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Yeah, Sure, Happy Birthday U.S. Economic Expansion

As of this month, the current U.S. economic expansion entered its 11th year, making it the longest expansion on record. As we write this, however, it isn't clear whether we should be celebrating the expansion's birthday or planning its funeral. We do not say that because we think the expansion's advanced age (at least by U.S. standards – Australia's current expansion began in 1991, rendering the U.S. expansion a mere pup by comparison) makes its end nearer than would otherwise be the case. We do not think so, and our view is consistent with work done by the Federal Reserve Bank of St. Louis and the Federal Reserve Bank of San Francisco that shows the age of an expansion has little, if any, impact on the probability of entering a recession. By the way, did we mention Australia's current expansion began in 1991?

Okay, but if old age doesn't get you, something else will, and that holds true for economic expansions. The pace of U.S. economic growth has clearly slowed, which is apparent in much of the high frequency economic data. The industrial sector of the economy has softened, freight markets have shifted into a lower gear, the pace of job growth has slowed, and the yield curve, as measured by the spread between yields on 10-year U.S. Treasury notes and 3-month U.S. Treasury bills, has become inverted, which in the past has been a reliable predictor of recession, albeit with a lengthy lag. At the same time, global economic growth has slowed and global business sentiment has deteriorated badly. Lingering uncertainty over the course of trade policy is weighing on firms, here and abroad, which is likely acting as a drag on business investment spending.

This has left many worrying that the deceleration in economic growth virtually everyone expected for this year could morph into something more serious, i.e., recession. The FOMC harbors similar concerns, as evidenced by the decidedly dovish shift made at the June FOMC meeting. As a result, financial market participants see a rate cut at this month's FOMC meeting as a done deal. Indeed, prior to the stronger than expected June employment report, the main debate was over whether the rate cut would be a 25-basis point cut or a 50-basis point cut.

We'll get to that discussion below, but, for now, we think it worth giving the current economic expansion something it gets very little of, i.e., respect. After all, despite being the longest U.S. expansion on record, this also has to be the most maligned, least appreciated U.S. expansion on record. Which mainly stems from this being the slowest U.S. expansion on record which, almost from the start, has been a common complaint about the current expansion. That this complaint began so early in the expansion reflects what at the time was a common, albeit deeply flawed, assumption, i.e., the "V-shaped" recovery. The premise being that deep recessions are

always followed by rapid recoveries, so, given the severity of the 2007-09 recession, the recovery that followed was bound to be rapid and robust.

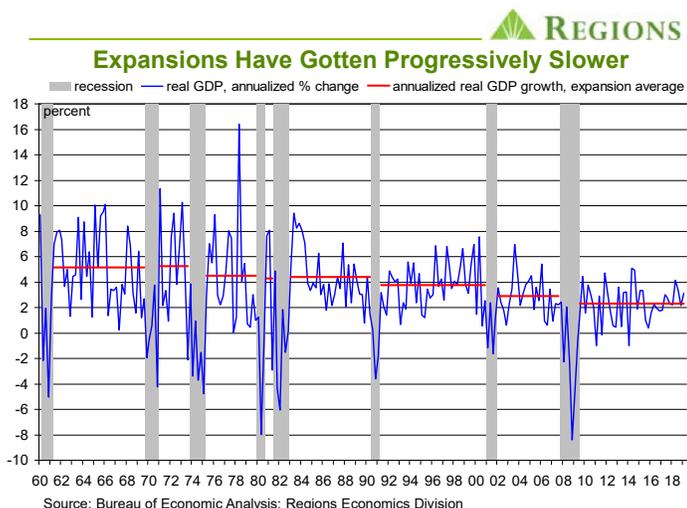
We'll repeat now what we said way back then, which was that anyone who argued there would be a "V-shaped" recovery did not understand three things, specifically: 1) where the U.S. economy was; 2) how the U.S. economy got where it was; and 3) that any recovery from the deep structural imbalances in the economy and the disruptions to the financial system would take time, and lots of it. In other words, the recovery from the 2007-09 recession was going to be anything but rapid and robust. We figured that if this was obvious to us, it had to have been obvious to everyone else, to the point that we dubbed those making the "V-shaped" recovery argument the "V-shaped knuckleheads."

