Investor behavior during economic slow-down

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Abstract:

Consumption, one of the key growth drivers of the economy, is on the slow lane. Though the slowdown started in high-ticket segments like real estate, auto and consumer durables thanks to the credit squeeze triggered by the NBFC crisis, it has now spread to other sectors. Consequently, the GDP growth rate for the first quarter of 2019-20 fell to a 6-year low of 5%. There was more bad news for investors. Experts say this slowdown will continue for some more time.

How Does the Business Cycle Impact Investors?

Understanding the business cycle doesn't matter much unless it improves portfolio returns. What's an investor to do during a recession? The answer depends on your situation and what type of investor you are.

First, remember that a bear market does not mean there's no way to make money. Some investors take advantage of falling markets by short selling stocks, meaning they make money when share prices fall and lose money when they rise. This technique should only be used by sophisticated investors, however, due to its unique pitfalls. The most important of these is that losses from short selling are potentially infinite: there is no obvious limit to how far a stock's value can rise.

Another breed of investor treats a recession like a sale at the local department store. This technique, known as value investing, looks at a declining share price as a bargain waiting to be scooped up. Betting that better times will eventually return in the economy, value investors take advantage of bear markets to pick up high-quality companies on the cheap.

There is yet another type of investor who barely flinches during a recession. A follower of the long-term, buy-and-hold strategy knows that short-term problems will barely be a blip on the chart over a 20- to 30-year horizon.

Key words: business cycles, Economic factors, Investment behavior.

Introduction:

The key is to understand your situation and pick a style that works for you. For example, if you are close to retirement, the long-term approach definitely is not for you. Instead of living at the whim of the stock market, consider diversifying into other assets such as bonds, the money market, and real estate.

Recession

The adage "what goes up must come down" applies perfectly here. After experiencing a great deal of growth and success, income and employment begin to decline due to any number of causes: an external event such as an invasion or a supply shock, a sudden correction in overheated asset prices, or a drop in consumer spending due to inflation, which in turn can lead firms to lay off employees. (Because the wages companies pay workers and the prices they charge consumers are "inelastic," or initially resistant to change, cutting payrolls is a common response.) Rising unemployment pushes consumer spending down even further, setting off a vicious cycle of economic contraction. A recession is generally defined as two or more consecutive quarters of decline in real GDP.

Objectives of the Study:

1. To study the Investor behavior during economic slow-down
2. To understand the state of the economy and the business cycle.
3. To study the factors affecting on Investor behavior during economic slow-down
4. To suggest best practices to take effective decisions Investor behavior during economic slow-down

Creativity - a process influenced by individual and organizational factors that results in the production of novel and useful ideas, products, or both

Business investment is a key component of the business cycle. When firms are optimistic about the outlook and demand for their products, they hire workers and invest in capital to improve their productive capacity. Thus, during economic expansions, investment increases along with the productive capacity of the entire economy; similarly, during recessions, the pace of investment decreases.

How to invest using the business cycle: Key takeaways

- **The business cycle reflects the aggregate fluctuations of economic activity, which can be a critical determinant of asset performance over the intermediate term.**
- **Changes in key economic indicators have historically provided a fairly reliable guide to recognizing the business cycle's 4 distinct phases—early, mid, late, and recession.**
- **Our approach seeks to identify the shifting economic phases, providing a framework for making asset allocation decisions according to the probability that assets may outperform or underperform.**
- **For example, the early cycle phase is typically characterized by a sharp economic recovery and the outperformance of equities and other economically sensitive assets.**
- **This approach may be incorporated into an asset allocation framework to take advantage of cyclical performance that may deviate from longer-term asset returns.**

A business cycle approach to asset allocation can add value as part of an intermediate-term investment strategy. Although every business cycle is different, our historical analysis suggests that the rhythm of cyclical fluctuations in the economy has tended to follow similar patterns. Moreover, performance across asset categories typically rotates in line with different phases of the business cycle.

Asset allocation framework

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to produce asset allocation recommendations for Fidelity's portfolio managers and investment teams. Our framework begins with the premise that long-term historical averages provide reasonable baselines for portfolio allocations. However, over shorter time horizons—30 years or less—asset price fluctuations are driven by a confluence of various short-, intermediate-, and long-term factors that may cause performance to deviate significantly from historical averages. For this reason, incorporating a framework that analyzes underlying factors and trends among the following 3 temporal segments can be an effective asset allocation approach: tactical (1 to 12 months), business cycle (1 to 10 years), and secular (10 to 30 years). The chart below illustrates our duration based asset allocation framework.

Over the intermediate term, asset performance is often driven largely by cyclical factors tied to the state of the economy—such as corporate earnings, interest rates, and inflation. The business cycle, which encompasses the cyclical fluctuations in an economy over many months or a few years, can therefore be a critical determinant of asset market returns and the relative performance of various asset classes.

