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Business cycle investing

White paper

Business cycle investing

Learn how the business cycle influences investment performance and how investors can identify potential return opportunities.

Key highlights

- Investment returns are driven in large part by changes in the business cycle.
- Certain asset classes and investment types have historically performed better than others in different stages of the business cycle.
- In the current expansion phase of the business cycle, investors can expect to find opportunities in select areas of the market.

Summary

Many factors can influence investment returns, but at a basic level the business cycle is perhaps the most important factor driving investment performance. That's because changes in value for a company's outstanding stock and bond issues are based in large part on the dynamics of a business's bottom-line performance: revenue, expenses, earnings and growth. These factors often fluctuate among individual businesses and industry sectors as the business cycle evolves.

The success of any particular investment decision or strategy may depend on understanding what conditions are often present within each phase of the business cycle and identifying how the business cycle transitions from one stage to the next.

Understanding the business cycle may help investors find opportunities in the investment markets.

In this white paper, we provide a framework to help investors evaluate investment decisions at any point in the business cycle and set reasonable expectations for future investment performance. We also put this framework to use in presenting our perspective on the current business cycle and implications for portfolio allocation decisions.

What drives the business cycle?

Cycles are a natural phenomenon in a developed economy. Business activity rises as companies innovate and produce new products and services. They also create jobs that help individuals build their purchasing power. But eventually, business activity declines as companies and markets mature, continued innovations and improvements have lesser impacts, consumer spending slows and economies slide into recession.

Slowdowns in business and economic activity are painful for companies and individuals alike, but they can be beneficial, too. Recessions offer opportunities for businesses to reorganize their operations and rebuild for future growth. The cyclical nature of economic activity provides businesses with the impetus to invest in the present and grow for the future.

Individuals can participate in these economic opportunities through the investment markets. The returns investors achieve on their investments are driven in large part by changes in the business cycle.

Business cycles generally last **5 to 10** years.

Understanding how changes in these factors impact the business cycle can help investors make informed decisions about how to allocate their portfolios, whether by asset class, investment style, size or sector.

Identifying business cycles

There are different types of cycles present in a developed economy. Market cycles are short-term and driven largely by emotional factors such as investor sentiment. Secular cycles are much longer, running over several decades and capable of transforming an economy on a large scale (e.g., the transition from a manufacturing to a service economy). Business cycles fall somewhere in between, at least in terms of duration, generally lasting five to 10 years.

Much like the passing of a 24-hour day, a full rotation of the business cycle will have two phases — expansion and recession. Expansion would take place during daylight hours, when business activity picks up, more people are working and economic growth is positive. Recession would occur at night, when business activity slows down, fewer people are working and economic growth stagnates or contracts.

Where are we in the business cycle? Ask these questions.

Forces in the marketplace, the financial system and the broader economy put business cycle changes in motion, including:

Business conditions

- Are companies reinvesting in their core businesses or diversifying into new industries?
- Is credit readily available?
- Are businesses able to affect prices or sales in their favor?
- Are earnings growing or contracting?