That argument, however, was fairly common, such that, right from the start, the current expansion was being measured against unrealistically high expectations. Indeed, many of the common complaints about the current expansion – that it took so long to get going, that it has been so uneven, across industries and across different parts of the U.S., that it took so long for wage growth to take off, that firms engaged in so little capital spending directed at expanding their capital stocks – can be traced to how deep of a hole the economy started from, which is kind of the opposite of the "V-shaped" recovery argument.

And, though it is, apparently, easy to lose sight of, recall all of the hurdles thrown in the path of the current expansion over the past decade. This includes what in the early stages of the expansion seemed to be unending fears of a double-dip recession, fiscal policy that in the early stages of the expansion was, for the most part, AWOL, the Greek debt crisis that rattled the financial markets and led to fears that the U.S. economy would be dragged into recession, the dreaded "fiscal cliff," the various slowdowns in the Chinese economy that were sure to drag the rest of the global economy down, and a regulatory environment that often seemed arbitrary and at odds with economic growth.

Somehow, through it all and despite all of the obstacles thrown in its path, the economic expansion endured, which to us should be the main story of the current economic expansion, as opposed to the steady stream of complaints about the expansion's alleged shortcomings. Furthermore, while no one may be all that happy with the pace of growth seen over the current expansion – average annualized real GDP growth of 2.3 percent – very few seem to realize that the pace of growth during economic expansions has gotten progressively slower over time, and that this has been going on for decades. In all honesty, we did not realize this until we were constructing the chart on the following page, in which we were originally only going to show real GDP growth over time and, almost as an afterthought, decided it would be useful to denote the average pace of real GDP growth for each of the expansions

shown in the chart. So, as perhaps you are, we were surprised to see the progressively slower average pace of growth.



As seen in the chart, the 1970-73 expansion is the last expansion in which the average pace of real GDP growth over the life of the expansion was faster than that of the prior expansion. Note that we're dismissing the Q1-Q3 1980 "expansion" that lasted all of three quarters as not really constituting an expansion, making it less noteworthy that growth over the 1983-1990 expansion was faster. Either way, the broader point is that the slow pace of growth during the current expansion is a continuation of a trend that has prevailed for decades. Obviously, growth patterns during each expansion help account for this; for instance, the expansion during the 1990s got off to a notably slow start, thus pulling average growth over the entire expansion lower, while the 2001-07 expansion was so heavily concentrated amongst housing and housing related industries that the overall pace of growth was fairly slow. More broadly, patterns in labor force growth and labor productivity growth also help account for the relatively slow pace of real GDP growth over the 2001-07 and current expansions.

Again, our point here is that the current U.S. economic expansion deserves more credit than it is generally given. So, consider this our birthday present to the expansion. Of course, the question on almost everyone's mind at present is whether the expansion will make it to another birthday. While we expect it will, we'll admit to being less confident in that call than we were a few months ago.

Not Whether. Not When. Maybe "Why?" Is The Right Question . . .

We clearly are not the only ones feeling less confident in the outlook for the economy. Having effectively adopted an easing bias at their June meeting and stating their intention to "act as appropriate to sustain the expansion," for the FOMC the question seems to be when, not whether, they will cut the Fed funds rate. As noted above, the financial markets see a cut in the Fed funds rate at the July FOMC meeting as a done deal.

While we do expect the FOMC's next move to be a rate cut, we do not see the July FOMC meeting as being the appropriate time for a rate cut. After all, late in June we laid down a series of markers

that we thought would go a long way towards determining the timing of the initial funds rate cut. Those markers were signs of progress on a trade agreement between the U.S. and China at the G-20 summit, signs that the U.S. manufacturing sector was beginning to stabilize, continued expansion in the services sector, and a solid June employment report. Our thought was that if each of these boxes was checked, it would be hard to justify a rate cut, at least on economic grounds, at the July FOMC meeting.

One could argue that each of those boxes has been checked, although admittedly at least some of the evidence is less than rock solid. For instance, the U.S. and China agreed to at least keep talking, thus foregoing the "nuclear" option of higher tariffs applied to a much broader range of goods. At least for now, as there is no guarantee we won't end up there at some point down the road. The ISM Manufacturing Index slipped a bit in June but, at 51.7 percent, did come in better than expected and indicates continued expansion, albeit at a slower pace, in the manufacturing sector. The ISM Non-Manufacturing Index remains firmly in expansionary territory, thus helping allay concerns that the softening in the industrial sector has spilled over into the broader economy. Finally, the June employment report came in much stronger than had been expected, with private sector payrolls rising by 191,000 jobs and job growth being more broad based across private sector industry groups than in any month this year.

