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PHASES OF THE BUSINESS CYCLE AND IT'S IMPACT ON CV INDUSTRY

What is a Business Cycle?

The term business cycle refers to the fluctuations of the economy between periods of expansion (growth) and contraction (recession). Factors such as gross domestic product (GDP), interest rates, total employment, and consumer spending, can help to determine the current stage of the business cycle. Understanding the business cycle can help investors and businesses understand when to make investments and when to pull their money out, as it has a direct impact on everything from stocks and bonds, as well as profits and corporate earnings.

KEY TAKEAWAYS

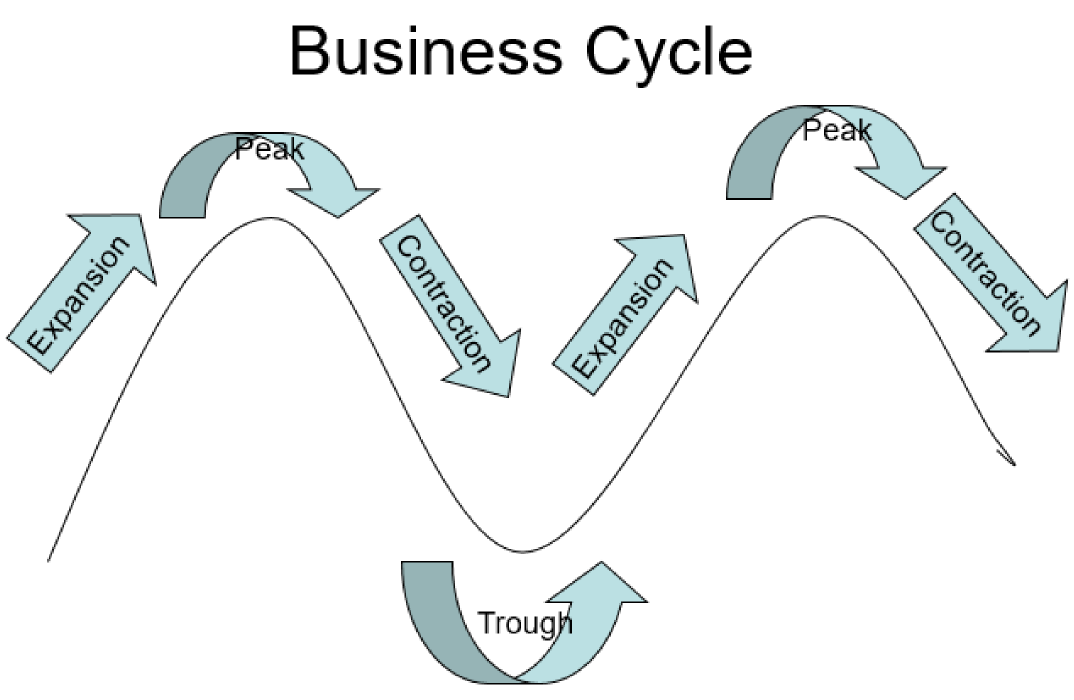
- A business cycle is the overall state of the economy as it goes through four stages in a cyclical pattern.
- The four stages of the cycle are expansion, peak, contraction, and trough.
- Factors such as GDP, interest rates, total employment, and consumer spending, can help determine the current stage of the business cycle.
- Insight into business cycles can be very useful for businesses and investors.
- The exact causes of a cycle are highly debated among the different schools of economics.

How the Business cycle Works

An economic cycle, which is also known as a business cycle, is the circular movement of an economy as it moves from expansion to contraction and back again. Economic expansion is characterized by growth. A contraction, on the other hand, sees it go through a recession, which involves a decline in economic activity that spreads out over at least a few months.

The business cycle is characterized by four stages, which are also referred to as the business cycle.

1 These four stages are:



Expansion: During expansion, the economy experiences relatively rapid growth, interest rates tend to be low, production increases, and inflationary pressures build.

Peak: The peak of a cycle is reached when growth hits its maximum rate. Peak growth typically creates some imbalances in the economy that need to be corrected.

Contraction: A correction occurs through a period of contraction when growth slows, employment falls, and prices stagnate.

Trough: The trough of the cycle is reached when the economy hits a low point and growth begins to recover.

The recovery phase may sometimes be referred to by some as a fifth stage.

You can use a number of key metrics to determine where the economy is and where it's headed. For instance, an economy is often in the expansion phase when unemployment begins to drop and more people are fully employed. Similarly, people tend to prioritize and curb their spending when the economy contracts. That's because money and credit are harder to come by as lenders often tighten up their lending requirements.

