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The art of business cycle analysis

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Since the Great Depression, cyclical fluctuations of income and wealth have become progressively more manageable for those in the developed world. Recessions have become shorter and the amplitude of cycles has generally trended lower. Some explanations for the smoother modern-day cycles include: an increasingly diverse global economy with a shift from goods-producing sectors toward a diverse array of service-oriented sectors, enhanced supply chain management through improved technology, and an increasingly active approach to monetary and fiscal policy to manage inflation and counteract recessions. For investors, this does not mean that volatility has gone away. Business cycles continue to play a significant role in influencing corporate earnings, credit conditions and investor sentiment, all of which contribute to market volatility. It is worthwhile to examine how business cycle analysis can help investors.

The business cycle is a simple concept. Over time, it captures the path of gross domestic product from one trough to the next, including a peak in between. Business cycles are easy to measure in hindsight, but often too complex to understand for sustained financial gain. Throughout history, renowned thinkers have conceived brilliant theories to explain the predictability of business cycles, but only after a crisis had struck, which is rather convenient. To date, there is no theory that can reliably and consistently predict the fluctuations of an economic cycle. This is likely because each cycle is a highly complex manifestation of numerous other cycles, tracking the ebbs and flows of business and consumer spending, credit conditions, personal incomes, raw materials prices, monetary policy, investor sentiment and countless other factors. To complicate matters further, each business cycle in the past has varied in length and amplitude. For these reasons, investors often prefer to take an agnostic view on cycles and effectively treat them as random outcomes.

Thankfully, past cycles do provide some useful clues for investors that are willing to use business cycle analysis as a guide for asset allocation and risk management. History suggests that business cycles are highly intertwined with the push and pull of the monetary cycle whereby central banks transition from stimulating the economy during recessions to tightening money supply in the later stages when inflationary pressures build up, though often with poor timing. The credit cycle has also played a major role in the business cycle and has been a good leading indicator of an impending recession when credit conditions start to tighten. Sentiment indicators appear to be useful contrarian indicators as they often reveal maximum optimism just prior to a recession and maximum pessimism at the beginning of a recovery. By keeping a close eye on some of the key markers, investors can gain a general sense of the evolving economic environment and have a better chance at intelligently filtering and synthesizing the daily blitz of news and data feeds.

Despite their highly unpredictable durations and amplitudes, business cycles tend to follow a fairly repetitive pattern as the economy gradually progresses through stages rather than switching suddenly from boom to bust and back to boom. During the good times, the economy progresses through the recovery, expansion and late cycle stages and, during the bad times, the economy experiences a slowdown followed by a recession. Rather than attempting to precisely time the next recession, there can be greater payoffs and less disappointments in directing efforts toward identifying the current phase of the cycle and preparing for the subsequent phase. Financial markets have tended to lead the economy by several months or longer, reinforcing the importance of taking a forward-looking approach rather than a backward-looking or even coincident one.

Today, there are multiple indications that the global economy remains in decent health but resides somewhere in the late cycle stage. Monetary policy has generally been tightening, albeit very slowly, leading to a narrowing of the gap between short-term and long-term interest rates. This is a possible sign that bond investors are becoming concerned about the economy and are not buying into the optimism of central bank policy makers. Consumer and producer price inflation remain weak but have crept up from their 2015 lows. This may start to put pressure on profit margins as businesses face rising input costs. Meanwhile, consumer and business spending momentum has been slowing following a few robust years. Despite the emerging signs of an impending slowdown, investor optimism remains high, evidenced by elevated equity valuations, low option premiums and thin credit spreads. Absent any material exogenous shocks such as a nuclear war, natural disaster or some other unthinkable crisis, a recession does not appear to be right around the corner. However, the next phase we will likely experience is the slowdown phase and there are indications that we are getting close.

Business cycle analysis is far from an exact science, arguably bordering on the realm of art. Until the day that a single, predictive theory of everything is discovered, the best we can hope to do is to leverage our knowledge of past cycles as one of the many inputs to investing. When combined with a sound understanding of larger, structural trends, cyclical analysis can be a powerful tool to manage risk and conduct asset allocation, especially for conservative investors with shorter time horizons.

Combined top 15 equity holdings as of July 31, 2017 of a representative balanced Private Client Managed Portfolio with alpha-style equity exposure*

1. Suncor Energy	6. ICICI Bank	11. HeidelbergCement
2. SNC-Lavalin	7. Walgreens Boots Alliance	12. Wal-Mart Stores
3. AltaGas	8. Athene Holding	13. Fortis
4. Atco	9. Loblaw Companies	14. Symantec
5. Canadian Natural Resources	10. E-L Financial	15. Galp Energia

Combined top 15 equity holdings as of July 31, 2017 of a representative balanced Private Client Managed Portfolio with value-style equity exposure*

1. Royal Bank of Canada	6. Alphabet Class C	11. Canadian National Railway
2. Apple	7. Manulife Financial	12. UnitedHealth Group
3. Bank of Nova Scotia	8. Chubb	13. CCL Industries
4. Microsoft	9. Suncor Energy	14. Canadian Natural Resources
5. Toronto-Dominion Bank	10. Enbridge	15. Air Canada

Combined top 15 equity holdings as of July 31, 2017 of a representative balanced Private Client Managed Portfolio with growth-style equity exposure*

1. Tourmaline Oil	6. Fairfax Financial	11. Palo Alto Networks
2. Walgreens Boots Alliance	7. Athene Holding	12. Exelon
3. Canadian Natural Resources	8. Praxair	13. AutoZone
4. Franco-Nevada	9. Symantec	14. Canadian Pacific Railway
5. George Weston	10. Keyera	15. Restaurant Brands International

*Approximately 33% fixed-income, 10% enhanced income, 49% equities, and 7% global real estate.

To see the top 15 holdings of the individual pools or the equity alpha mandates, please contact us.