

The DWS Macro Metric Part II – Investment Grade

“Superior investing doesn't come from buying high-quality assets, but from buying when the deal is good, the price is low, the potential return is substantial, and the risk is limited.”

Mastering the Market Cycle, by Howard Marks

IN A NUTSHELL

The credit cycle is a natural outcome of the business cycle, with corporate profits as its transmission channel. Investors can try to map the evolution of the credit cycle to inform tactical asset allocation in fixed income markets.

We reinvoke the “DWS Macro Metric” - the ratio of Leading-to-Coincident Economic indicators - to see if we can glean any insights about the performance of investment grade (IG) corporate credit when the business cycle is inflecting from a trough.

We find that, during the five upward inflections over the last fifty or so years, the subsequent 18-month performance of IG fixed income has been stronger than treasury securities of a similar duration, and by more than all the average 18-month returns.

Finally, we show that the average outperformance is relatively stable to the timing around the inflection point, but that, helpfully to the investor, its volatility goes down as the inflection point is passed (allowing more certainty over its identification).

Bonds and the Business Cycle

Finance and psychology go hand in hand. When you work in the former field, you simply cannot avoid a default grounding in the latter. And the impact of the human tendency to lurch between euphoria and despair (and back again) is never more evident than in the cyclical pattern that one can observe in certain economic phenomena.

In our view, Figure One shows just such a pattern. It is the closely watched series known as the Senior Loan Officer Opinion Survey (SLO). Every quarter the Fed sounds out the providers of credit at large US banks to determine changes in their lending conditions. A net tightening of such conditions maps to a higher reading on the chart, so the way to interpret this is that spikes represent weak demand for credit, while lower readings represent business as usual.

It is surely reasonable to conclude that there is a degree of cyclicity in the data, which, for us, makes perfect sense. After all, if the business cycle tracks the oscillations of economic growth, and corporate profits are one component of that growth, then we would expect to see the willingness of credit officers to lend to those companies change over time.

The literature on credit cycles is vast, but we like the relatively simple explanation that the renowned investor Howard Marks provides in his book, *Mastering the Market Cycle*. In this text, he provides a straightforward description of the credit boom and bust cycles. It runs along these lines:

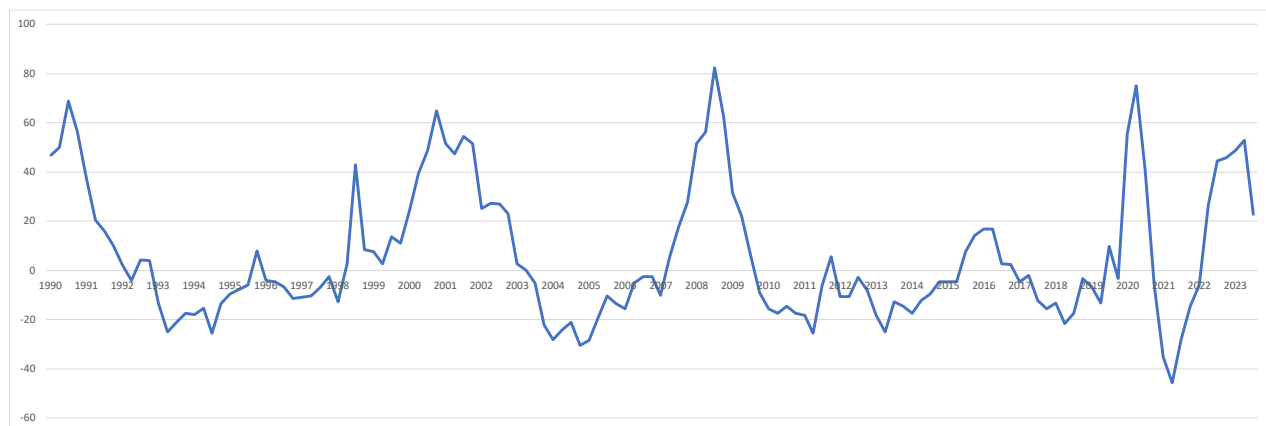
The Boom

- Strong economic growth, and a period of prosperity leads to...
- ...an increase in capital provision, and an increase of the capital base.
- Bad news becomes scarce, which leads lenders to underestimate risk, and risk aversion to plummet.
- Now, financial institutions try to expand their businesses, i.e., to provide even more capital.
- This competition for market share lowers required returns and credit standards, and eases covenants.