As noted above, it's important for investors and corporations to understand how these cycles work and the risks they carry because they can have a big impact on investment performance. Investors may find it beneficial to reduce their exposure to certain sectors and vehicles when the economy starts to contract and vice versa. Business leaders may also take cues from the cycle to determine when and how they'll invest and whether they'll expand their companies.

Businesses and investors also need to manage their strategy over economic cycles, not so much to control them but to survive them and perhaps profit from them.

Special Considerations

The National Bureau of Economic Research (NBER) is the definitive source of setting official dates for U.S. economic cycles. Measured primarily by changes in the gross domestic product (GDP), NBER measures the length of economic cycles from trough to trough or peak to peak.2

U.S. economic cycles have lasted about five and a half years on average since the 1950s. However, there is wide variation in the length of cycles, ranging from just 18 months during the peak-to-peak cycle in 1981 to 1982 up to the expansion that began in 2009. According to the NBER, two peaks occurred between 2019 and 2020. The first was in the fourth quarter of 2019, which represented a peak in quarterly economic activity. The monthly peak happened in a different quarter altogether, which was noted as taking place in February 2020.34

This wide variation in cycle length dispels the myth that economic cycles can die of old age, or are a regular natural rhythm of activity akin to physical waves or swings of a pendulum. But there is debate as to what factors contribute to the length of a business cycle and what causes them to exist in the first place.

Managing Economic Cycles

Governments, financial institutions, and investors manage the course and effects of economic cycles differently. Governments often use fiscal policy. In order to end a recession, the government may use expansionary fiscal policy, which involves rapid deficit spending. It can also try contractionary fiscal policy by taxing and running a budget surplus to reduce aggregate spending to stop the economy from overheating during expansions.

Central banks may use monetary policy. When the cycle hits the downturn, a central bank can lower interest rates or implement expansionary monetary policy to boost spending and investment. During expansion, it can employ contractionary monetary policy by raising interest rates and slowing the flow of credit into the economy to reduce inflationary pressures and the need for a market correction.

During times of expansion, investors often find opportunities in the technology, capital goods, and basic energy sectors. When the economy contracts, investors may purchase companies that thrive during recessions such as utilities, financials, and health care.

Businesses that can track the relationship between their performance and business cycles over time can plan strategically to protect themselves from approaching downturns, and position themselves to take maximum advantage of economic expansions. For example, if your business follows the rest of the economy, warning signs of an impending recession may suggest you shouldn't expand. You may be better off building up your cash reserves.

Analyzing Economic Cycles

Different schools of thought break down economic cycles in different ways.

Monetarism

Monetarism is a school of thought that suggests that governments can achieve economic stability when they target their money supply's growth rate. It ties the business cycle to the credit cycle. Changes in interest rates can reduce or induce economic activity by making borrowing by households, businesses, and the government more or less expensive.

Adding to the complexity of interpreting business cycles, famed economist and proto-monetarist Irving Fisher argued that there is no such thing as equilibrium. He argued that these cycles exist because the economy naturally shifts across a range of disequilibrium as producers constantly over or underinvest and over or under produce as they try to match ever-changing consumer demands.

Keynesian Economics

The Keynesian approach argues that changes in aggregate demand, spurred by inherent instability and volatility in investment demand, are responsible for generating cycles. For whatever reason, when business sentiment turns gloomy and investment slows, a self-fulfilling loop of economic malaise can result.

Less spending means less demand, which induces businesses to lay off workers and cut back even further. Unemployed workers mean less consumer spending and the whole economy sours, with no clear solution other than government intervention and economic stimulus, according to the Keynesians.

Austrian Economists

These scholars argue that the manipulation of credit and interest rates by the central bank creates unsustainable distortions in the structure of relationships between industries and businesses which are corrected during a recession.

Whenever the central bank lowers rates below what the market would naturally determine, investment and business get skewed toward industries and production processes that benefit the most from low rates. But at the same time, the real saving necessary to finance these investments gets suppressed by the artificially low rates. Ultimately, the unsustainable investments go bust in a rash of business failures and declining asset prices that result in an economic downturn.

How Do You Define an Economic Cycle?

An economic cycle, which is also referred to as a business cycle, has four stages: expansion, peak, contraction, and trough. The average business cycle in the U.S. has lasted roughly five and a half years since 1950, although these cycles can vary in length.3

Factors that are used to indicate the stages in the business cycle include gross domestic product, consumer spending, interest rates, and inflation.

