A closer look

The U.S. economy: how close to a late cycle?

Overview

The economic expansion[1] in the United States keeps rolling along. It's already more than nine years old, the second longest on record, and it shows little sign of flagging. It has even gained strength over the past year, and though this acceleration is unlikely to be sustained, the expansion is well positioned to become the longest in U.S. history by summer 2019. Age alone will not do it in. As we have argued before, the probability of a U.S. expansion coming to an end is independent of how long it has already lasted – no higher for "old" expansions than "new" ones.[2] And what constitutes "old" has been changing, with expansions since the 1980s lasting longer on average than their predecessors. That's true outside the United States as well, where some countries (e.g., United Kingdom, Australia) have seen expansions last well over a decade.

So if age doesn't kill expansions, what does? In a word, excesses. Expansions can strain the economy's resource capacity, generating destabilizing inflationary pressures that prompt aggressive tightening by the U.S. Federal Reserve (Fed) and ultimately bring on recession. Expansions can also be felled by a different, albeit related excess: households and businesses becoming imprudent, weaving an interconnected web of debt, mal-investment, and leveraged financial claims built on unduly optimistic expectations that eventually provokes a day of reckoning. Prime examples include the tech or overinvestment binge turned to bust in the early 2000s commonly known as the Dotcom bubble, and the housing or consumer debt bubble that precipitated the financial crisis. In short, expansions get undone either because the economy overheats or overindulges – sometimes a bit of both.

How vulnerable is the current expansion on these fronts? Fortunately, it still seems largely devoid of the kinds of excesses that derailed the last two expansions. Chastened by the crisis, households and businesses, borrowers and lenders, savers and spenders (and regulators) have been more cautious this time. What's more, inflation expectations appear firmly anchored, and wages and prices seemingly less responsive to changes in slack, suggesting the economy is less prone to inflationary overheating. But it's hardly immune. Labor markets are tight and likely to get tighter still, threatening not only an uptick in inflation, but also suggesting that monetary policy may still be too accommodative, and might yet kindle broader financial and economic excesses. Or these excesses could develop on their own. Though not imminent or unavoidable, these are non-negligible risks. Labor markets are eventually going to have to stop tightening, and perhaps even ease up a bit, and some further snugging of monetary policy and

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In a nutshell

- So if age doesn't kill expansions, what does? In a word, excesses.
- Expansions get undone either because the economy overheats or overindulges.
- Shifting the economy onto a more sustainable trajectory will likely be the key challenge to the sustainability of the expansion.

[1] Expansion is the phase of the business cycle when the economy moves from a trough to a peak. It is a period when business activity level surges and gross domestic product (GDP) expands until it reaches a peak.

[2] A Closer Look, February 2017, "Does the U.S. expansion still have legs?" https://dws.com/US/EN/resources/insights/market-insights/A_Closer_Look_by_Josh_Feinman_March_2018.pdf

financial conditions will likely be needed to make that happen (and to forestall other financial or economic imbalances). This process may not be seamless. Cooling the financial and economic backdrop enough to pre-empt destabilizing excesses without short-circuiting the expansion has historically proven challenging. Though the economy today does seem better positioned to pull off this kind of "soft landing[3] ," it's still going to be tricky.

The private sector is not over its skies

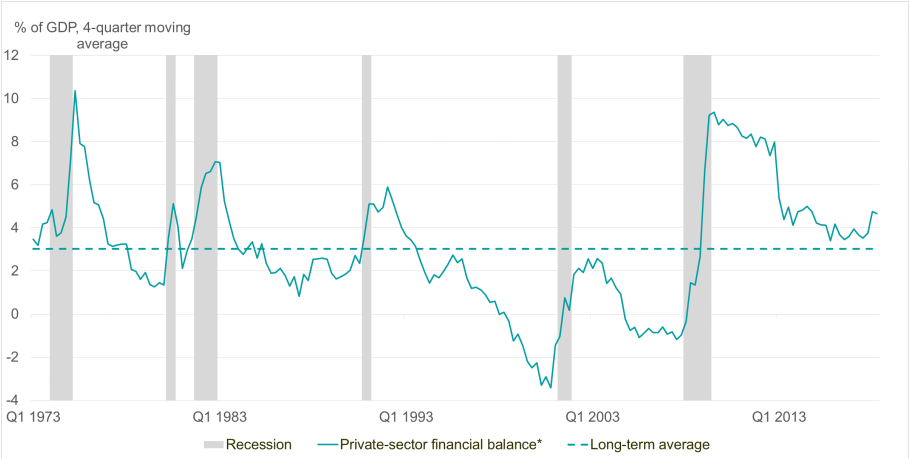
There are many ways of gauging economic and financial excess. Aggregate debt, current account balances, asset prices and financial market valuations, lending standards and practices, are just a few of the telltale barometers commonly scrutinized for signs of imprudence. A broad measure that encapsulates many of these indicators, and that has been a pretty reliable portent of trouble, is the private sector financial balance: the sum of the total income less the total spending of all households and businesses. Equivalently, it is the private sector's domestic saving less its domestic investment – essentially, its contribution to the nation's current account balance (which is also comprised of the government's fiscal balance). When the private sector is running a large financial surplus, its income well above spending, it is generally on firm ground, well able to support continued growth, and not a threat to financial stability. That ground becomes shakier, however, as the financial balance shrinks, and especially if it turns to deficit – if spending outstrips income, forcing households and firms to rely on net borrowing (or asset sales) to keep the music playing. That's inherently unstable, making households and businesses especially vulnerable to shifts in credit availability, financial conditions, risk appetites, and expectations. And if those shifts force the private sector to hunker down – to bring spending suddenly into better alignment with income – that can create a vicious, negative feedback loop between deteriorating economic and financial conditions that may even threaten the stability of the financial system.

