We are in the seventh year of an economic expansion, but how long will it last?

As we enter into the seventh year of an economic expansion, many investors are anticipating the end of the current credit cycle and preparing for the next downturn. When will this occur? More importantly, how do investment grade credit investors make money in this environment? At Standish, we believe that an actively managed portfolio, constructed using rigorous bottom-up fundamental research from an experienced team of dedicated credit analysts combined with a top-down macroeconomic view, is the most effective way to navigate this challenging environment.

What is the Credit Cycle?

The credit cycle is a pattern of the relative availability and use of credit throughout time. It is important because access to credit impacts a company's ability to borrow and invest and therefore influences economic growth. The credit cycle is expressed through a risk premium in the form of additional spread over a government yield. Therefore, having a clear understanding of the various phases of the cycle is critical to investing in the credit markets.

The credit cycle is generally broken into three phases: Repair/Recovery, Expansion and Downturn. In the Repair/Recovery phase, accommodative monetary policy is gradually moving the economy out of a recession. Companies are working out of the excesses that developed during the tail end of the previous cycle and are aggressively repairing their balance sheets. This combination typically results in slow, but positive earnings growth, lower leverage, an improvement in cash flows and therefore significantly tighter spreads. A sustained economic recovery eventually leads to improved business and consumer confidence which marks the beginning of the next phase of the credit cycle: Expansion.
Expansion is typically the longest phase of the cycle. At the start of the Expansion phase, lenders feel more confident extending credit and borrowers feel more comfortable using credit. As a result, lending standards loosen and leverage increases. Spreads continue to tighten during the first several years of the Expansion phase as cash flows are stable and positive earnings growth offsets additional borrowing. However, toward the end of the Expansion phase, spread volatility increases as investors become concerned about the deterioration of credit fundamentals in the face of a potential economic slowdown. Eventually central banks start tightening monetary policy to rein in the overheating economy and ultimately the cycle transitions into the Downturn phase.

The Downturn phase is characterized by an economy experiencing a significant slowdown or a recession following a period of excess borrowing. As a result, earnings growth is slowing, leading to weaker credit metrics and significantly wider spreads. The Downturn phase is the worst phase for corporate bonds. During this phase, central banks usually begin easing monetary policy which sets the stage for the next Repair/Recovery and the cycle starts all over again.

Credit Cycles Since the Mid-1980s

Excluding the current cycle, there have been two other complete credit cycles since the late 1980s. In the chart below, Downturns are highlighted in gray, Repair/Recoveries in gold and Expansions in blue. The previous cycles have lasted an average of nine years, which is roughly the length of the current cycle.

Historical Credit Cycles

![](image)

Source: Barclays as of May 31, 2016
Where Are We in the Current Credit Cycle?

As you can see from the chart above, the Expansion phase of the previous cycle ended nine years ago in early 2007 when the US housing market started to show the first signs of stress that would eventually lead to the biggest financial crisis since the Great Depression. The subsequent Downturn lasted until the end of 2008 before unprecedented government intervention paved the path for the Repair/Recovery phase. While the European sovereign debt crisis threatened to upset the credit cycle in 2011-2012, the market proved to be resilient and has been in the Expansion phase since 2012. How much longer do we have before we shift from the Expansion phase to the Downturn phase and spreads start to widen? In order to answer this very important question, we examine the following five indicators:

1) Leverage and Profitability

As mentioned earlier, the Expansion phase is marked by a deterioration in credit fundamentals as business confidence improves and debt grows faster than earnings. Current measures of leverage and profitability are consistent with the later stages of the credit cycle, as seen in the charts below. After four consecutive years of record breaking supply, US corporate debt growth is outpacing earnings growth resulting in increased leverage. In addition, profit margins are peaking. While generally a positive sign indicating that companies are doing a good job at managing costs in the face of disappointing revenue growth, peak profit margins may indicate an impending shift in the cycle. In fact, there has not been a post war cycle where profit margins didn’t peak prior to a recession. This is because labor is the largest share of a company’s cost structure. As the economy improves, companies compete for labor. Not only does the increased competition pressure profit margins, but it also results in inflation pressures which eventually lead to monetary policy tightening and then ultimately a recession.

U.S. Net Leverage

![U.S. Net Leverage Chart](chart)

U.S. EBITDA Margin %

![U.S. EBITDA Margin Chart](chart)

Source: JPMorgan as of December 31, 2015

M&A activity usually increases late in the Expansion phase as does the cash paid to shareholders in the form of dividends and share buybacks.
2) How Are Companies Behaving Towards Their Creditors?

Typically, late in the Expansion phase, companies start to focus more on their shareholders at the expense of their creditors because identifying organic growth opportunities becomes more difficult. As a result, M&A activity usually increases late in the Expansion phase as does the cash paid to shareholders in the form of dividends and share buybacks. With low borrowing costs and high demand for credit creating the perfect market conditions for M&A, activity has returned to levels last seen prior to the financial crisis in terms of both volumes and deal count. Cash to shareholders has also reached levels last seen prior to the financial crisis as activist investors are successfully encouraging cash to be returned to owners.

3) Lending Standards

Tighter lending standards are an indicator that lenders are concerned about higher policy rates and a cooling economy and therefore usually mark the end of the Expansion phase of the credit cycle. As you can see in the chart, lending standards have a high correlation to default rates; tighter standards are typically followed by higher defaults. After several years of loosening, banks have just recently started to tighten these standards.

Source: Bloomberg as of March 31, 2016
4) Spread Dispersion?

Unlike in the Recovery phase and early in the Expansion phase where “the rising tide lifts all boats”, at the end of the Expansion phase there are more idiosyncratic risks due to deteriorating fundamentals and diminished growth prospects. This dynamic creates greater spread dispersion with more negative outliers, which was the case throughout 2015.

**Investment Grade Spread Change from 12/31/14 – 12/31/15**

Source: Barclays POINT as of March 31, 2016

**High Yield Spread Change from 12/31/14 – 12/31/15**

Source: Barclays POINT as of March 31, 2016
5) Ratings Trends.

Given the deterioration in credit fundamentals in the late stages of the credit cycle, there are typically more downgrades than upgrades at the end of the Expansion phase. Unfortunately, these actions usually lag the cycle, so it is an indicator used more for confirmation than prediction, but still useful to watch. While ratings have been migrating lower for a while now, the trend has been accelerating recently due to downgrades in the commodity related sectors.

Source: Moody’s as of April 30, 2016
Managing Through The Cycle

While we believe we are in the later stages of the Expansion phase of the credit cycle, we think we still have at least a year, perhaps longer, before transitioning into the Downturn phase. While we have already reached the average length of the previous two credit cycles, the prolonged period of historically low interest rates has made this time different. As mentioned above, the Downturn phase is typically characterized by a recession which we are not forecasting in the intermediate term because we don’t see the excesses that usually precede these periods. Furthermore, the consumer is in good shape, bank balance sheets are strong and corporate liquidity is solid. History also suggests that the expansionary phase continues well after monetary policy tightening which has yet to occur in any meaningful way. That is not to say that there will not be volatility during this phase, but volatility creates opportunities.

In this type of environment, we believe active portfolio management is key to outperforming because avoiding the deteriorating credits and sectors is as important as identifying the stable to improving ones. Standish’s experienced team of portfolio managers and dedicated credit analysts are well equipped to navigate these difficult markets. By combining rigorous bottom up fundamental credit research with top-down macroeconomic views, the Standish team actively manages sector and issuer exposures in order to seek to outperform throughout the various phases of the credit cycle.
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