From the start, we attached much more weight to the June ISM Non-Manufacturing Index and the June Employment Report, and together these tell us that the broader economy is still on solid ground despite uncertainty over trade policy and a slowing pace of growth in the manufacturing sector. While not ruling out a rate cut at this month's FOMC meeting, this does make a rate cut harder to justify, at least in our view.

To be sure, the rate of economic growth is slowing from last year's 2.9 percent pace of real GDP growth. But, this is what we and virtually every other analyst, not to mention the FOMC, have anticipated for quite a long time now. It is valid to ask whether the deceleration in growth has gone beyond what was expected, which seems a natural question in light of the pronounced softening in the industrial sector. If so, then one could argue a rate cut, or a few rate cuts, would be warranted to help keep the economy from slipping into recession. It can further be argued that the FOMC acting pre-emptively is much more important at present, given that the low level of the Fed funds rate leaves the FOMC limited scope to use interest rates to help sustain the expansion.

But, we're simply not there yet. Even if slowing growth gives way to contraction in the manufacturing sector, there is a long way from there to a recession in the broader economy. For instance, the ISM Manufacturing Index stands at 51.7 percent as of June, but according to the ISM's estimates, any value of better than 42.9 percent over a period of time is generally consistent with expansion in the broader economy.

This gets us back to our earlier point about the significance of the June Employment Report and the June ISM Non-Manufacturing Index and the signals they are sending on the health of the broader economy. And, as with the broader economy, we and most others expected the pace of job growth to slow this year, particularly as the extraordinarily strong pace of job growth in

2018 is the outlier here. As it is, job growth has been volatile from month-to-month of late, but the trend rate of job growth (an average of 176,000 private sector jobs per month over the past 12 months) remains more than sufficient to keep downward pressure on the unemployment rate and upward pressure on wage growth. Which hardly strikes us as grounds for a rate cut.

If not pre-emptive rate cuts to fend off recession, how about justifying Fed funds rate cuts on the grounds that they would help the FOMC hit their 2.0 percent inflation target. We don't find this to be a very compelling argument. Clearly, the combination of globalization, technology, and demographics has acted as a source of downward pressure on inflation over recent years and, rather than abating, these forces seem likely to intensify over coming years. Sure, the virtues of globalization are increasingly being called into question, but we'd argue demographics and technology are likely to dominate. As such, inflation figures to be (or, perhaps we should say, remain) unresponsive to monetary policy, well beyond the remaining life of the current expansion.

So let's just go right to what is the 800-pound gorilla, the elephant in the room, and the crazy uncle hiding in the attic all rolled into one – the considerable uncertainty over trade policy, which has dampened business sentiment, not only here in the U.S. but globally. Is that grounds for a rate cut or a series of rate cuts? To the extent this uncertainty is weighing on business investment and could at some point weigh on the pace of job growth, one could argue that rate cuts would be warranted. We'd simply ask how one or more rate cuts changes any of this. To be sure, we think a worst-case outcome in the trade dispute between the U.S. and China could trigger a global recession, but our point is simply that a rate cut does nothing to diminish the risk of recession stemming from trade disputes. For that matter, the FOMC could cut the funds rate back to zero tomorrow and it still would not diminish the risk of recession stemming from a worst-case outcome on trade.

Still, there are many who argue that the FOMC should cut the Fed funds rate this month on the grounds that a rate cut would act as "insurance" against a softening manufacturing sector, souring business sentiment, and slowing global growth teaming up to push the U.S. economy into recession. Our question is just what does a rate cut buy us, and we mean this literally as well as figuratively. If the premise is that lower interest rates are going to spark a wave of business and household spending and thereby firm up the pace of real GDP growth, the reality is that market interest rates have, in effect, already done the FOMC's work for it.

Already low interest rates and fairly narrow credit spreads mean that the cost of financing investment is not, nor has it been for quite some time, a constraint on business investment, particularly for those large corporations already sitting on ample piles of cash. To be sure, the housing market has responded to the sharp decline in mortgage interest rates since they peaked at 4.95 percent last November, but this response has been fairly muted. We'd argue this is a reflection of the supply constraints that have acted as drags on both new and existing home sales over much of the current expansion. Even were mortgage interest rates to fall further in response to a cut in the Fed funds rate, which we question, lower mortgage interest rates won't do anything to relax the supply constraints that have weighed on home sales. By pulling more prospective buyers into the market, however, lower

mortgage interest rates may reignite house price appreciation and again bring affordability issues to the fore.