The Bust

- As first losses from these covenant light loans appear, lenders become nervous.
- Risk aversion rises, as do interest rates, credit restrictions, and covenant requirements.
- Now less capital is made available, and, eventually, is offered only to the most qualified of borrowers.
- Companies become starved of capital; some are unable to roll their debts...
- ...leading to debt defaults and bankruptcies, and ultimately contributing to an economic contraction.

Figure One: Senior Loan Officer Opinion Survey (Net % of large domestic banks tightening standards for C&I loans to large and middle-market firms, quarterly data 1990-2023)



Source: Federal Reserve Board of Governors as of January 30, 2024

The DWS Macro Metric

In an earlier paper (*The DWS Macro Metric: Mapping Markets to Moves*) we built on the work of Ed Yardeni and Martin Pring to introduce readers to the “DWS Macro Metric,” a useful economic tool to help understand the state of the economy. Essentially, we argued that traditional measures of the business cycle (current GDP vs trend GDP) relied on data that came out too infrequently and was revised too often. We also showed that, in practice, the business cycle was far choppier than the theoretical, smoothly oscillating, wave found in the textbooks.

Instead, we suggested that a simple ratio of the Conference Board’s Leading Economic Indicator series (LEI) and its Coincident Economic Indicators series (CEI) can provide investors with a metric (the “DWS Macro Metric”) that is cyclical, smooth, free to obtain, and correlates well with the traditional business cycle. Our view is that these cycles potentially map well to asset class moves, starting with the less risky sectors of fixed income (sovereign and IG), and then moving down the capital structure, and up the risk spectrum, to high yield, EM, and, finally, equities. In our first paper (see *The DWS Macro Metric: Mapping Markets to Moves*, DWS Research Institute) we drew out inferences for the US and German sovereign bond markets, and, in this short additional paper, we extend the analysis to the IG universe in three steps.

Step One – Inflections

Figure Two shows the DWS Macro Metric over the last fifty years or so. We think it is reasonable to conclude that there is a degree of cyclicity in this time series, and enough to map

clear inflection points: times when the metric was shifting direction, either from peak to trough, or trough to peak.

At the time of writing there have been ten inflections (five of each, of course, they must always come in pairs), and it seems as though we are currently enroute from a post-Covid peak to our next trough. Or, in practical terms, the Leading Economic Indicators are showing a trend of relative pessimism versus the state of the economy that the Coincident Indicators captures.

Step Two – Reflections

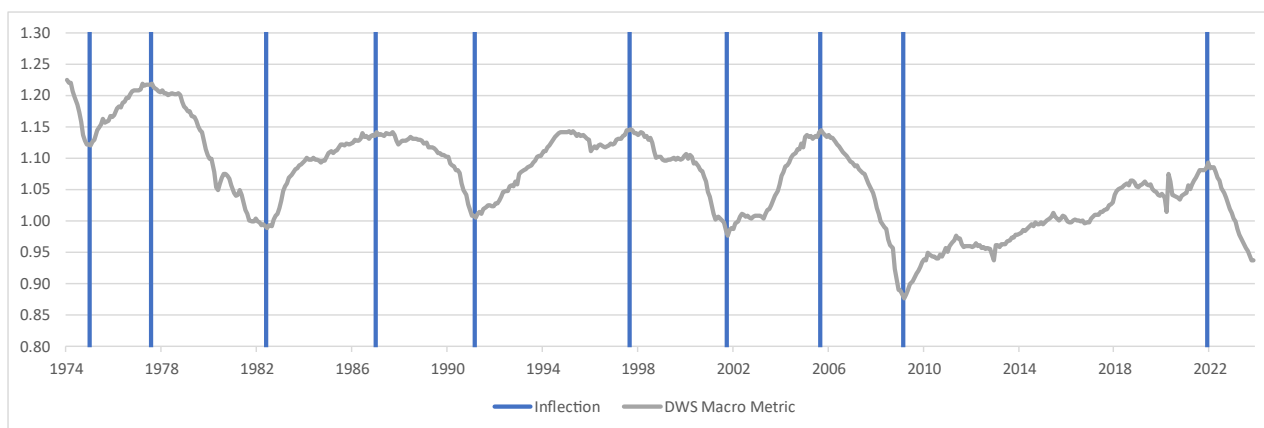
The question now becomes - how do we use these inflection points to draw out useful information for investors? We undertook the following analysis. First, we pinpointed the five empirical inflections when the data started to exit a trough - these were: 1/31/1975, 6/30/1982, 3/31/1991, 10/31/2001, and 3/31/2009.