Debt alone is not necessarily the problem. The private sector's debt-to-income and debt-to-asset ratios were trending higher for decades prior to the tech and housing bubbles, but much of that rise in leverage was benign; a reflection of financial innovations (like the increased availability of credit) that helped households and firms better manage their cash flows, smooth their spending, and spread risk around the financial system.[4] It's when the debt enabled unsustainable spending – pushing the private sector's financial balance below historical norms, and especially into deficit – that trouble ensued. That's what happened prior to the financial crisis, in the run-up to the 2001 recession, and to a lesser extent before the recessions of the early 1990s and early 1980s.

[3] A soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

[4] The debt ratio is a financial ratio that measures the extent of a company's or consumer's leverage and is defined as the ratio of total debt to total assets.

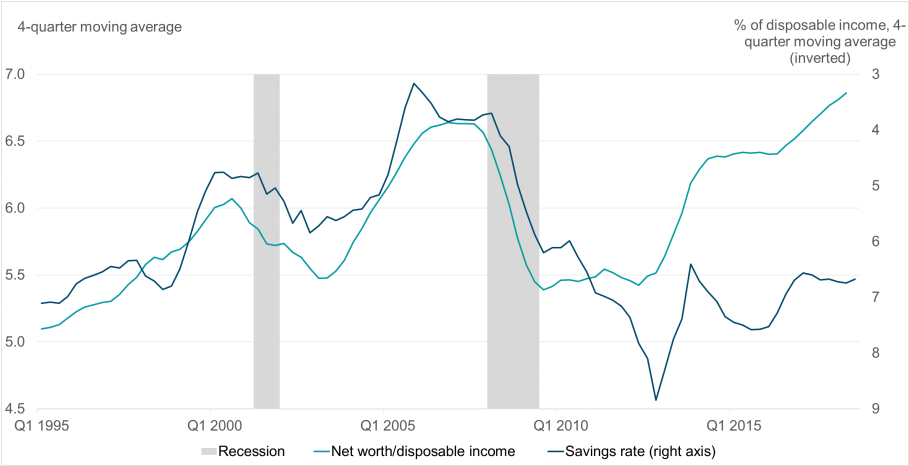
Private Sector Financial Balance: Not Stretched



Sources: U.S. Bureau of Economic Analysis (BEA), National Bureau of Economic Research as of 11/2018
*Total income minus total spending

