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INVESTMENT MANAGEMENT

Economic Perspectives

DESPITE CONCERNS, U.S. EXPANSION REMAINS STEADY SEPTEMBER 2017

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Figure 1

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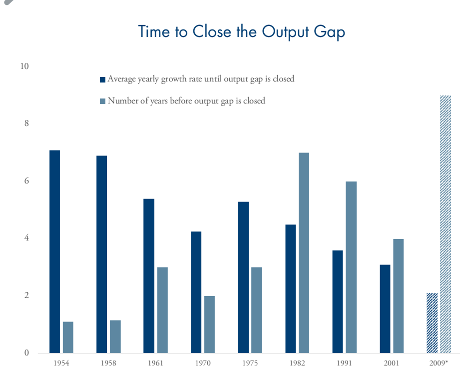

Source: Congressional Budget Office (CBO) August 2017

With continued dysfunction in Washington, heightened geopolitical tensions, and the tragedy unfolding in the south, the recent nervousness among investors is understandable. Yet, there is little reason to doubt the ongoing U.S. economic expansion.Despite eight years of uninterrupted growth, few serious cracks in the economic foundation have developed. Given the general lack of excess in the economy, we would not be surprised to see it continue for some time longer. If you're waiting for 3-4% annual real growth, you may be disappointed. But this expansion does have one thing going for it: longevity.

Economic cycles tend to follow similar paths. After reaching an inflationary peak late cycle, a recession drives business activity to a trough. Output falls below potential, and slack in the economy opens up. Eventually, a recovery begins and then, as spare capacity is used up, we enter another reflationary period, leading to a new peak. While cycles often share these milestones, the time between them varies depending on each expansion's robustness.

This means that economic slack is arguably a better way to benchmark where we are in the business cycle rather than simply looking at the time elapsed since the last recession. The current U.S. economic expansion, at nearly 100 months old, is already the third longest on record. And it's true that when compared with the other two long-lasting expansions, that the current one looks weak. GDP has grown just 19% over the past eight years—significantly less than the 51% growth posted in the first eight years of the 1961-69 expansion and the 34% in the same span of the 1991-2001 expansion.

However, lower growth rates also imply that slack is being eroded much more slowly relative to previous cycles—especially given the sheer spare capacity created after the financial crisis. Cautiousness remains pervasive even eight years on and, outside of some labor market indicators, measures such as the output gap indicate the economy continues to operate well below potential. This just goes to show how long it takes for confidence to return after a severe crisis.

Still, the longer it takes to absorb economic slack, the longer the business cycle should last. Though the U.S. economy continues to expand, it has yet to approach full capacity and reach the limits that begin to constrain growth. Capacity utilization rates in the past two expansions, for example, reached 81-82%, compared with 75-76% today. In fact, according to data from the Fed, every recession in the past 50 years was preceded by capacity utilization of more than 80%.

With substantially more capacity remaining, additional growth is possible before worrisome inflation rears up. While a number of factors contribute to a recession, the trigger for every downturn over the past 40 years has been an increase in real interest rates, typically to a level of 2% or higher. As economic expansions mature, the Fed often becomes determined to raise interest rates, either to squeeze out inflation or because they are worried that a rise in inflation is just around the corner. In turn, higher real interest rates hit spending on rate-sensitive areas such as durable goods consumption and residential investment.

Today, there is little evidence we've approached the stage of the business cycle where the buildup of excesses or imbalances leads to aggressive Fed tightening and a subsequent economic downturn. Instead of robust growth, aggressive borrowing, and rampant inflation, we have almost opposite conditions: modest growth, a restrained pace of borrowing, and low inflation. In truth, we believe the Fed would prefer higher inflation, not lower inflation, yet classic factors such as lower energy costs and commodity prices have combined with changing demographics, global completion, and newer, technology-driven developments to keep inflation under wraps. As a result, interest rates are not being pushed higher as they were in past cycles.

No expansion lasts forever, and after eight years we're almost certainly closer to the end of the current cycle than the beginning. Still, assuming the economy does not slip into recession between now and 2019, the current expansion should surpass the 1990s as the longest period of uninterrupted growth since at least 1854. This economy has never been called robust, but it sure has been durable.

The Fed is expected to take a break from rate increases.

THE FED

After pushing up the federal funds rate at the past three quarter-end meetings (see *Figure 2*), the Fed is expected to take a break from the rate increases at its upcoming meeting on September 19-20. Instead, it will likely take other steps toward removing accommodation and announce plans to reduce the size of its balance sheet. Throughout the stages of quantitative easing, the Fed has scooped up treasury and mortgage-backed securities to help bring interest rates down. The holdings, found on its balance sheet, grew from a level below $1 trillion to about $4.5 trillion. With the economy now on stable footing, we believe it is time to reduce the size of these holdings. The Fed will likely do so by letting a preset amount of securities mature each month. This gradual approach should have a minimal effect on the market.

