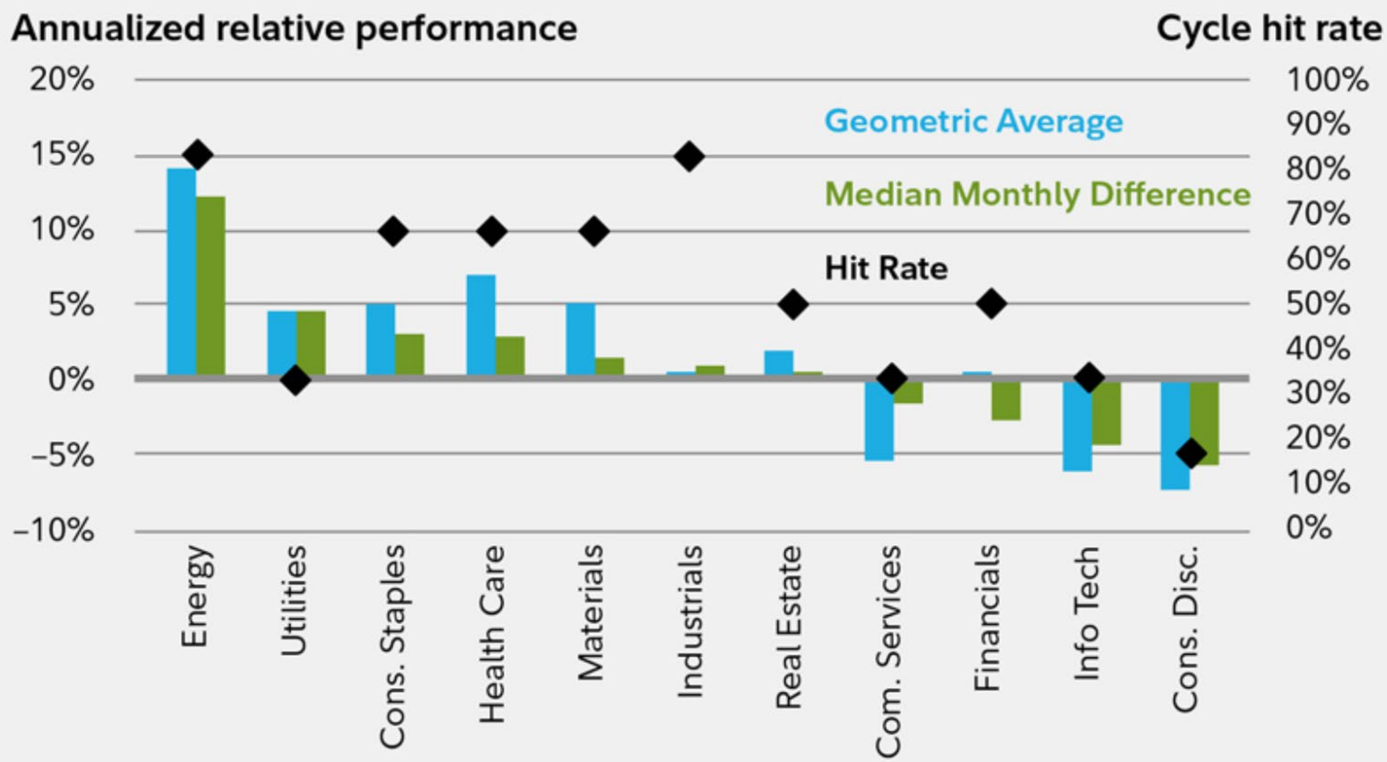
- Performance shifts towards defensive sectors, such as healthcare, consumer staples, and utilities.

- Beginning of late-cycle phase: precious metals, chemicals, steel, mining, defense, machinery, ship and railroad equipment, aircraft, electrical equipment.

- End of late-cycle phase: agricultural, beer and liquor, candy and soda, food products, healthcare, medical equipment, pharmaceutical products, tobacco, coal, petroleum and natural gas.

