Current Economic Conditions

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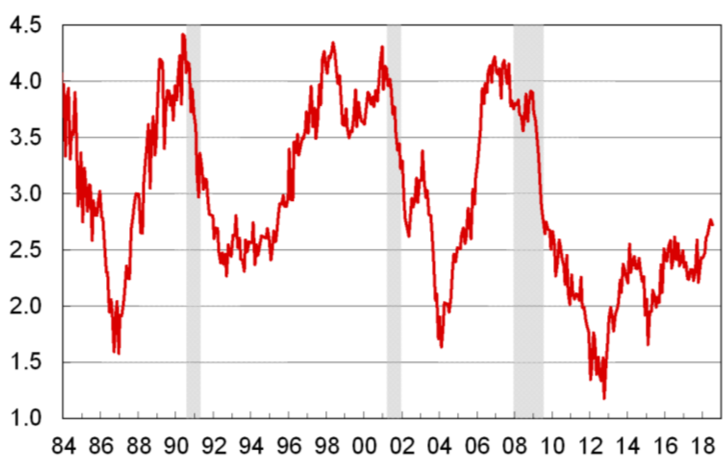
THE EXPANSION COULD LAST A LONG TIME

The current economic expansion entered its tenth year this summer. The expansion is likely to continue through next July, making it the longest expansion in U.S. history. But the advanced age of the expansion does not imply that it is nearing an end. Many of the economic indicators I follow suggest the current economic expansion has several more years to run. Tariffs and tight labor markets are the main threats to continued expansion, and these threats can be removed with appropriate policies.

A typical recession occurs after the Federal Reserve raises short-term interest rates to bring inflation down. When short-term rates rise above long-term bond yields – what economists call an inverted yield curve – a recession can be expected within the next 6-18 months. Many market analysts have pointed out that the yield on 2-year Treasury notes has gotten very close to the yield on 10-year Treasury notes, but research by the Federal Reserve, the Federal Reserve Banks of New York and San Francisco, and this author shows that the spread between the 10-year note yield and the Federal Funds Rate or the discount rate on 3-month Treasury bills is a better leading indicator of recessions than the 10-2 spread. Even if the 10-year note yield were to remain constant (unlikely) rather than rising (more likely), it would take five more quarter-point rate hikes to put the Federal Funds Rate above the 10-year note yield. Unless the Fed is willing to commit monetary malpractice, it is not going to invert the yield curve unless inflation is persistently above the Fed's 2% target. In July, the Personal Consumption Expenditures Price Index, the Fed's preferred measure of inflation, was up 2.3% from a year earlier. That is slightly above the Fed's target, but prior-year comparisons, declining oil prices, and a core (ex food and energy) PCE inflation rate of 1.9% suggest that the PCE price index is likely to fall back below 2% in coming months.

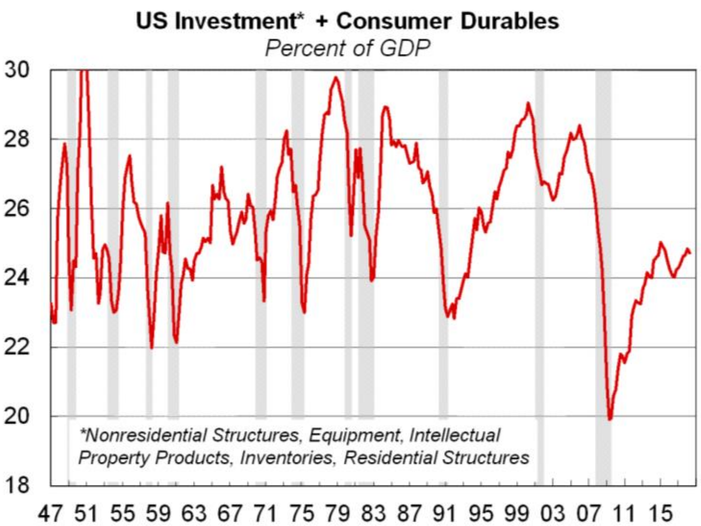
Average Hourly Earnings, Production & Nonsupervisory
Percent Change from Year Ago



Because wages and salaries account for the lion's share of income on the consumer side and of costs on the business side, inflation seldom rises to expansion-threatening levels unless wages and salaries accelerate as well. Since Paul Volcker broke the back of double-digit inflation, no economic expansion has ended before the year-over-year increase in average hourly earnings (for production and nonsupervisory workers) rose above 4.3%. In August, earnings were up just 2.8% year-over-year and were accelerating very slowly.