We could make a similar argument about motor vehicle sales. Our view is that a slowing pace of motor vehicle sales is not a function of financing costs, but instead an indication that what had been a considerable degree of pent-up demand has been sated. If we are correct, then lower interest rates won't do much to stem the slowdown in motor vehicle sales. What lower interest rates likely would do, however, is sustain the ongoing shift in the mix of sales that is seeing higher priced SUVs/light trucks capture a larger share of sales at the expense of lower priced automobiles.

Furthermore, regardless of how low, or how much lower, they may go, interest rates alone won't do much in an environment in which an increasingly uncertain economic outlook is sapping business and consumer confidence. To illustrate our point, we'll note that we spend a fair amount of time interacting with commercial clients, and the next commercial client who tells us a funds rate cut would make them feel so much better about the world that they would embark on new capital spending will be the first commercial client who tells us that. We simply see there being few, if any, material effects on the real economy should the FOMC opt for an "insurance" cut in the Fed funds rate at this month's meeting.

We will, however, go back to the point we made earlier about market interest rates having more or less already done the FOMC's work for it. One could argue that the Fed funds rate is out of alignment with market interest rates. We're sympathetic to this argument, particularly as we look at an inverted 10/3 yield curve, knowing and respecting the predictive power of an inverted yield curve. On this basis, a cut in the Fed funds rate would make sense.

Still, it is important to keep in mind that a 10-year U.S. Treasury note yield hovering around 2.00 percent reflects three factors – diminished expectations for U.S. economic growth, diminished expectations for inflation, and extraordinarily low (in many cases negative) interest rates across much of the globe. It is the third of these factors that is often overlooked, but which poses a dilemma for the FOMC. In other words, does the FOMC respond to foreign central banks set to add even more monetary accommodation, which would draw even more foreign capital to the U.S., putting further upward pressure on the U.S. dollar, further downward pressure on market interest rates, and further downward pressure on inflation.

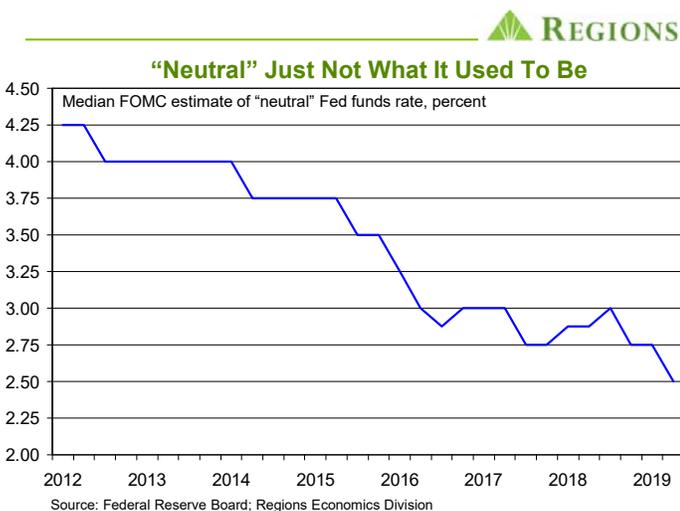
We disagree with those who see currency manipulation as the motivation for foreign central banks set to provide greater degrees of monetary accommodation. Exchange rate movements are secondary effects of changes in monetary policy motivated by domestic growth and inflation concerns. That said, the more relevant question is whether, or to what degree, this distinction actually matters if you're the FOMC and you're watching the market interest rates fall further and inflation move further away from your target rate. There are many who complain that the FOMC is a captive of the financial markets, and while we don't entirely disagree with this, it is perhaps more problematic that the FOMC is effectively put in the position of having to respond to the actions of foreign central banks.

In short, the body of U.S. economic data does not convince us that a rate cut is warranted at the July FOMC meeting, nor do we buy

the argument that a rate cut is needed to guard against the adverse effects of uncertainty over trade policy. We do, however, expect that by year-end the FOMC will cut the funds rate by a total of 50 basis points, which has more to do with more closely aligning the funds rate with where market interest rates are, and more closely aligning the FOMC with where foreign central banks are, these two factors not being unrelated. Hardly an ideal basis for monetary policy decisions, but this is where the last decade has left us.