Late-cycle sector performance

As the economic recovery matures, the materials and energy sectors have typically performed well, as have defensive-oriented sectors



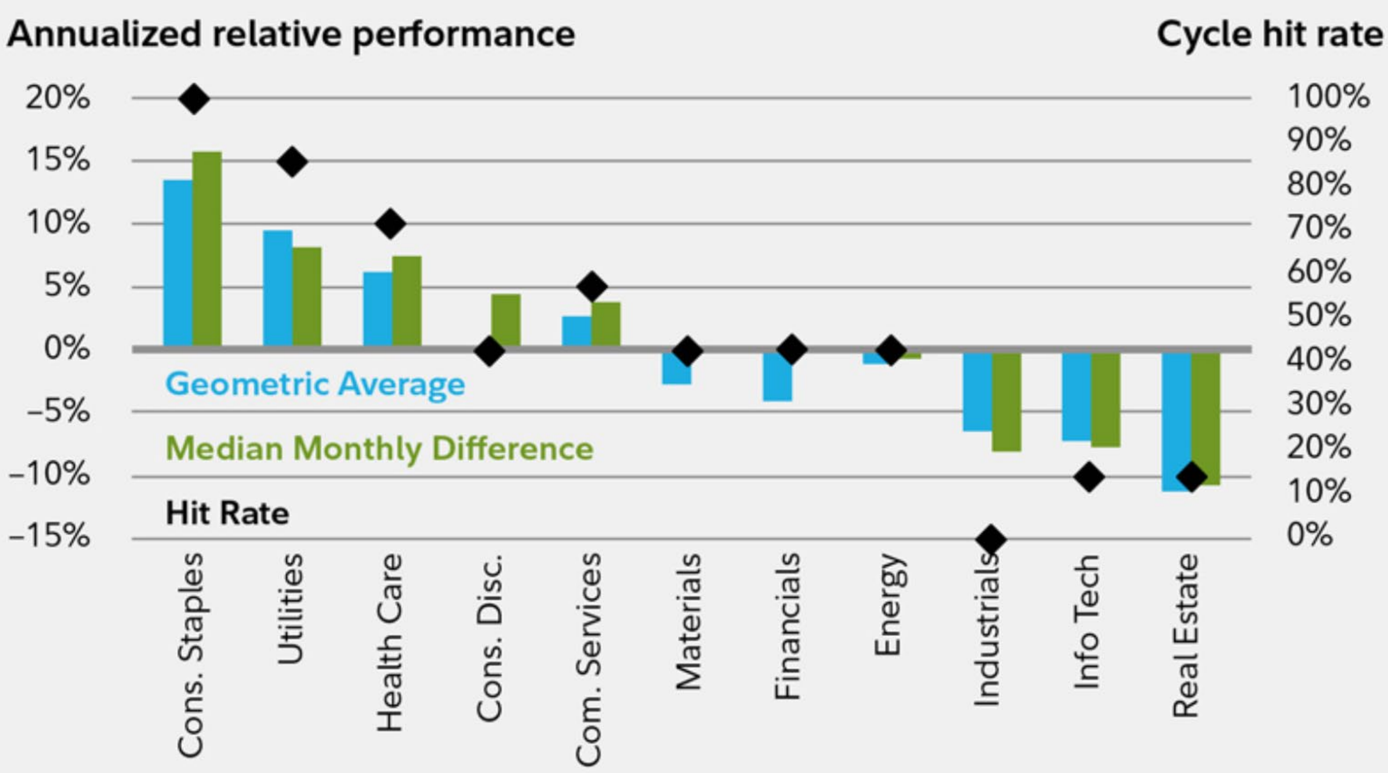
Sectors as defined by GICS. Source: Fidelity Investments (AART), as of March 31, 2019. **Past performance is no guarantee of future results.**

Recessionary phase

- Average return is -15%, with an average duration less than a year.
- Peak in short-term interest rates, rising corporate defaults, overexpansion, value destruction, deleveraging, scarce credit, and inventories gradually fall despite low sales levels.
- Losses across the board. Consumer staples, utilities, telecom, and healthcare tend to hold up the best. No sectors generate positive returns.
- High quality fixed income performs well.

Recessionary phase sector performance

Defensive-oriented sectors have tended to outperform during the recession phase



Sectors as defined by GICS. Source: Fidelity Investments (AART), as of March 31, 2019. **Past performance is no guarantee of future results.**