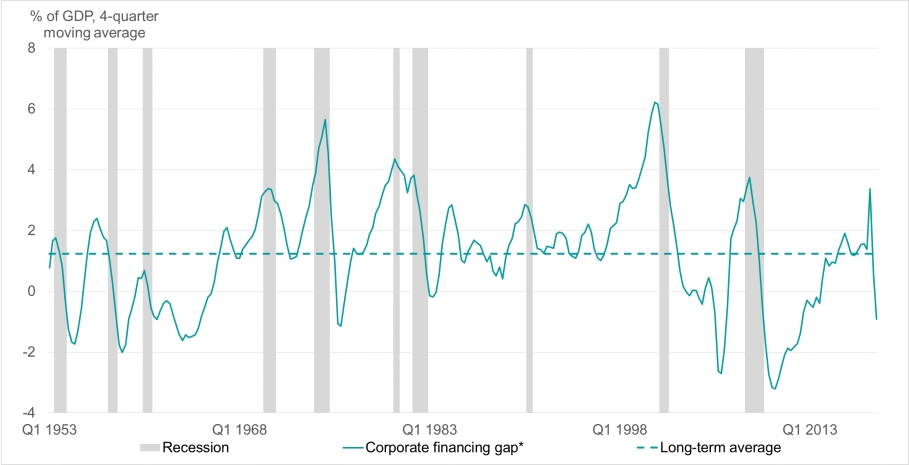
That sort of trouble does not seem to be brewing today. Although the private sector's financial surplus is down substantially from the peaks reached following the massive retrenchment of the Great Recession, it remains moderately positive, above long-term averages and far from the precarious depths plumbed prior to past downturns (particularly the deficits that preceded the last two recessions). On this metric, then, the private sector does not seem stretched. Households, nonfinancial firms, and financial intermediaries are being decidedly more prudent this time around; the personal savings rate, for example, remains well above the lows reached during the housing bubble, even though household net worth is back at record highs. Households seem not just wealthier, but wiser. So too do their lenders (and perhaps their regulators). The banking system, for example, is much better capitalized and less leveraged, and though lending and credit standards have eased substantially since the crisis, they have not become wantonly reckless again. On the nonfinancial corporate side, the financing gap remains in check, reversing a temporary jump related to tax reform and retracing to well below the peaks reached in the run-ups to prior downturns (especially the tech boom). Firms do not seem overextended in their capital outlays, or overly reliant on external financing.

Households: More prudent this time



Sources: U.S. Federal Reserve Board, U.S. Bureau of Economic Analysis (BEA), National Bureau of Economic Research as of 11/2018

Corporate Financing Gap in Check



Source: U.S. Federal Reserve Board as of 11/2018
*Capital expenditures minus internally generated funds

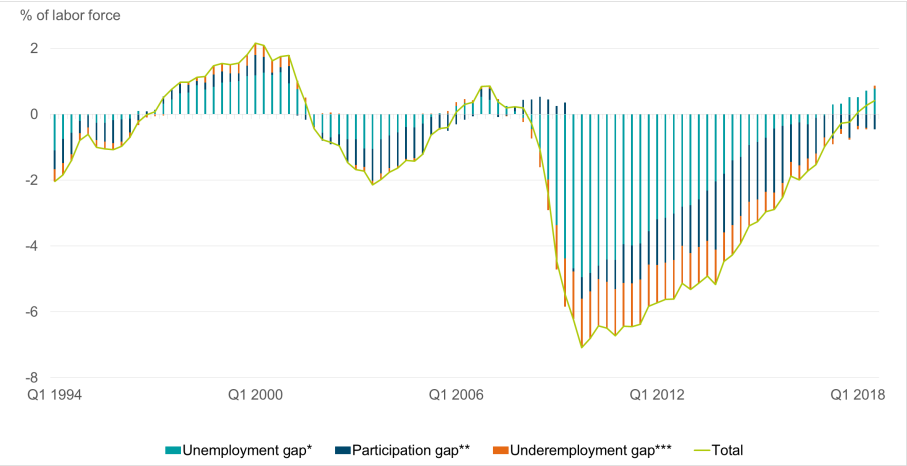
Still, there are areas of concern. Equity valuations and credit spreads are demanding, some segments of households and firms stretched, and certain types of credit hinting at excess (e.g., leveraged loans, bond covenants). But overall, risk appetites and expectations of future growth do not seem unduly giddy, and perhaps most importantly, the private sector's spending does not appear to rest on the kinds of unsustainable foundations that brought such trouble in the past.

But labor market overheating is a risk

The labor market, though, is starting to flash some amber warning lights – not of imminent slowing, but of potential overheating. Although it's hard to say for sure just where "full employment" lies, and we can't definitively rule out that there may still be some small reservoirs of slack remaining, a host of statistical indicators and anecdotal reports suggest the labor market is tight – perhaps not quite as tight as in some (rare) instances in the past, but close. And getting closer. Indeed, the labor market is still tightening, with job growth running well above even the most optimistic estimates of what's needed to keep up with trend demographics.

Tight labor markets have their upsides. They can help cement inflation's recent move back up to the Fed's target, reminding people grown accustomed to sub-par inflation that 2% is not a ceiling but a truly symmetric target, thus solidifying their long-term expectations around that target. Also, drum-tight labor markets might draw still more people into the labor force and keep them there, lifting the economy's long-run growth potential. They may also help reverse the tilt of income towards capital and away from labor that has contributed to rising inequality.

