

Credit-Market Sentiment and the Business Cycle

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Abstract

Using U.S. data from 1929 to 2015, we show that elevated credit-market sentiment in year $t - 2$ is associated with a decline in economic activity in years t and $t + 1$. Underlying this result is the existence of predictable mean reversion in credit-market conditions. When credit risk is aggressively priced, spreads subsequently widen. The timing of this widening is, in turn, closely tied to the onset of a contraction in economic activity. Exploring the mechanism, we find that buoyant credit-market sentiment in year $t - 2$ also forecasts a change in the composition of external finance: net debt issuance falls in year t , while net equity issuance increases, consistent with the reversal in credit-market conditions leading to an inward shift in credit supply. Unlike much of the current literature on the role of financial frictions in macroeconomics, this article suggests that investor sentiment in credit markets can be an important driver of economic fluctuations.

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