The Next Economic Downturn, Part 2

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Economic downturns are notoriously hard to predict as mentioned in last month's article although certain patterns have indeed emerged from past recessions that can help us see where we are in a business cycle. Perhaps the most relevant indicator that has typically preceded a downturn is a persistently low unemployment rate. If we assume the "natural rate" of unemployment is 4.5%, the U.S. has been below this threshold for almost one year (since March of 2017, seasonally adjusted). A tight labor market increases wages, which in turn, increases prices. The Federal Reserve attempts to keep inflation in check by raising interest rates, but some experts say this has been overdone in the past. The higher rates trigger a contraction in business and consumer borrowing that appears in past years to have been over proportionate to the spending increases when unemployment was low and the economy was expanding. In short, perhaps the rate increases have been too much medicine.

As mentioned last month, however, interest rates have been so low for so long, that there is a general consensus that our low unemployment rate and (finally) rising wages do call for a gradual contraction in monetary policy. The new Federal Reserve chair, Jerome Powell, appears to be of a similar mindset to the previous chair in his belief that rates are a powerful tool that should be handled carefully. Hence, the latest estimates are for a Fed Funds rate in the 2.25% range around this time next year. This is still a very low rate by historic standards as shown in last month's trend graph going back to 1973 making it likely that consumer and business borrowing shouldn't come to a screeching halt by 2019. I postulated last month that the relatively low rates alongside the short-term impact of the tax cuts should keep the U.S. economy afloat a bit longer, which makes my job presenting economic data significantly more pleasant.

There are at least two other key factors that are likely to prolong the economic expansion through 2018. The first one goes back to that fundamental indicator: jobs. If the unemployment rate falls and stays at roughly one percentage point below the "natural rate" of 4.5%, we are typically six to twelve months out from a recession. This is validated by looking at five previous cycles (Guggenheiminvestments.com). That key threshold of too-low-an-unemployment rate of 3.5% is where many experts say we will be by the end of 2018 – so we are not there yet. In addition, we also still have some slack in the labor market, which is best measured by the civilian participation rate. This measure tells us the proportion of working age people who consider themselves part of the labor force – either actually working or actively looking for work. From January 2003 to the *end* of the recession, June 2009, the civilian participation rate was 66.0%. From July 2009 to December 2017, the participation rate has been 63.5%. Many people assume that this decline is exclusively due to our aging workforce, but that is not the only factor. The graph on the next page shows us that the largest absolute number of people unemployed belongs to the 25-34 year-old cohort. There are skills gap implications here, but putting that aside for now, this low rate means we have a potential pool of entrants or re-entrants into the labor market who undoubtedly view the higher wages favorably. This could keep our job numbers growing. More workers means greater productivity and output (GDP), more wealth and consumer spending, and therefore continued business growth. Fewer unemployed also means a reduction in transfer payments like Medicaid, unemployment insurance and food stamps. The bottom line is that continued increases in employment could be a central force in prolonging this current expansion for at least another year barring geopolitical or other exogenous factors.

In El Paso County, the unemployment rate has ticked upwards for three consecutive months not because employers are not hiring or are laying off, but because residents are joining the labor force, which is a good thing. If they find employment, it's a double benefit: they are both taxpayers and consumers. This is why the recent trend of a modest upward movement in our regional unemployment rate is not necessarily a bad thing.

The weakening of the U.S. dollar since the beginning of 2017 will likely be another positive force in 2018 since a weaker dollar increases exports. Manufacturing, in particular, benefits from a lower dollar and indeed, the manufacturing index has shown expansion for the past 17 months. Given that the manufacturing sector is a primary industry where most of the revenue emanates from external or "new" dollars to the economy, the ripple effects within the U.S. are significant.

Manufacturing also presents opportunity in terms of decent paying middle-skill jobs for the (growing number) of people in the U.S. who cannot afford 4-year degrees. These may very well include some of the aforementioned individuals who are re-entering the workforce.