Our next step was to use those as starting points to examine the relative performance of two assets classes – US Treasuries, and US Investment Grade. For the former, we used the Bloomberg US Treasury Long Index, which measures US dollar denominated debt issued by the US Treasury, with ten years or more to maturity. For the latter, we used the Bloomberg US Long Corporate Bond Index. This is comprised of investment grade, fixed-rate, taxable corporate bonds, also with maturities of ten years or longer. Finally, all the bonds in the index are US dollar denominated securities that are publicly issued by US and non-US industrial, utility, and financial issuers.

By restricting the analysis to bonds with similar maturities, we effectively remove much of the interest rate sensitivity (i.e., duration), from the equation, leaving the credit component as the variable of interest. We note that the duration in these two indexes does not match perfectly, and indeed there are times when it is significantly different, but we weigh against the added complexity of isolating the credit component the practical simplicity of our approach. Figure Three shows the results, in the form of the subsequent 18-month return to each asset class (non-annualized, we use 18-months as a reasonable period that is at the longer end of what might qualify as “tactical”, to reflect the fact that the cycles themselves are quite long).

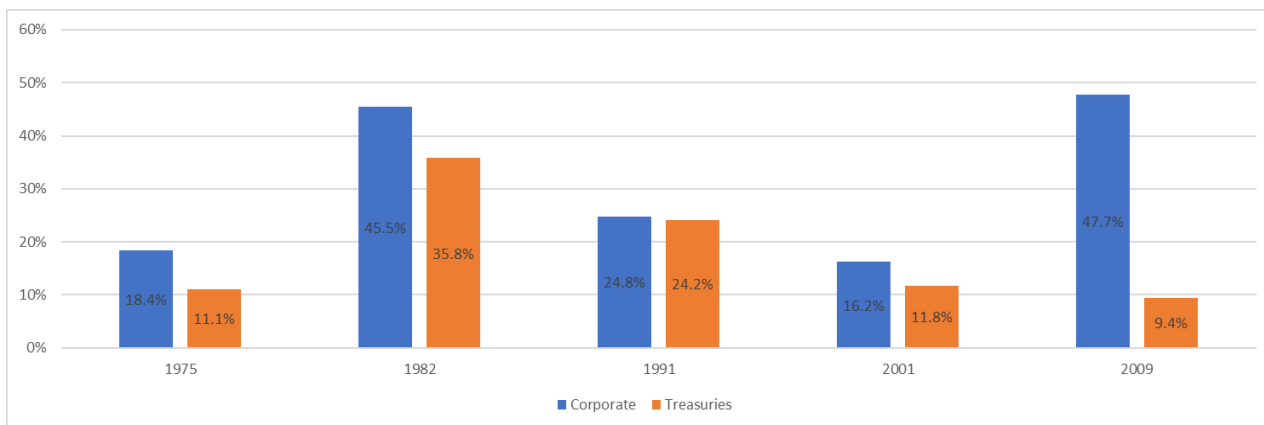
It is clear to us that, although both classes of bonds had strong returns in each period, the investment grade sector also outperformed every time. Of course, one might expect that, given the riskier nature of investment grade bonds, and so putting Figure Three in the context of the average 18-month outperformance of investment grade should help. Over the period in question (1973-present), that average excess return was 0.52%. Clearly, buying the segment at times that coincided with dips in economic activity was a sensible strategy that yielded higher than average returns (at least for the five of five occasions we examined).

Figure Two: The DWS Macro Metric, and its inflection points (1973-2023)



Source: DWS, The Conference Board as of January 30, 2024

Figure Three: 18-month returns of Treasuries and Investment Grade bonds post five Macro Metric inflection points (1973-2023)



