The Next Downturn, Part 1

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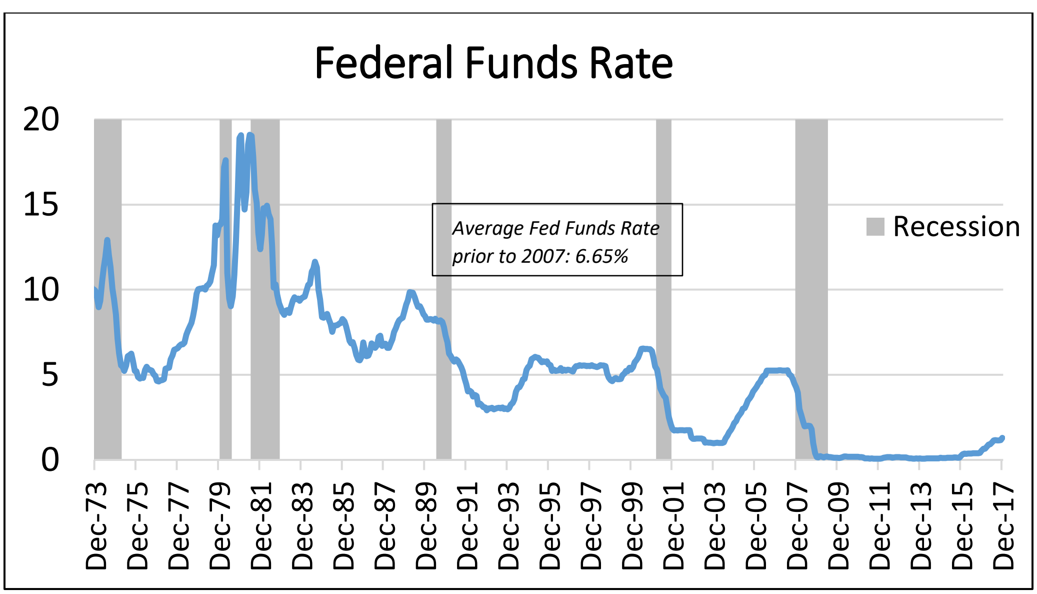
There is much speculation amongst both the general public and economists on the timing of the next economic downturn. The running joke in my field is that economists are about as good as weathermen in terms of accurate predictions. Fair enough, but in our defense, there are so many variables at play that prognostication is indeed difficult, and even more so as the world has become increasingly globalized. That doesn't stop us from trying, however, mostly because businesses and individuals like to capitalize on good times, as well as be prepared for the tough times. Since we at least know we are in the latter stages of the expansion, it seems reasonable to examine whether we are prepared for a downturn when it does occur.

Looking objectively at the current situation, there are two anomalies of this economic expansion: how long it has been and how temperate it has been. The U.S. economy has been expanding for 103 months, or almost nine years. The only other economic expansion that has been longer is the ten-year run during the Clinton years (1991-2001). The average expansionary period between recessions since 1981 has been shorter, roughly eight years. Moreover, the average, real GDP growth rate has been only 1.9% during the nine years, hardly worthy of exuberance. The first several of those nine recovery years were coined an "anemic recovery." The last few years, however, have indeed felt more like an economic expansion with low unemployment, high job postings, high consumer confidence, solid home sales and appreciation, and new construction. Even some of the more stubborn parameters like wages, inflation and civilian participation rates have finally seen improvement in the past year – both long overdue in the normal course of an expansionary period. These late-to-the-game indicators are a mixed bag. Everyone welcomes a low unemployment rate, plentiful jobs, positive buying attitudes, and a sense of wealth via home appreciation. What economists see, however, is a confluence of indicators that signal the "latter stages" of an economic cycle.

The truth is downturns happen as a reality check on some of the inefficiencies that can result from expansions. The reality check from 2007 to 2009 was quite stark, and it is possible that this expansionary period has been so prolonged precisely because of the severity of the Great Recession. Even our historically low interest rates have not caused the over-borrowing usually seen prior to downturns. Interest rates have been kept low specifically to spark investment, but now we find ourselves in the twilight of the expansion and interest rates are still low. That's a problem because even a year from now, the Fed's target rate won't be high enough to sufficiently manipulate rates to help stimulate the economy when we do have a downturn (see graph). Monetary policy via interest rate manipulations is perhaps the most powerful policy tool for moderating recessions and putting economies back on a path to recovery. If we do have a downturn in the next two years, which is likely, the Fed won't have its usual bag of tricks.



The tax cuts recently passed by Congress are another reason the economy may coast a bit longer. Most experts have been tepid in their response to the cuts saying any boosts to the economy are likely to be relatively short term. Also, such cuts are typically more impactful when used as a stimulus during a downturn – not when the economy is reasonably healthy. There is also the obvious tradeoff of increasing the deficit and perhaps exacerbating a downturn when it does occur. Nonetheless, the perception by consumers and businesses is positive for now, and there may be a one-time boost in terms of consumer confidence and corporate re-shoring. Both of these short-term effects, if they do materialize, will likely be felt in 2018.

Having built a case for continued economic growth, geopolitical factors and the particularly tense domestic political climate may, of course, throw a monkey wrench into everything during 2018. These are the external variables that are much more difficult to gauge.

For now, let's look at the glass half full and hope that economists' forecasts are correct. Next month, I will discuss two other key factors that may keep us afloat a bit longer: the recent improvements in labor participation rates and the weakening dollar.

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