The key will then be whether we can sustain the current expansion at a level that the Federal Reserve does not interpret as so "overheated" that it raises rates too quickly. The subdued expansion of the past nine years has in some ways shielded us from the over exuberance that can characterize bubbles and other shocks. No doubt there is a downtown in our future, but most metrics are showing that we are in the aging phase of a business cycle, but not quite yet among the departed.

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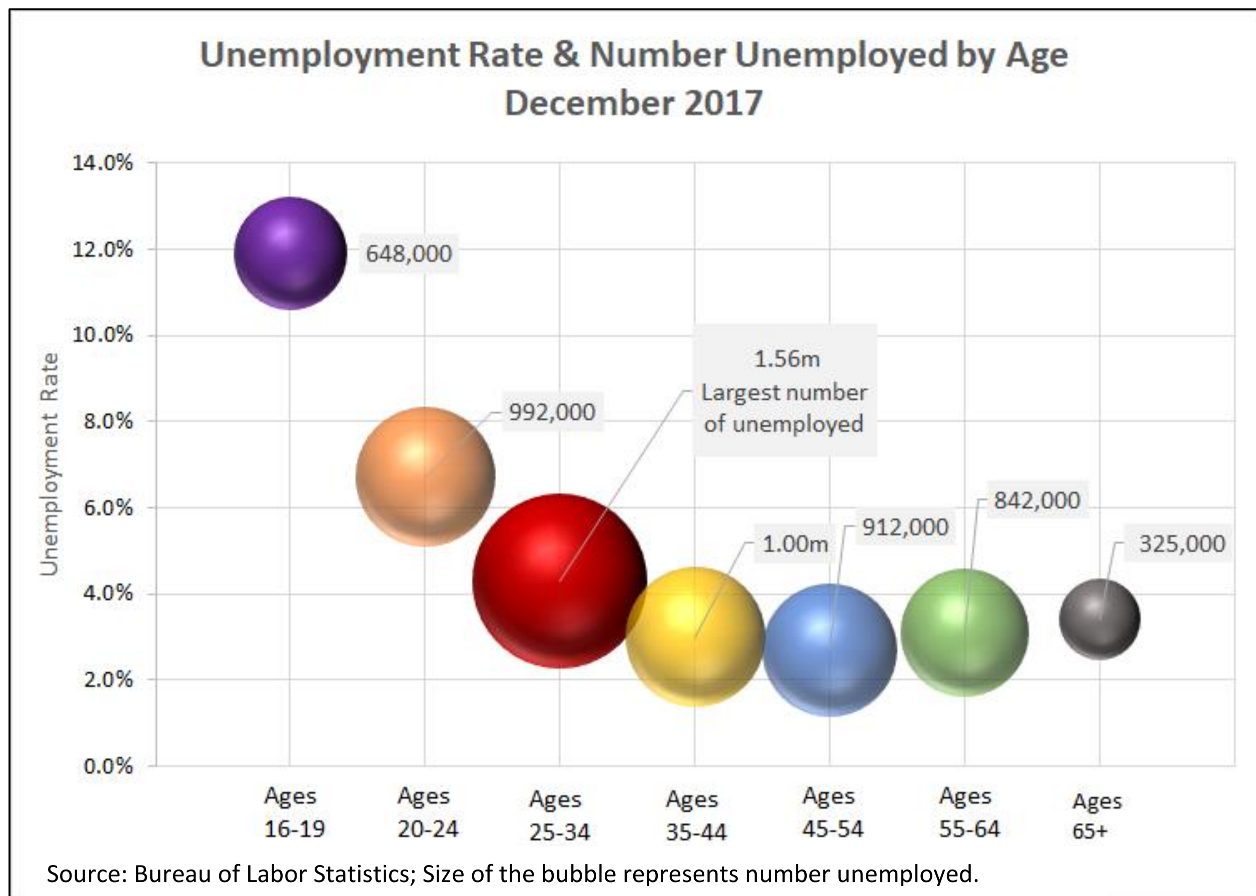

Source: Bureau of Labor Statistics; Size of the bubble represents number unemployed.