While many economists look at labor markets for signs of rising inflation, I prefer to look directly at markets for goods and services. In particular, I look at capacity utilization in manufacturing. Capacity utilization is below levels that have signaled rising inflation in the past, and if tax reform stimulates investment that increases capacity, it will take a while for it to get to those levels. Despite solid growth since last September, industrial production, the numerator in capacity utilization, is below its 2000 cyclical peak, not just its 2007 peak, in most manufacturing industries. And even if capacity utilization rises to levels that have historically signaled rising inflation, imports could provide a relief valve that keeps inflation down. Unless tariffs clog this relief valve, capacity utilization would have to be high around the world for inflation to rise enough to force the Fed to invert the yield curve and cause a recession.

Rising interest rates end expansions primarily through their impact on the housing market; it isn't much of an exaggeration to say that the U.S. business cycle is really a housing cycle. Nearly all U.S. recessions have been preceded by **big** declines in home sales and housing starts, beginning well before the business-cycle peak. But it's hard to have an expansion-threatening housing bust without first having a housing boom, and residential construction has been a major disappointment during the current expansion. A housing-led recession would require a big increase in housing starts, a few years of overbuilding, and then a big downturn. That's almost impossible within the next three years. More broadly, the cyclical share of Gross Domestic Product (residential and nonresidential investment plus consumer spending on durable goods) is still well below the 28% level it has reached before the peak of most previous expansions. Corporate profits also tend to peak well before business-cycle peaks. Profits rose strongly through the second quarter. Unless that turns out to be the peak, a recession is unlikely before 2020.



There is, however, one economic indicator that suggests that the current expansion is long in the tooth and that the risk of recession is rising. The civilian unemployment rate currently stands at 3.9%, well below the Congressional Budget Office's 4.6% estimate for the natural rate of unemployment, the rate the CBO deems consistent with stable inflation. To those who believe in the Phillips Curve, unemployment below the natural rate means that inflation will rise, forcing the Fed to raise interest rates and, unless they can execute the elusive soft landing, end the economic expansion. Even for those of us who don't believe in the Phillips Curve, low unemployment suggests that growth in employment will soon slow and economic growth will be limited to what can be generated from growth in the adult population and growth in productivity. Slower economic growth increases the likelihood that a shock (e.g., financial crisis, oil supply disruption) or a policy mistake (e.g., inverted yield curve, tariffs) will push the economy into recession.

An increase in the labor force participation rate could boost growth in employment and GDP, but not by much or for long. Productivity growth is likely to be higher than the anemic rate that prevailed from the fourth quarter of 2010 to the first quarter of 2017, but we shouldn't expect miracles. If we want sustained strong growth, we need faster growth in the adult population. It takes about two decades to increase the adult population by having babies; increasing adult population growth quickly enough to extend the current economic expansion requires increased immigration. President Trump wants to increase the contribution of immigration to growth by replacing family-based immigration and the green card lottery with a merit-based system, but his other policies would significantly cut legal immigration, exactly the opposite of what he should do if he wants to extend the expansion through the 2020 election. To win that election, he might have to convince his political base to accept a big increase in immigration.

I'm still assuming that trade negotiators come to their senses before U.S. tariffs push measured inflation to levels that force the Fed to raise interest rates to expansion-threatening levels. If I'm correct, the current economic expansion is likely to become the longest in U.S. history in July 2019, and tight labor markets and a consequent slowdown in employment growth will replace trade policy as the biggest threat to the economic expansion. Increased immigration would remove this threat, allowing the expansion to continue through 2020 and perhaps beyond.