Macroeconomic conditions

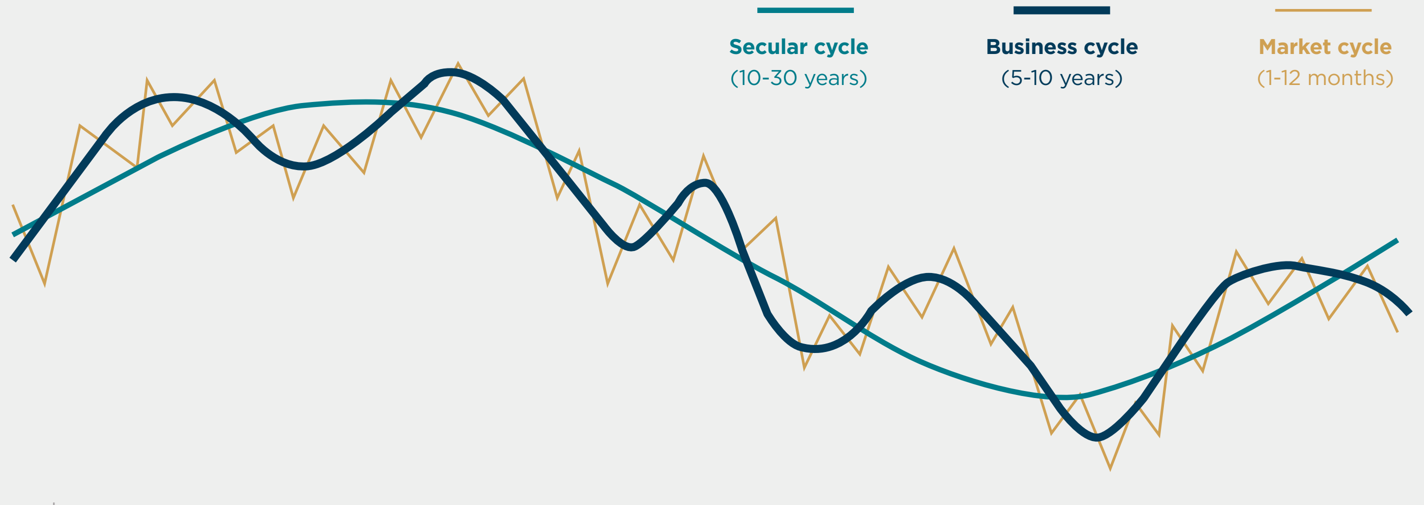
- Is the larger economy in expansion or recession mode?
- Is inflation rising or falling, or are prices stagnating or in a period of deflation?
- Are businesses creating jobs and are people capable of finding full-time work?
- Are central bank monetary policies accommodative or restrictive?

Market conditions

- What is investor sentiment at the moment? Are investors more willing to accept risk, or are they fearful and seeking safety?
- Do investors favor stocks of large companies over small, or vice versa?
- Are investors keen on businesses with a strong potential for growth, or mindful of risk and seeking value-oriented stocks?

Different investment cycles through time

The business cycle is just one type of cycle investors may experience. It's important for investors to know how to identify the different cycles.