Understanding the business cycle

Every business cycle is different in its own way, but certain patterns have tended to repeat themselves over time. Fluctuations in the business cycle are essentially distinct changes in the rate of growth in economic activity, particularly changes in 3 key cycles—the corporate profit cycle, the credit cycle, and the inventory cycle—as well as changes in monetary and fiscal policy.

Asset performance is driven by a confluence of various short-, intermediate-, and long-term factors.

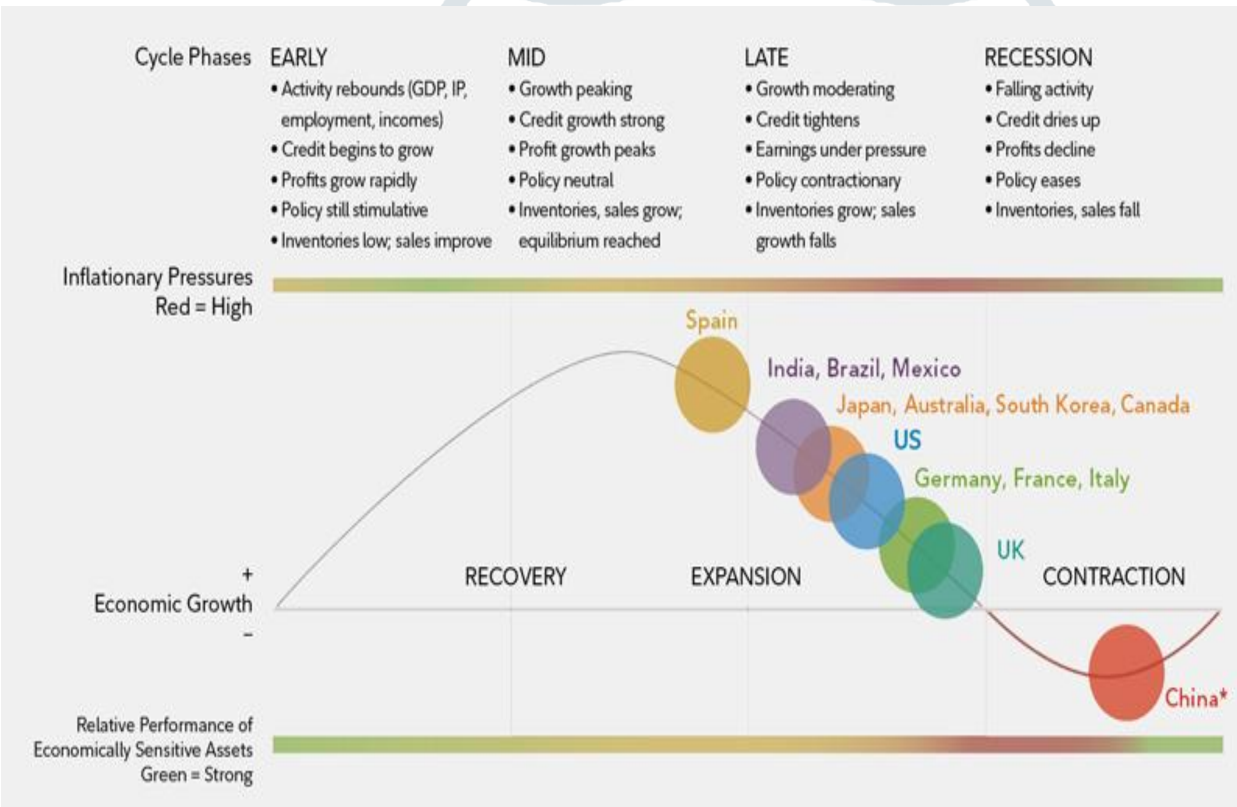
While unforeseen macroeconomic events or shocks can sometimes disrupt a trend, changes in these key indicators historically have provided a relatively reliable guide to recognizing the different phases of an economic cycle. Our quantitatively backed, probabilistic approach helps in identifying, with a reasonable degree of confidence, the state of the business cycle at different points in time. Specifically, there are 4 distinct phases of a typical business cycle (see chart below):

- **Early-cycle phase:** Generally a sharp recovery from recession, marked by an inflection from negative to positive growth in economic activity (e.g., gross domestic product, industrial production), then an accelerating growth rate. Credit conditions stop tightening amid easy monetary policy, creating a healthy environment for rapid margin expansion and profit growth. Business inventories are low, while sales growth improves significantly.
- **Mid-cycle phase:** Typically the longest phase of the business cycle. The mid cycle is characterized by a positive but more moderate rate of growth than that experienced during the early-cycle phase. Economic activity gathers momentum, credit growth becomes strong, and profitability is healthy

against an accommodative—though increasingly neutral— monetary policy backdrop. Inventories and sales grow, reaching equilibrium relative to each other.