Summary of sector performance

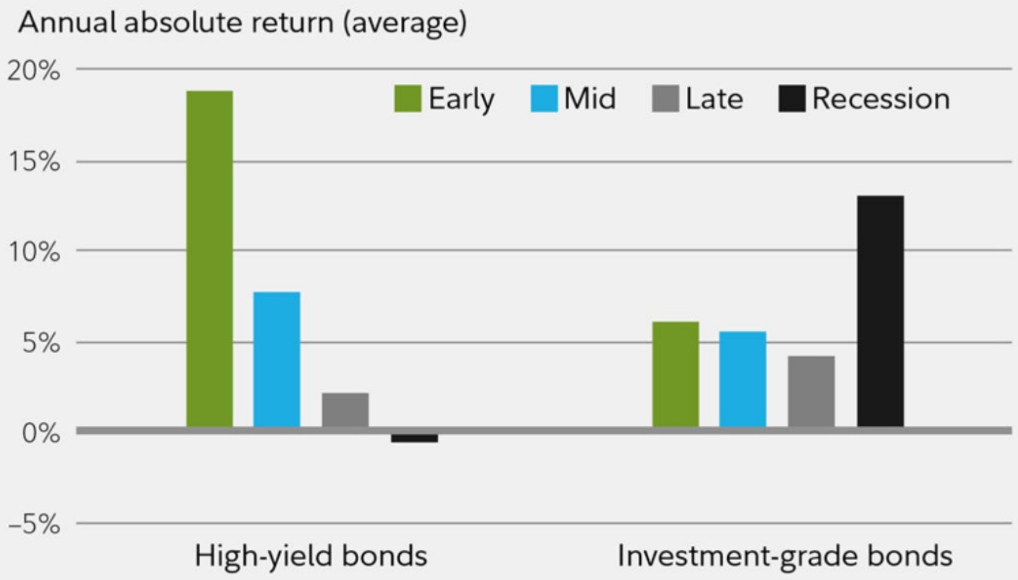
Looking at sectors throughout the business cycle

	Early cycle Rebounds	Mid cycle Peaks	Late cycle Moderates	Recession cycle Contracts
Financials	+			
Real Estate	++			––
Consumer Discretionary	++	–	––	
Information Technology	+	+	––	––
Industrials	++			––
Materials	+	––	++	
Consumer Staples			++	++
Health Care	––		++	++
Energy	––		++	
Communication Services		+		–
Utilities	––	–	+	++
	Economically sensitive sectors may tend to outperform, while more defensive sectors have tended to underperform.	Making marginal portfolio allocation changes to manage drawdown risk with sectors may enhance risk-adjusted returns during this cycle.	Defensive and inflation-resistant sectors tend to perform better, while more cyclical sectors underperform.	Since performance is generally negative in recessions, investors should focus on the most defensive, historically stable sectors.

Bond performance

The economic sensitivity of high-yield bonds has caused them to behave more like equities than investment-grade bonds

Bond performance across business cycle phases 1950–2010

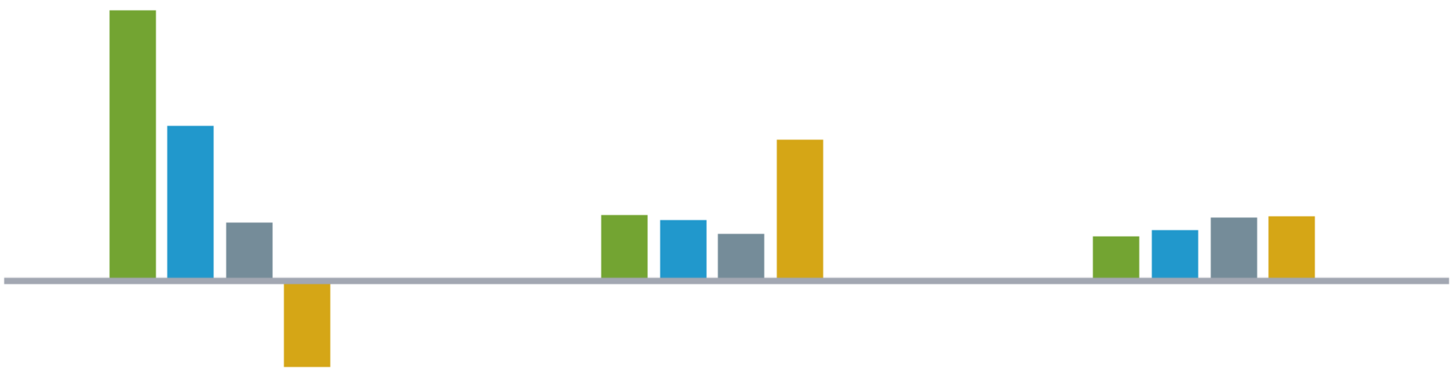


Past performance is no guarantee of future results. Asset class total returns are represented by indexes from the following sources: Fidelity Investments, Bank of America Merrill Lynch, Ibbotson Associates, Barclays, as of July 31, 2014. Source: Fidelity Investments proprietary analysis of historical asset class performance, which is not indicative of future performance.

Asset class performance

EXHIBIT 3: Historically, performance of stocks and bonds has been heavily influenced by the business cycle.