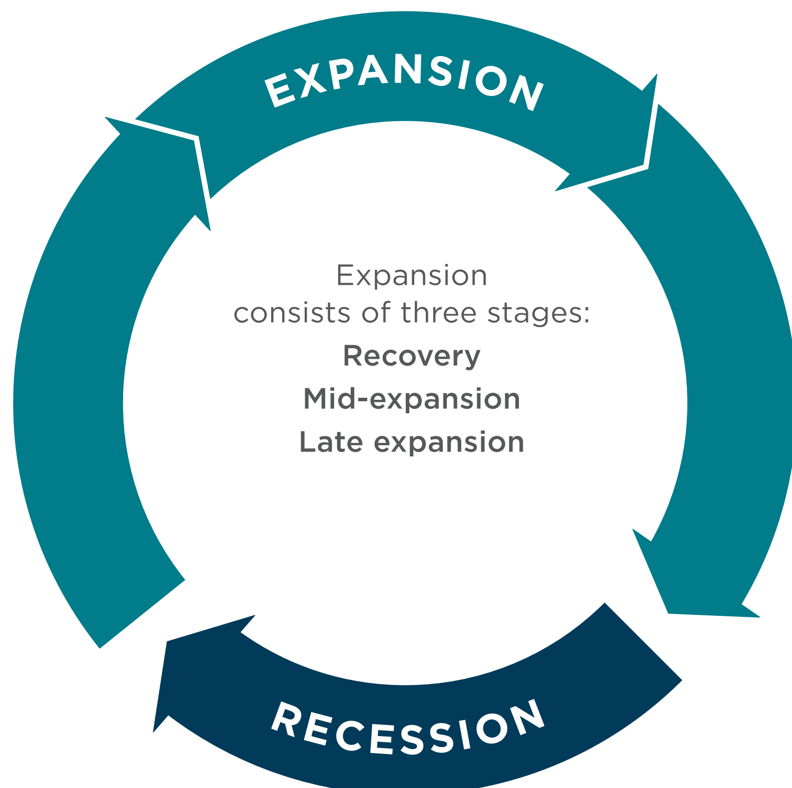


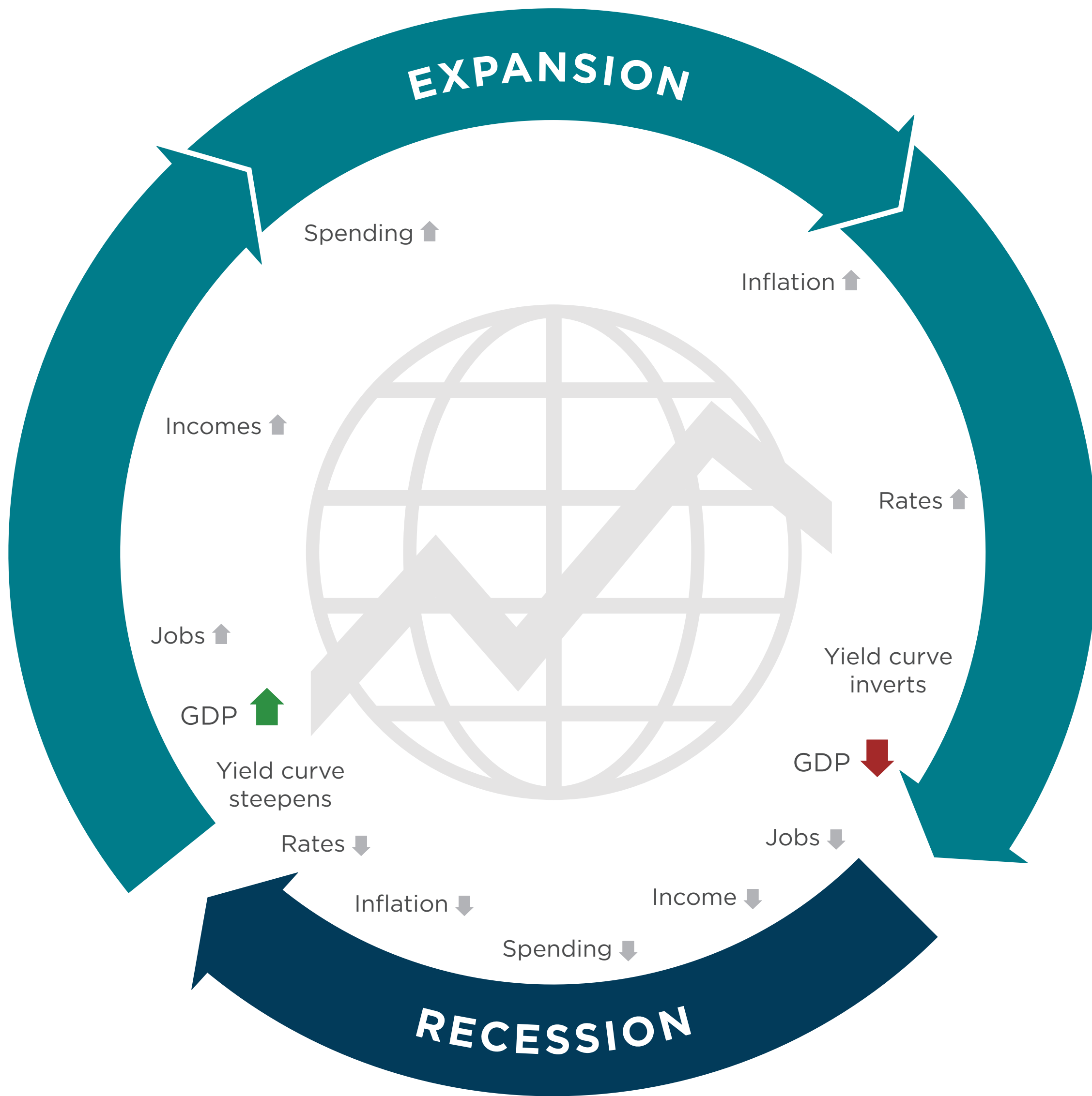
Expansion is made up of three stages. Every expansion begins when negative economic growth turns a corner and business activity picks up. However, every expansion will eventually reach a maturation point, where economic growth peaks and business activity moderates before sliding into a recession.

Economists and investors can read different barometers such as employment, inflation, economic growth and more to help identify the current position of the business cycle. Some measurements may show changes before others and follow a pattern for the duration of an expansion or recession.

For example, employment is one of the earliest indicators to show improvement during expansions or weakness during recessions. Changes in personal incomes typically follow changes in employment for obvious reasons. (See illustration on next page.) However, these indicators haven't always followed this set pattern in previous expansions and recessions, as we will see later in this discussion.