The National Bureau of Economic Research is a leading source for indicating the length of a cycle, as measured from peak to peak or trough to trough.

What Are the Stages of an Economic Cycle?

Expansion, peak, contraction, and trough are the four stages of an economic cycle.1

In the expansionary phase, the economy experiences growth over two or more consecutive quarters. Interest rates are typically lower, employment rates rise, and consumer confidence strengthens.

The peak phase occurs when the economy reaches its maximum productive output, signaling the end of the expansion. After this point, once employment numbers and housing starts begin to decline, leading to a contractionary phase begins.

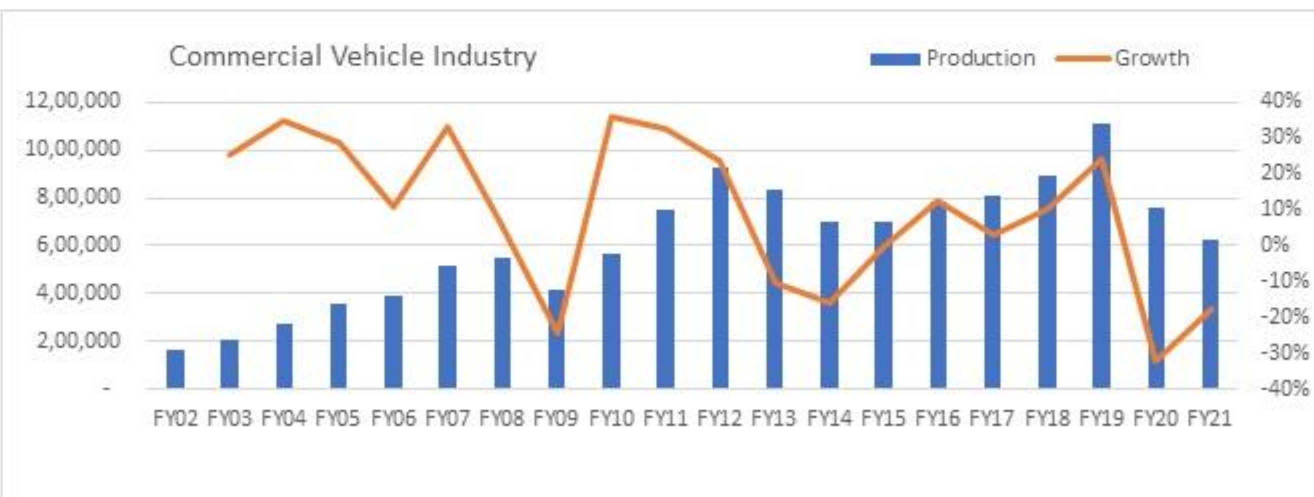
The lowest point on the business cycle is a trough, which is characterized by higher unemployment, lower availability of credit, and falling prices.

What Causes an Economic Cycle?

The causes of a business cycle are widely debated among different economic schools of thought. Monetarists, for example, link the business cycle to the credit cycle. Here, interest rates, which intimately affect the price of debt, influences consumer spending and economic activity. On the other hand, a Keynesian approach suggests that the business cycle is caused by changes in volatility or investment demand, which in turn affects spending and employment.

Commercial Vehicles – From down cycle to upcycle?

Analysis of India's CV production data for 20-year data indicate existence of steep cyclical trends in the Commercial Vehicle industry.



Cyclicity in the industry is driven by fluctuations in economic activities, utilization level of trucks and replacement requirements, which in turn impact freight rates and purchase of new CVs. Current down cycle in the industry has been steepest ever in the last 20 years, which was aggravated by increase in rated payload (resulted in higher effective tonnage), BS VI transmission and finally COVID epidemic. Volume decline in FY20 was 32% which was followed by another decline of 17% during FY21.

Nevertheless, every down cycle (ranging between 1-3 years) has been followed by even stronger upcycle as requirement of new CVs emerges due to growing trade as well as replacement demand. Going by the historical trend, there is possibility of revival in the CV industry going forward. Possible triggers for the same are expected to be both economic growth and replacement demand.

Potential beneficiaries could be pure play commercial vehicle OEMs, auto ancillaries supplying to CV OEMs and CV financiers. First sign of revival would be improvement in the freight rates. However, generally stocks tend foresee revival ahead of data indictors.