Asset Class Performance Across Business Cycle Phases 1950–2010

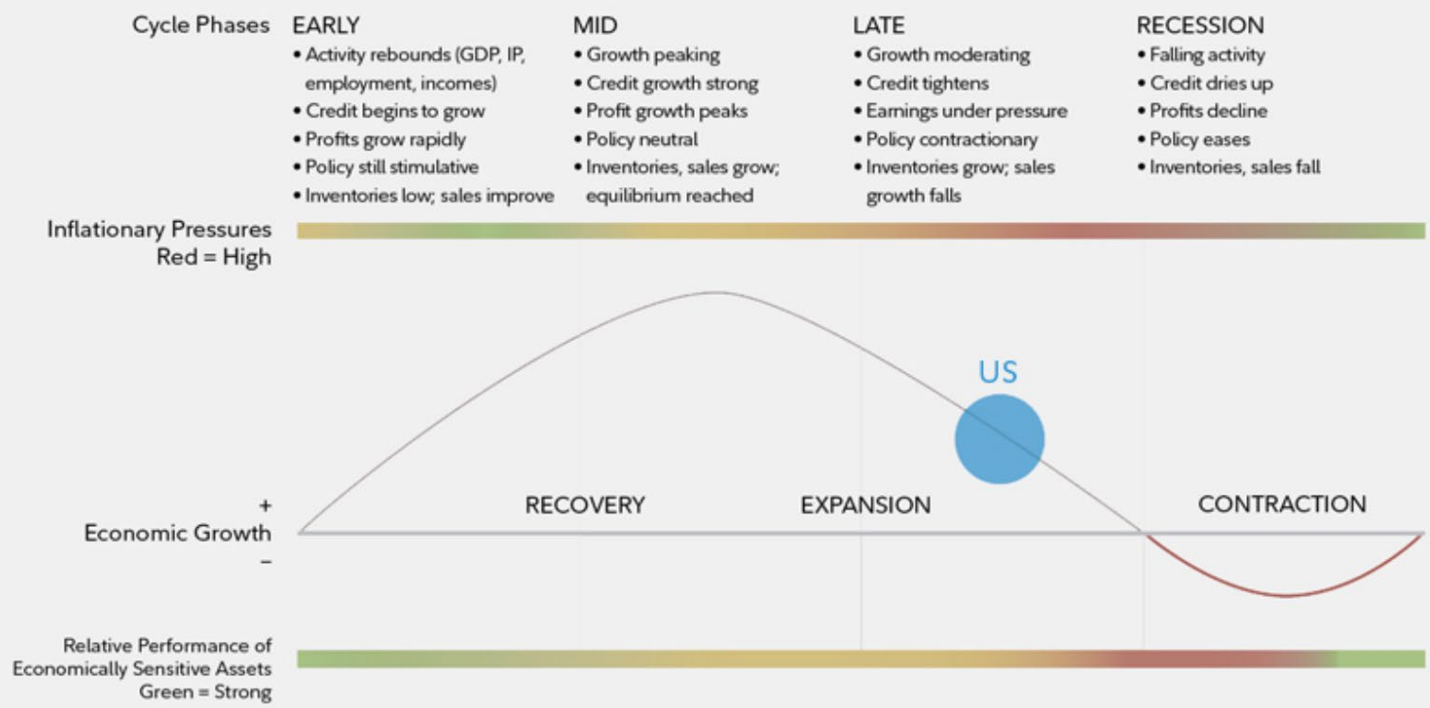


	Stocks	Bonds	Cash
Early	25%	6%	4%
Mid	14%	5.5%	4.5%
Late	5.5%	4%	6%
Recession	-7%	13%	6%

Past performance is no guarantee of future results. Asset class total returns are represented by indexes from the following sources: Fidelity Investments, Ibbotson Associates, Barclays, as of July 31, 2014. Source: Fidelity Investments proprietary analysis of historical asset class performance, which is not indicative of future performance.

Before COVID-19 cycle was mature

The business cycle has 4 distinct phases. The US is firmly in the late cycle as of 2019.



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Economically sensitive assets include stocks and high-yield corporate bonds, while less economically sensitive assets include Treasury bonds and cash. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (AART), as of March 31, 2019.

As of June 2020

NBER Determination of the February 2020 Peak in Economic Activity

Cambridge, June 8, 2020 -- The Business Cycle Dating Committee of the National Bureau of Economic Research maintains a chronology of the peaks and troughs of U.S. business cycles. The committee has determined that a peak in monthly economic activity occurred in the U.S. economy in February 2020. The peak marks the end of the expansion that began in June 2009 and the beginning of a recession. The expansion lasted 128 months, the longest in the history of U.S. business cycles dating back to 1854. The previous record was held by the business expansion that lasted for 120 months from March 1991 to March 2001.