A full rotation of the business cycle will have ***two phases.***





*Actual timing of economic indicators may change based on the cycle.

How economic indicators typically progress during a business cycle

Cycle phase	Economic growth (GDP)	Jobs	Incomes	Spending	Inflation	Interest rates
Expansion	Business activity increases as the economy recovers from recession.	Businesses add workers to quickly meet a surge in demand.	Paychecks rise as the labor market tightens.	As workers bring home fatter paychecks, they buy more goods and services.	Higher demand from consumers raises prices in the marketplace.	Monetary policy tightens as the Federal Reserve seeks to cool a heated economy.
Recession	Business activity slows down as higher interest rates and prices constrict spending.	Businesses lay off workers as demand decelerates.	Falling employment reduces total income.	Smaller paychecks reduce consumer demand.	Falling demand lessens the upward pressure on consumer prices.	Monetary policy loosens as the Fed seeks to reignite economic growth and business activity.

The yield curve as a business cycle indicator

One of the more reliable indicators of business cycle transitions is the yield curve. In the last 50 years, every recession in the U.S. economy has been preceded by an inversion in the U.S. Treasury yield curve.

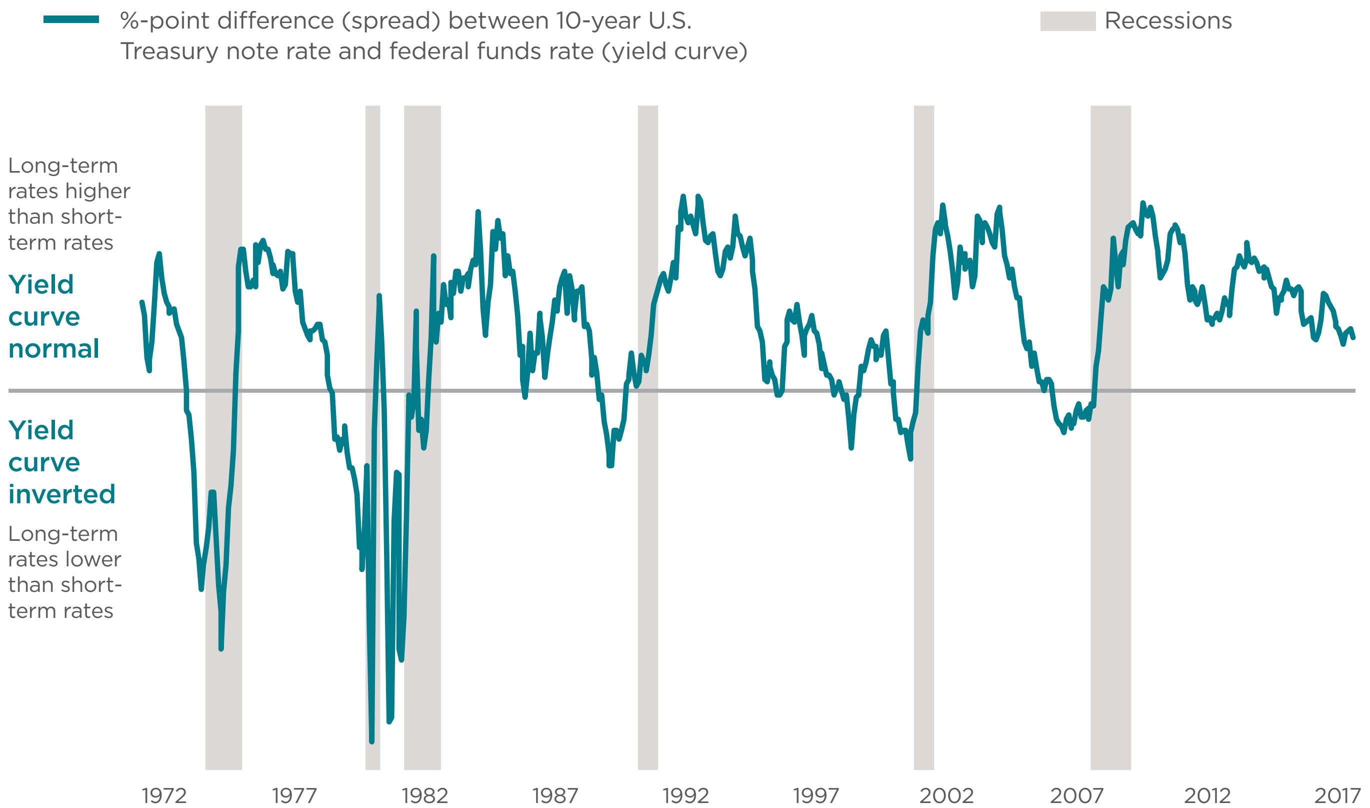
First, let's define what's going on. The yield curve represents interest rates for U.S. Treasury debt at all issued maturities — currently from four weeks to 30 years. A normal yield curve will be upward sloping, with short-term interest rates lower than long-term interest rates.

