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Five Things to Know About the Credit Cycle

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The Federal Reserve meets eight times a year and moves the short-term interest rate up or down by one quarter of one percent – sometimes. Then they hold a press conference and the market goes bonkers and twitter blows up. We don't think we can explain all of that to you, but we can start by laying out the basics of the credit cycle and the role of interest rates.

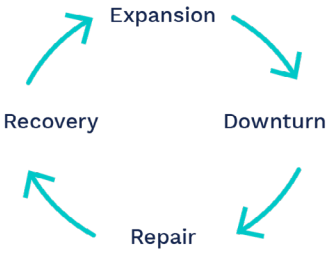
1. WHAT IS THE CREDIT CYCLE?

The "credit cycle" is a shorthand way to refer to the growth and then shrinking of the availability of credit. "Credit" refers to loans – to both businesses and individuals, in the form of direct loans, corporate and municipal bond issuance, mortgages, personal loans, etc. The credit cycle is one of the factors driving the economic cycle, as businesses access additional capital to expand and produce more products or services, and people access money to purchase or improve their homes, buy cars, go to school, etc. – all of which increases economic activity and overall economic health. This phase, when money is available and the economy is growing, is called the "expansion phase".

2. SO – WHY IS IT A "CYCLE" IF MORE IS BETTER?

Well, even though economies are generally on an upward sloping trend over long periods of time (multiple decades), in the short-term there are usually some glitches. Any one economic cycle usually lasts for about a decade – although the one we are in now is breaking records as the economy has been expanding for more than ten years. The credit cycle helps to drive the economic cycle, but it's not the only factor, and eventually, economic growth slows. This results in a downturn of the credit cycle

A Helpful Visualization: The Credit Cycle



3. WHAT CAUSES THE DOWNTURN?

The downturn in the credit cycle is when banks tighten credit standards and make fewer loans. For lenders, the critical element is the risk of default, which just means whether they will get paid back what they are owed. Consumer sentiment, monetary policy and global events may all play a role in this phase, as all three have the potential to threaten business growth.

If consumers fear recession and stop purchasing, businesses experience slower growth. Similarly, the risk of increased inflation can lead to a monetary policy of increasing interest rates in order to slow the economy. This also can lead to a situation in which businesses may struggle.

The same thing happens with various global events – generally, some types of macro situations may result in weakening or slowing of the economy. For example, in the current situation, investors are carefully watching the ongoing trade and tariff negotiations that are happening amongst the U.S. and many of its larger trade partners, as they may negatively affect businesses.

4. CAN'T BUSINESSES BORROW SOMEWHERE ELSE?

Yes, sometimes they can. Businesses that are unable to get bank loans often look to financial firms to lend them money. These non-bank financial firms have more flexibility than traditional lenders and can take positions in various parts of a borrower's capital structure. A private equity firm will purchase a business outright or buy a controlling stake. Other non-bank financial firms prefer to invest in debt. When they just make a loan to a business, it's called "private credit".

Because these financial institutions are different than banks, they may continue to lend money when the economy is contracting – which new studies have shown may have the effect of smoothing the credit cycle and hastening the recovery phase.[1]

5. ARE WE HEADED FOR A DOWNTURN?

Eventually. The problem is no one can predict when. Consumer balance sheets are still healthy with job and wage growth up, but in August the University of Michigan Consumer Sentiment Index posted its largest monthly drop since 2012, indicating that consumers may begin to pull back on spending. On the business side, corporate debt issuance is still robust. However, debt issuance in the BBB category is at a high. BBB is the lowest corporate debt rating that is still considered "investment grade". In the ten years after the financial crisis in 2008, the amount of the U.S. Investment-grade corporate market increased to 51.2% from 33.1%[2]

In an attempt to maximize yield while still managing for risk, investors have flocked to BBB debt. However, this category will be vulnerable during a credit downturn, as investors who are constrained by investment criteria that prohibit holding any assets lower than investment grade may become forced sellers if these bonds are downgraded.

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For investors concerned with the credit cycle, some cyclical adjustments to your portfolio may be in order. Switching to defensive sectors can help lower portfolio volatility. Also, incorporating income-producing investments can help smooth portfolio volatility.

And finally, if the fixed income allocation in your portfolio is primarily passively managed index-tracking debt funds, you may want to consider adding actively managed products. Remember all those BBB bonds being issued? They're probably in your passively managed index-tracking debt investment. Most fixed-income indexes are weighted by capitalization; this means that issuers with large amounts of outstanding debt end up constituting a greater part of the index than companies with less debt.

Understanding how the credit cycle can impact your portfolio is important, and there are steps you can take that may lessen the impact of downturns.

To learn more about the Credit Cycle, please contact your financial advisor.

[1] Alicia McElhaney, Private Credit Funds Stabilize Markets, Research Shows, Institutional Investor, (February 15, 2019)

[2] Bloomberg, as of 31 Dec 2018