Labor-market slack seems all gone



Sources: Bureau of Labor Statistics, Congressional Budget Office, DWS Investment Management Americas Inc. as of 11/2018
* Unemployment rate minus Congressional Budget Office estimate of the natural rate ** Labor force participation rate minus Congressional Budget Office estimate of the trend rate *** 0.5*(Part-time workers who want full-time work minus rate consistent with NAIRU)

But white-hot labor markets are not devoid of risks. The more materially full employment is exceeded, the greater the chance that unsustainable strains develop, that inflation pressures keep building, and that they potentially even unmoor inflation expectations. Though there's no indication we're near that point yet, there are hints of stresses. Firms are reporting increased difficulties finding workers and meeting demand, and wages have been accelerating in response – reminding us, yet again, that reports of the death of the Phillips Curve have been greatly exaggerated. The pickup has been moderate so far, and has only pushed labor costs back up into a range likely to be consistent over time with the Fed's 2% inflation target. But wages have accelerated with a bit more vigor of late, and given that they often respond with a lag to labor market tightness, there's likely more to come – especially if labor markets tighten further. Well-anchored inflation expectations and a generally attenuated responsiveness of wage and prices to changes in slack provide some protection, but there is some evidence that the process could intensify if labor markets get very tight.[5] Tightening labor markets and above-trend growth may also signal that financial conditions are still too lax, and could yet stoke destabilizing economic and financial excesses.

And unsustainably-tight labor markets can be hard to unwind seamlessly – difficult to be cooled just enough to ease the strains without sending the economy into a tailspin. Achieving that kind of

[5]See, for example: Babb, Nathan R. and Alan K. Detmeister (2017). "Nonlinearities in the Phillips Curve for the United States: Evidence Using Metropolitan Data" Federal Reserve Board Finance and Economics Discussion Series, (070).

soft landing has proven challenging historically – not impossible, as evidenced by the "pauses that refreshed" during the long cyclical expansions of the 1980s and 1990s, for example – but a delicate balancing act all the same, all the more so the tighter labor markets become.

Labor costs moving up

Sources: Bureau of Labor Statistics (BLS) of the U.S. Department of Labor, U.S. Federal Reserve Board as of 11/2018
*Unweighted, 3-month moving average

A soft landing?

The economy does have a few aces up its sleeve, though. Perhaps most importantly, as already noted, the private sector has not overindulged. It is not harboring the kinds of excesses and imbalances that precipitated past downturns. Also, risks of a sharp, destabilizing inflation outbreak still seem remote. And the economy's supply side potential may be improving, at least modestly, aided by tax and regulatory reform and some recovery from the unusual sluggishness of productivity in recent years, which may afford the expansion additional non-inflationary running room. Finally, the impact that fiscal stimulus is having right now in stoking demand will likely dissipate over the next year or so, reducing overheating pressures. All of this should help the Fed to go slowly, reducing the likelihood that more aggressive tightening of monetary and financial conditions will be needed, and suggesting the economy will be better able to handle whatever tightening does ensue. Indeed, this is all central to our expectation that the economy will achieve something close to a soft landing over the next couple of years. Still, it will be a tough needle to thread. Shifting the economy onto a more sustainable trajectory will likely be the key challenge to the sustainability of the expansion.

Glossary

Accommodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Covenants

Covenants designate contractual obligations or restrictions intended to protect the financial interests of creditors.

Credit market

The **credit market** is the market for corporate bonds

Current account

The **current account** includes trade in goods and services, a net-factor-income balance (e.g. earnings on foreign investments and cash transfers from individuals working abroad) and transfers (e.g. foreign aid). It is a part of the balance of payments.

Dotcom bubble

The **dotcom bubble** refers to the rapid rise and eventual collapse of equity market valuations of technology stocks from the late 1990s to 2001.

Financial crisis

The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Great Recession

The **Great Recession** refers to the prolonged economic downturn in much of the world after the financial crisis of 2007-08.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Leverage

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

leveraged loan

Leveraged loans are loans extended to companies or individuals that already have considerable amounts of debt. Lenders consider leveraged loans to carry a higher risk of default and, as a result, a leveraged loan is generally more costly to the borrower.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Monetary-policy tightening cycle

A monetary-policy tightening cycle is a period of time during which a central bank raises interest rates with the aim of slowing GDP growth or inflation.

Non-Accelerating Inflation Rate of Unemployment (NAIRU)

The **Non-Accelerating Inflation Rate of Unemployment (NAIRU)** describes rate of unemployment refers to a level of unemployment below which inflation accelerates.

Phillips curve

In economics, the **Phillips curve** is a historical inverse relationship between rates of unemployment and corresponding rates of inflation.

Productivity

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Soft landing

A **soft landing** is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

Soft landing

A **soft landing** is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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