Quantitative easing likely prevented the economy from stumbling too severely, as it

Figure 2

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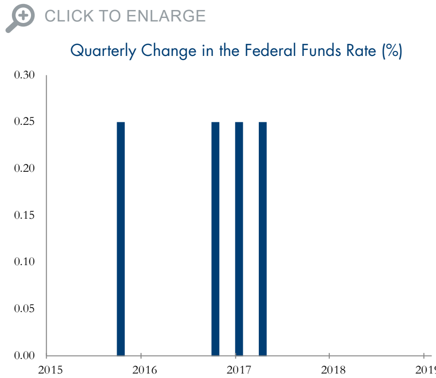

Source: Federal Reserve Bank
July 2017

Figure 3

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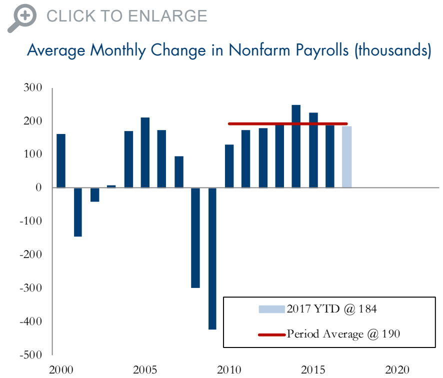

Source: Bureau of Labor Statistics
July 2017

did during the Great Depression. However, with the economy in its ninth year of an expansion, it is time to unwind. Thus, the Fed is expected to bring its balance sheet down to the $2.0-2.5 trillion range.

LABOR

Payroll gains continue to surge this year.

Payroll gains continue to surge this year. In July, employers added 209,000 jobs, which brought the 2017 average monthly gain to 184,000 (see *Figure 3*). That is about the same as the 2016 monthly average of 187,000. As exhibited in past expansions, job growth tends to slow down after a number of years, and that had been the case with this expansion. Yearly job growth peaked in 2015 and has been falling since. But this year's renewed thirst for hiring additional workers has stabilized that descent. The unemployment rate, which is calculated from a different survey, fell to 4.3%, a joint 16-year low.

We are in an interesting time. This expansion has had a growth rate that has averaged about 2.0%. The economic output is the weakest of all the post-World War II expansions (up just 13% from the previous cycle peak). Yet, this expansion has been the longest period of continuous gains in payrolls (82 months) and has had the greatest increase in the amount of workers (16.2 million). Stated simply, this expansion is playing the role of the tortoise from Aesop's classic fable "The Tortoise and the Hare."

INFLATION

A big question facing the Fed is, "Why is inflation so low?"

The big question facing the Fed is, "Why is inflation so low?" The Consumer Price Index is at just 1.7%, below the Fed's target rate of 2.0% (see *Figure 4*). While it has spent most of the past five years below that level, it did make a run above it back in the first quarter. However, it has since fallen again due to lower prices for energy, prescription drugs, used cars, and mobile phone plans. Normally at this stage of the business cycle, inflationary pressures build up, especially when the unemployment rate is so low (4.4%). We believe this is making it difficult for the Fed to follow through with its planned rate increases.

This subject was discussed heavily at the Fed's recent meeting. It believes the recent weakness is transitory and reflects "idiosyncratic factors." It is confident that inflation will bounce back toward the target level. That said, the Fed will maintain an attentive watch of all incoming inflation data. Our view is that once energy prices stabilize (oil is

Figure 4

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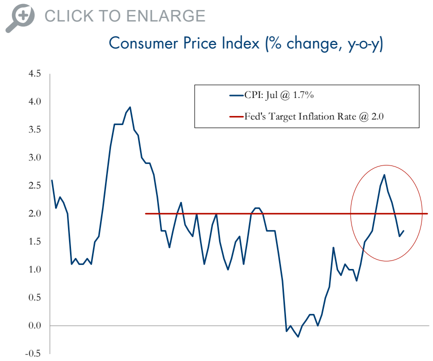

Source: Bureau of Labor Statistics
July 2017

Figure 5

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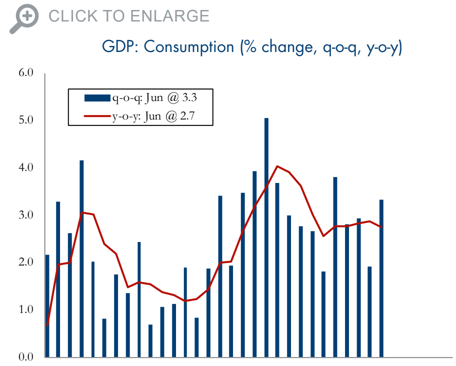

Source: Bureau of Economic Analysis
August 2017

down 7.2% in the past year) and other one-time events (such as the mobile phone plans) work their way through the year-over-year calculation, inflation should start to move up back to the 2.0% level.

Consumption, which had fallen in the first quarter, appears to be experiencing a sustained rebound.

CONSUMPTION

Consumption, which had fallen in the first quarter, appears to be experiencing a sustained rebound. This is an important movement since consumption makes up more than two-thirds of GDP. The drop in the growth rate in Q1, which increased just 1.9%, is being blamed on a temporary decrease in disposable income resulting from high medical insurance deductibles and a concurrent bump in inflation. Growth in consumption in Q2 has moved up to 3.3% (see *Figure 5*), and the early data for Q3, based on retail sales data, is showing an even higher rate of growth. The post-recession average is 2.5%.

The July retail sales report, parts of which feed into the consumption calculation for GDP, showed broad-based strength. More importantly, the June report had a sizable upward revision. This data puts us on a firm footing for the start of the Q3.

Long-term fundamentals point toward strong consumption. Household wealth is at record levels, the unemployment rate is low, consumer confidence is high, access to credit is expanding, interest rates are low, and household leverage is at levels not seen since the 1980s.

Index Definitions

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, including transportation, food, and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.