How does the yield curve indicate business cycle recessions? As the business cycle progresses and inflation rises, the Federal Reserve may hike its target federal funds rate to cool off an overheating economy. Because this benchmark directly affects overnight loans between banks, it has more of an indirect impact on short-term Treasury yields than on longer-term rates. The yield curve will then flatten as a Fed rate hike cycle continues, eventually inverting as short-term rates rise above long-term rates.

As the chart and table below show, over the last 50 years the inverting of the U.S. Treasury yield curve has always preceded a U.S. economic recession. On average, a recession has occurred 18 months after the inversion of the yield curve.

In the last **50** *years,* every U.S. **recession** has been preceded by an **inversion in the yield curve.**

U.S. Treasury yield curve as a predictor of recessions, 1972-2017



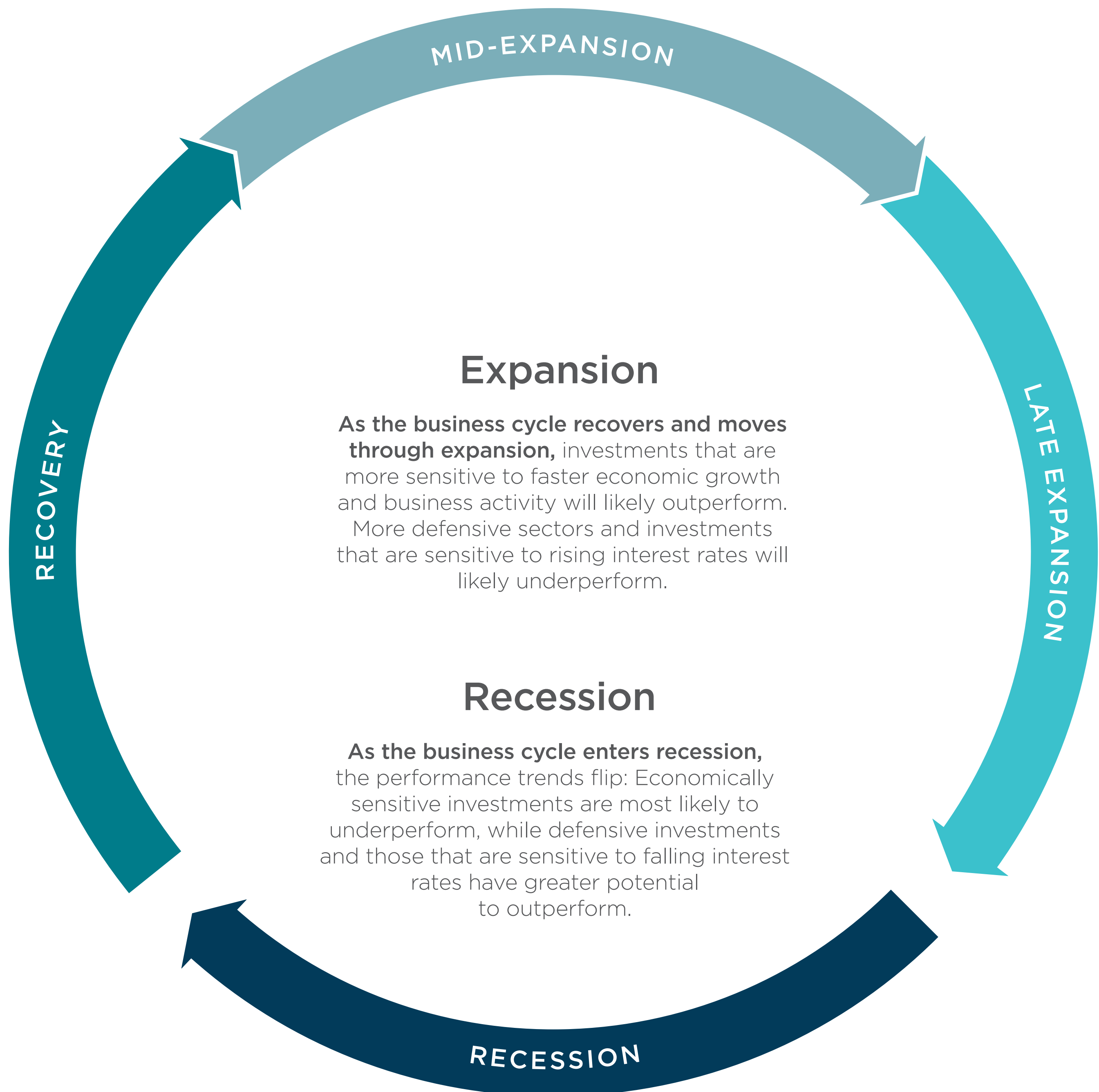
Date of yield curve inversion	Feb 1973	Sep 1978	Sep 1980	Dec 1988	Jun 1998	Jun 2006
Months until recession starts	9	16	10	19	33	18