- **Late-cycle phase:** Often coincides with peak economic activity, implying that the rate of growth remains positive but slows. A typical late-cycle phase may be characterized as an overheating stage for the economy when capacity becomes constrained, which leads to rising inflationary pressures. While rates of inflation are not always high, rising inflationary pressures and a tight labor market tend to crimp profit margins and lead to tighter monetary policy.
- **Recession phase:** Features a contraction in economic activity. Corporate profits decline and credit is scarce. Monetary policy becomes more accommodative and inventories gradually fall despite low sales levels, setting up for the next recovery.

The world's largest economies are all in expansion, though in various phases of the business cycle.



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. *A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use the "growth cycle" definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (AART), as of April 30, 2019.

Asset class performance patterns

The US has the longest history of economic and market data, and is thus a good use case to illustrate asset class return patterns across the business cycle. Looking at the performance of US stocks, bonds, and cash from 1950 to 2018, we can see that shifts between business cycle phases create differentiation in asset price performance in the chart below. In general, the performance of economically sensitive assets such as stocks tends to be the strongest when growth is rising at an accelerating rate during the early cycle, then moderates through the other phases until returns generally decline during recessions.

Equity sector relative performance has tended to be differentiated across business cycle phases.

	Early cycle Rebounds	Mid cycle Peaks	Late cycle Moderates	Recession cycle Contracts
Financials	+			
Real Estate	++			--
Consumer Discretionary	++	-	--	
Technology	+	+	--	--
Industrials	++			--
Materials	+	--	++	
Consumer Staples			++	++
Health Care	--		++	++
Energy	--		++	
Communication Services		+		-
Utilities	--	-	+	++

Unshaded (white) portions above suggest no clear pattern of over- or under-performance vs. broader market. Double +/- signs indicate that the sector is showing a consistent signal across all three metrics: full-phase average performance, median monthly difference, and cycle hit rate. A single +/- indicates a mixed or less consistent signal. Annualized returns are from 1962 to 2016, represented by the performance of the largest 3,000 US stocks measured by market capitalization. Sectors are defined by the Global Industry Classification Standard (GICS®). Source: Fidelity Investments (AART), updated as of March 31, 2019, to reflect the revised GICS sectors.

Merits of the business cycle approach

Many academics and market participants agree that economic factors influence asset prices. However, while academic research has shown that asset allocation decisions can be responsible for anywhere between 40% and 90% of return variability among portfolios, there is still debate over the best way to incorporate economic factors into asset allocation approaches.*

Our approach to business cycle investing

Our quantitatively backed, probabilistic approach encompasses a number of key attributes:

First, the approach focuses on critical drivers of relative asset performance. As demonstrated above, there is a large differential in asset performance across the various phases of the business cycle. A key to identifying the phase of the cycle is to focus on the direction and rate of change of key indicators, rather than the overall level of activity.

We focus on economic indicators that are most closely linked with asset market returns, such as corporate profitability, the provisioning of credit throughout the economy, and inventory buildups or drawdowns across various industries.

Second, we employ a practical and repeatable framework that provides a solid foundation and can be applied more consistently. Our business cycle dating scheme measures high-quality indicators that have a greater probability of representing economic reality and are not dependent on perfect hindsight. For instance, tangible measures such as inventory data are less likely to be revised or present false signals than other, broader indicators such as GDP growth. We use a disciplined, model-driven approach that helps minimize the behavioral tendency to pay too much attention to recent price movements and momentum, called the extrapolation bias, which is a common pitfall suffered by many investors.

Third, the cycle phases we employ are grounded in distinct, intermediate-term fundamental trends, typically only shifting over periods of several months or longer. This approach unfolds more slowly than tactical approaches, whose frequent shifts can whipsaw investors during periods of high volatility. Our approach is best suited to strategies with an intermediate-term time horizon and a lesser ability or willingness to trade into and out of positions quickly. On the other hand, this approach captures more frequent phases than the 2-state NBER strategies, thus providing more scope for generating active returns.

Investment implications

As a result, complementing the business cycle approach with additional strategies may further enhance the ability to generate active returns from asset allocation over time. For instance, tactical shifts in portfolio positioning may be used to mitigate the risks or opportunities presented either by the threat of external shocks or by major market moves that may be unrelated to changes in the business cycle. Another possibility is to analyze the domestic business cycle combined with the business cycles of major trading partners or the entire world, in order to capture more of the exogenous risks facing an economy.

Using additional complementary strategies may be particularly relevant during phases when the relative performance differential from the business cycle framework tends to be more muted. For example, performance differences have been less pronounced during the late-cycle phase among stocks, bonds, and cash, or the mid-cycle for equity sector relative performance. During these phases, it may make sense to take fewer active allocation tilts based on the business-cycle approach compared with other strategies.

Every business cycle is different, and so are the relative performance patterns among asset categories. However, by using a disciplined business cycle approach, it is possible to identify key phases in the economy's natural ebb and flow. These signals can provide the potential to generate incremental returns over the intermediate term, and they can be incorporated into an asset allocation framework that analyzes underlying factors and trends across various time horizons.

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