Neutral Just Ain't What It Used To Be . . .

In another sign of where the last decade has left us, at their June meeting the FOMC once again marked down its estimate of the “neutral” Fed funds rate (or, more precisely, mid-point of the Fed funds rate target range that would be considered neutral). Simply put, the “neutral” value of the funds rate is the value that would prevail were the economy operating at full employment with stable inflation. Many dismiss the concept of a neutral funds rate as being nothing more than a theoretical nicety with no practical value, mainly due to the fact that the neutral funds rate cannot be observed directly, only estimated. We of course do not agree with that view and, directly observable or not, the reality is that the concept of a neutral policy rate serves as a guide for the FOMC and other central banks as they set monetary policy. That the value of the neutral policy rate varies over time may make it seem that central bankers are blindfolded and shooting at a moving target without ever knowing if they actually hit it, but we think that too harsh of an assessment, and central bankers do see the concept of a neutral policy rate as a useful guide.



The chart above shows the path of the median value of FOMC members’ assessments of the neutral funds rate, beginning in 2012 when the FOMC first started releasing economic and financial projections four times a year. First pegged at 4.25 percent back in 2012, the median estimate of the neutral Fed funds rate has fallen considerably and as of the June 2019 projections stood at just 2.50 percent (estimates ranged from 2.375 percent to 3.25 percent). Note that as late as September 2018, the median estimate of the neutral funds rate stood at 3.00 percent, with estimates as high as 3.50 percent, which was Chairman Powell’s frame of reference

when he stated last October that we were “a long way from neutral.” It was only a month later that Chairman Powell stated that rates were “just below a range of estimates” of neutral. So, with the estimate of neutral again having been marked down in June, that pretty much leaves rates at neutral.

One immediate implication is that, with a Fed funds target range of 2.25 to 2.50 percent, monetary policy can no longer be considered stimulative to any meaningful degree (particularly when the Fed’s balance sheet is contracting). Consider this in the context of our earlier discussion of foreign central banks either already adding or set to add further monetary accommodation, meaning that U.S. monetary policy becomes relatively tighter even with the FOMC taking no actions to make it so. Again, the notion of the FOMC having to move to effectively stand still is one argument for the FOMC to begin lowering the Fed funds rate.

Another implication is that, with such a low neutral funds rate, the FOMC has less room to cut rates during a recession (or, to cut rates pre-emptively to help fend off recession). This means that during future downturns, at least those which begin with such a low neutral funds rate, the FOMC will have no choice but to rely on “unconventional” policy tools with which to provide monetary accommodation. In other words, if you thought the FOMC got creative during the last downturn, it could be that you ain’t seen nothing yet, as the saying goes.

The chart showing the diminishing value of the neutral Fed funds rate is in essence just another way of looking at our by now familiar but not necessarily beloved chart showing the economy’s “speed limit,” or the rate at which it can grow on a sustainable basis without sparking inflation pressures. An economy with slack, in the labor market and/or the industrial sector, as is still the case with the U.S. economy, can grow at a faster pace without sparking inflation until that slack has been absorbed. Recall that at present our estimate puts the economy’s speed limit at less than 2.0 percent, as do the estimates of many others. That the speed limit is so low reflects what has been a steadily decelerating rate of labor force growth and an anemic trend rate of productivity growth. These factors also help account for the neutral value of the Fed funds rate being so low, but other factors, such as a heightened degree of risk aversion in the wake of the 2008 financial crisis, are also weighing on the neutral funds rate.

That said, the recent improvement in the rate of productivity growth would, if sustained, push up the economy’s speed limit and with it the neutral value of the Fed funds rate. That is a big “if” at present, and is contingent on the improvement in business investment spending that began in 2017 being sustained. That is indeed a taller task in light of fading business sentiment, but it is simply too soon, at least for us, to rule it out. While we do see some further upside room for labor force participation to increase, it is unlikely that we will see a meaningful and sustained increase in the rate of labor force growth over the next decade, if not for even longer. This again illustrates the importance of faster growth in business investment spending being sustained.