Source: DWS, The Conference Board as of January 30, 2024

Step Three – Deflections

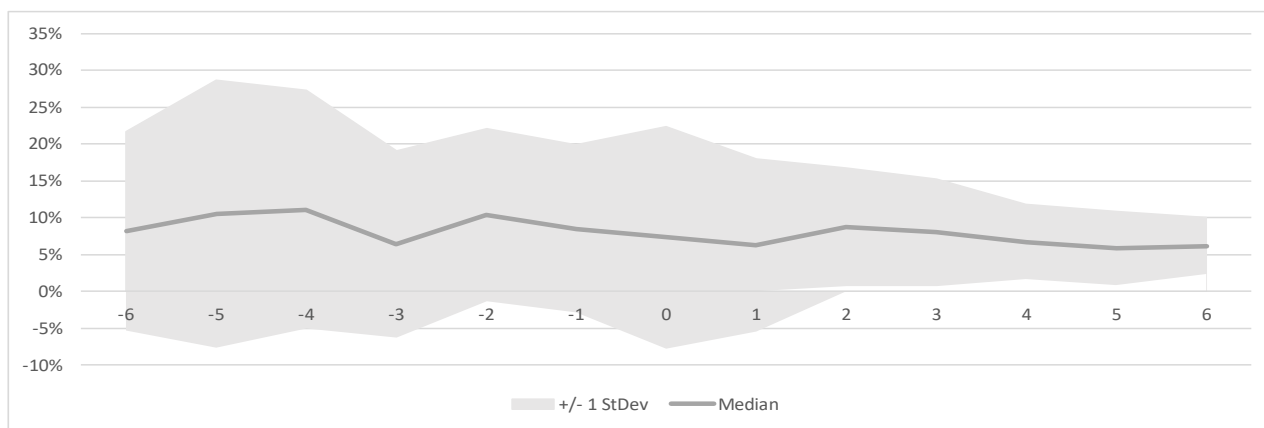
Figure Four takes - what we hope you agree is already an interesting finding - one step further. And it reveals a very helpful outcome in our view. It shows the median outperformance of investment grade bonds over Treasuries around each of the five inflection points described above, this time examining the impact of entering the position up to six months before, and six months after, the trough in the Macro Metric.

It is clear that the median outperformance is relatively stable, regardless of the entry point, but, crucially, the volatility of the

outperformance decreases as one moves through the inflection point.

Since a tighter volatility here means a smaller chance of a negative outperformance (i.e., the trade not working), it seems to us that the bias should be towards waiting. This is good news in practical terms because it means that, unlike many financial signals whose usefulness goes down once they are identified, here we are saying that the time lag needed to establish that the Macro Metric has indeed passed its inflection, is arguably *helping* the investor, and not *hurting* them.

Figure Four: The average outperformance of investment grade over Treasuries, and the one standard deviation range, for the six months prior and post Macro Metric inflections (1973-2023)



Source: DWS, Bloomberg as of January 30, 2024

Conclusions

This paper follows a more extensive note that the DWS Research Institute published in 2023 (*The DWS Macro Metric: Mapping Markets to Moves*) and builds on that analysis. In that original piece, we argued that:

- Business cycle analysis is a powerful tool, but that traditional methods of evaluating the cycle relied on data (current GDP vs trend GDP) that is too slow to come out, is revised too often, and produces very volatile cycles that are hard to interpret in practice.
- We therefore introduced the DWS Macro Metric, a simple ratio of the Conference Board's Leading Economic Indicator series divided by its Coincident Economic Indicator series. The resulting data series is timely, free, exhibits smooth cyclicity, and correlates well to the business cycle.

Where that former piece focused on the sovereign sector of US and European fixed income markets, this note (the next in a series), extended the analysis to the investment grade sector. We found that:

- There have been ten "inflection points" in the DWS Macro Metric since 1973 - moments at which the cycles have moved from peak to trough, or vice versa.
- If we take the view that half of these times represent a period of relative pessimism in the credit cycle, then we could potentially use them as interesting entry points, with the anticipation that the credit cycle should improve from there.
- We examined the relative 18-month performance of investment grade bonds versus US Treasuries following each of the five troughs in the last 50 or so years and found that, in every case, the investment grade sector outperformed (respectively by 7.28%, 9.65%, 0.65%, 4.41%, and 38.24%), and by more than was typical (0.52% was the average for all 18-month periods). We do not attribute this to interest rate moves because the duration of each index is similar.
- Finally, we note that if one runs the same analysis, but with starting points six months prior, and post, to the trough, then the average outperformance remains similar. However, the range of the outperformances (measured by its standard deviation) tightens as one moves past the trough. This is a good result for investors because it means that one can be more confident in calling the trough, while increasing the chance of capturing the outperformance.
- Of course, we invoke the well-known, and extremely important, caveat that all investors should follow – that past performance is not indicative of future performance.

Asset Allocation and Positioning

For investors who have the mandate to make tactical asset allocation decisions in fixed income markets, and who find the above analysis compelling, we believe that following the DWS Macro Metric adds another economic arrow to their investment quiver. We do not believe that the Metric is currently at, or through, its trough (which would be the signal needed to consider IG relatively attractive versus sovereign grade).

Indeed, we now believe that that trough, and a small recession in the US, will come slightly later than we had originally thought (Q4/23 was our original thinking). But we argue that when it comes, then empirical evidence suggests that the investment grade sector has had subsequent 18-month returns above the Treasury market, and by more than is typical.

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