Source for yield curve data: FactSet Research Systems; Source for recession dates: National Bureau of Economic Research

How cycles can influence portfolio decisions

A rising economic tide will generally lift all businesses, but certain businesses — and by extension, their investments — may perform better than others in the various stage of the business cycle.

These performance differences exist among different asset classes, investment categories, industry sectors, countries and regions. Because performance can vary among investments at different points in the business cycle, understanding the business cycle can help investors achieve their performance goals through informed portfolio allocation decisions.



Asset class performance throughout the business cycle

In a typical business cycle, investors' appetite for risk increases with the higher prospects for growth that come in the early stages of expansion. Stocks are preferred to bonds, and equity asset classes that are more growth-oriented and have a higher risk profile tend to perform well. This would include stocks of midsize and small companies, as well as emerging market equities.

Once the expansion is well-established, growth moderates and the stocks of larger companies tend to do well, often outperforming higher-risk small-cap stocks. As the expansion reaches maturity and the threat of recession looms, investors look to reduce their exposure to riskier assets. A "flight to safety" to higher-quality and fixed-income asset classes typically occurs, and bonds tend to outperform stocks during recessions.

	Recovery	Mid-expansion	Late expansion	Recession
Asset classes that have outperformed	Small-cap stocks Emerging market stocks Commodities	Large-cap stocks Mid-cap stocks Intermediate U.S. bonds	International stocks Global real estate U.S. corporate high-yield bonds	Commodities Emerging market stocks Mid-cap stocks
Asset classes that have lagged	Large-cap stocks International stocks International bonds	Emerging market stocks International bonds Commodities	Intermediate U.S. bonds International bonds Commodities	Large-cap stocks International stocks Global real estate

Sector performance during the business cycle

Business naturally booms during cyclical expansions, and younger, growth-oriented firms and industries often enjoy strong spurts of growth that make their investments attractive early in these cycles. When the inevitable recession arrives, business activity doesn't cease entirely, of course. Historical performance shows that certain industry sectors tend to outperform others when the business cycle is in recession.

In the early stages of business cycle expansion, industrial and technology companies benefit from increased demand as businesses begin to reinvest in their operations when growth resumes after recession. Financial stocks become more attractive as the renewal of business activity increases the demand for borrowing. As the expansion strengthens, so does consumer confidence, helping to drive higher demand for discretionary goods.

But as the pace of growth decelerates, sectors that offer steadier performance such as health care and energy tend to outperform. The looming slowdown also dampens demand for technology products and weakens consumer discretionary spending. Businesses that experience steady consumer demand even during economic slowdowns, such as consumer staples and health, tend to outperform during recessions.

	Recovery	Mid-expansion	Late expansion	Recession
Industry sectors that have outperformed	Industrials Technology	Financials Consumer discretionary	Materials Energy	Consumer staples Health care
Industry sectors that have lagged	Energy Telecom	Materials Utilities	Consumer discretionary Technology	Industrials Financials

Where we are now

Reading business cycle indicators is open to interpretation and comes with caveats about the inability to predict or foresee future investment performance. There are pitfalls in using these indicators to try to time investment decisions to capture periods of outperformance. Investors should continue to diversify their portfolios and maintain a long-term perspective as effective strategies for managing risk and achieving overall investment objectives.