For now, though, that the neutral value of the Fed funds rate is so low leaves the FOMC, and perhaps by extension the rest of us, in an uncomfortable spot. It also raises the likelihood that unconventional policy tools will play an even larger role in monetary policy during the next downturn.

ECONOMIC OUTLOOK



Q4 '18 (a)	Q1 '19 (a)	Q2 '19 (f)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)	Q2 '20 (f)	Q3 '20 (f)		2016 (a)	2017 (a)	2018 (a)	2019 (f)	2020 (f)
2.2	3.1	1.7	1.8	2.0	2.1	1.7	1.5	Real GDP ¹	1.6	2.2	2.9	2.5	1.8
2.5	0.9	3.8	2.3	2.6	2.3	2.1	1.9	Real Personal Consumption ¹	2.7	2.5	2.6	2.5	2.3
								Real Business Fixed Investment:					
8.3	4.3	3.5	4.0	5.1	4.6	3.8	2.8	Equipment, Software, & IP ¹	2.1	5.5	7.5	5.1	4.0
-3.9	4.3	-5.7	-2.0	0.9	1.4	1.5	2.1	Structures ¹	-5.0	4.6	5.0	-0.6	0.4
-4.7	-2.0	-2.7	0.6	-0.6	2.3	2.5	2.0	Real Residential Fixed Investment ¹	6.5	3.3	-0.3	-2.4	1.2
-0.4	2.8	5.8	1.3	0.2	0.1	-0.3	-0.1	Real Government Expenditures ¹	1.4	-0.1	1.5	2.3	0.5
-955.7	-905.0	-937.3	-944.2	-955.1	-967.3	-978.6	-991.3	Real Net Exports ²	-786.2	-858.7	-912.2	-935.4	-980.9
828	864	841	862	878	890	909	917	Single Family Housing Starts, ths. of units ³	786	852	873	861	908
357	349	399	355	352	352	349	345	Multi-Family Housing Starts, ths. of units ³	392	357	377	364	347
17.5	16.8	17.0	16.8	16.7	16.5	16.5	16.4	Vehicle Sales, millions of units ³	17.5	17.1	17.2	16.8	16.4
3.8	3.9	3.6	3.6	3.6	3.5	3.4	3.4	Unemployment Rate, % ⁴	4.9	4.4	3.9	3.7	3.4
1.8	1.8	1.6	1.5	1.3	1.2	1.2	1.1	Non-Farm Employment ⁵	1.8	1.6	1.7	1.5	1.1
3.2	2.0	1.3	1.5	2.1	1.9	1.7	1.4	Real Disposable Personal Income ¹	1.7	2.6	2.8	2.1	1.7
2.2	1.8	1.7	2.0	2.2	2.6	2.5	2.3	GDP Price Index ⁵	1.1	1.9	2.3	1.9	2.4
1.9	1.4	1.5	1.7	1.8	2.3	2.1	2.1	PCE Deflator ⁵	1.1	1.8	2.0	1.6	2.1
2.2	1.6	1.9	1.7	1.7	1.9	1.6	1.7	Consumer Price Index ⁵	1.3	2.1	2.4	1.7	1.7
1.9	1.7	1.6	1.8	1.9	2.1	2.1	2.0	Core PCE Deflator ⁵	1.7	1.6	1.9	1.7	2.1
2.2	2.1	2.0	1.9	1.8	1.8	1.8	1.9	Core Consumer Price Index ⁵	2.2	1.8	2.1	2.0	1.9
2.16	2.38	2.38	2.34	2.07	1.88	1.88	1.88	Fed Funds Target Rate Range Mid-Point, % ⁴	0.39	0.97	1.78	2.29	1.88
3.03	2.65	2.33	2.02	1.95	1.86	1.87	1.87	10-Year Treasury Note Yield, % ⁴	1.84	2.33	2.91	2.24	1.86
4.78	4.37	4.01	3.77	3.67	3.61	3.61	3.62	30-Year Fixed Mortgage, % ⁴	3.65	3.99	4.54	3.96	3.61
-2.6	-2.4	-2.5	-2.7	-2.7	-2.8	-2.8	-2.9	Current Account, % of GDP	-2.3	-2.3	-2.4	-2.6	-2.9

a = actual; f = forecast; p = preliminary

- Notes:
- 1 - annualized percentage change
 - 2 - chained 2012 \$ billions
 - 3 - annualized rate
 - 4 - quarterly average
 - 5 - year-over-year percentage change

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