Let's look at what the current indicators are saying about the business cycle as of this writing, plus consider what's different about these indicators that may challenge this business cycle assessment. As of the beginning of 2018, the major indicators point to a business cycle in the late expansion stage.

Economic growth (GDP)

Growth has been steady although not strong since the end of the last recession, but has picked up in recent quarters.

Employment

Job creation has improved, and the unemployment rate stands well below the historical average.

Income

Income growth has remained below average since the end of the last recession, but more recently it has begun to show some improvement.

Inflation

Inflation is still low, but inflation expectations have begun to rise. Commodity prices, which are one signal of inflation, are low but have edged up.

Interest rates

The Federal Reserve has been raising the fed funds rate since December 2015. Gradual hikes are expected in 2018.

Yield curve

Although the curve has flattened considerably in the past year, it still has some distance to go before it inverts.

Opportunities in a late expansion

Global stocks
Stocks outside of the U.S. have historically lagged before this point but are poised to outperform as the business cycle matures.

Capitalization
Large-cap stocks should be driving market performance at this point. Small-cap outperformance historically has run its course by this phase of the business cycle.

Sectors
Industries with steady growth and value-oriented sectors such as health care and energy would typically do well here.

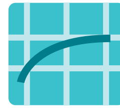
*As of January 2018

What's different this time?

As we mentioned earlier in this white paper, business cycle indicators do not always follow the same pattern of performance. For example, there are a number of idiosyncrasies in current market and economic indicators that should be considered when making asset allocation decisions. These include:

Cycle duration

Economic growth during the current expansion, as measured by GDP, has been slow on a relative basis, averaging just 2.1% since the end of the previous recession in June 2009. This tepid pace of growth has occurred even with an ultra-accommodative monetary policy by the Federal Reserve. Should growth continue beyond mid-2019, the expansion phase of the current business cycle will become the longest on record. This would suggest the different stages of the current business cycle would be longer as well, as would the investment opportunities that appear during these stages.



Yield curve

The spread between U.S. Treasury rates and the federal funds rate has grown wider recently, resulting in a steeper yield curve. But the long-term trend going back several years shows a flattening yield curve, which would be consistent with prior expansionary cycles. The recent steepening of the yield curve has come after a long period of historically low interest rates, driven primarily by factors in international markets rather than domestic concerns. Any further flattening or inversion of the yield curve, which in previous business cycles has increased the probability of a recession, would appear to be far off at this point.

If we're earlier in expansion

Given these idiosyncrasies in the economic readings, investors may want to give closer consideration to asset allocation decisions at this point in the business cycle expansion, including:

Small-cap stocks

After many years of business cycle expansion, small-cap stocks only recently exhibited outperformance relative to large-cap stocks, beginning in February 2016. Earnings for smaller companies are expected to be stronger than those of larger firms, at least into 2018.

International stocks

U.S. stocks have outpaced developed markets in Europe and Asia, and there is little indication this trend will change in the near term. Even as international equities have lagged U.S. markets, the growth prospects between the U.S. and the rest of the world is as narrow as it has been in the current business cycle. Global stocks have the potential to outperform in the coming years as the expansion cycle continues.

Risk creates *opportunity* for **informed** investors.

Putting knowledge into practice

Uncertainty about the future direction and pace of economic growth can lead to unpredictability in the financial markets. Investors face a greater degree of risk as the business cycle transitions from one stage to the next. But risk also creates opportunity for informed investors to seek outperformance through prudent asset allocation decisions related to the business cycle.

When using the business cycle as a guide, it is always important to follow a prudent approach to portfolio management that aligns with your risk tolerance. Short-term noise can distract from the bigger picture, so it's also necessary to tune out emotional reactions to news and market events and take a long-term view of investment opportunities.

Key takeaways

Maintain awareness of business cycle transitions in readings of economic reports to set proper expectations for investment performance.

Follow a strategy of diversification that seeks to manage market risk through all stages of the business cycle.

Tune out the market noise to avoid making emotional investment decisions and keep a focus on long-term opportunities in the financial markets.

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NFM-16172AO.1 (03/18)