This Expansion Is Now 100 Months Old. What's Next?

It is hard to believe, but December marks the tenth anniversary of the start of the last economic downturn, most commonly known as the Great Recession, a downturn more severe than any recession since the Great Depression. The Great Recession lasted 18 months, longer than the average recession length of 11 months since World War II. It caused U.S. GDP to contract by 5.1%, the unemployment rate to rise to 10%, and housing values to fall by 40% or more in several major metropolitan areas. Economic growth following the Great Recession has been subdued compared to all other post-WWII economic expansions. That is not a surprise based on tempered growth rates following other major financial crises. The U.S. economy in this expansion has not experienced 3%-plus annual GDP growth rates that were common in past economic expansions. Despite lower growth, the current expansion is now 100 months long, making it the third longest economic expansion in U.S. history. As shown below, this current expansion is only six months away from becoming the second longest growth period and 20 months away from being the longest.

Source: Tower Square Investment Management, National Bureau of Economic Research

The current economic expansion is more than eight years old, and some are wondering if a downturn is around the corner. The average economic expansion since World War II has lasted about five years. Our current expansion has been long, but economic expansions do not die of old age. Recessions are usually caused by an overheating economy or a shock to the financial system. Compared to recent U.S. recessions, most key economic indicators are not flashing recession warning signs just yet. For one, our labor market is still strong. In the past six months, the U.S. economy has added an average of 163,000 jobs per month and the unemployment rate is 4.1% and trending lower. In the six months before the start of the last recession, the U.S. economy added an average of 51,000 jobs per month.

The unemployment rate was 5.0% at the start of the last recession and had been rising for over a year. Additionally, initial jobless claims at the start of the 2007-09 recession were more than 100,000 higher than they are today. Similar patterns of labor market weakness occurred heading into other post-World War II recessions and widespread job cuts occurred around the time that past recessions officially started.

Other current key economic indicators appear healthy, as well. Manufacturing and services activity recently reached their strongest readings in over a decade. Historically, manufacturing and services activity weakens heading into a recession. Consumption readings also remain a positive. Recent figures for retail sales, durable goods orders, auto sales, and consumer sentiment all point to continued strength in consumer activity. We are also seeing economic activity strengthening globally. There are improvements in labor market conditions, along with healthy retail sales and consumption data in several key markets globally, which has contributed to strong GDP growth in several major economies in recent quarters.

One potential cause for concern is the flattening of the Treasury Yield curve– in particular the spread between the 2- and 10-year (2-10 Yield Curve). As of November 14, the spread is 0.70% and it has been trending lower since ending 2016 at 1.29%. That is disconcerting, because a flattening yield curve is viewed as a warning sign for weakening economic growth prospects. However, the yield curve historically has not flashed recession warning signs until it inverts, which it has done heading into the last five recessions. Additionally, the last three recessions officially began an average of 17 months after the 2-10 Treasury Yield curve inverted. Today, we do not have an inverted yield curve. Recession warning signs are also not flashing in other areas of the bond market including high yield bond spreads, which historically increase heading into recessions. The high yield spread (the difference between the yield on below-investment grade bonds relative to similar U.S. Treasuries) is currently near its lowest level in over a decade.

While there is no way to predict recessions with 100% accuracy, we believe that the economic landscape today does not resemble periods immediately preceding previous recessions. Recession probability is low based on current economic activity, barring an unforeseen shock to the economic system. The Federal Reserve is currently in an interest rate tightening cycle, and the pace of rate increases could accelerate next year if inflationary pressures and economic activity pick up. On the other hand, interest rates are still extremely low by historical standards and Congress could pass a tax reform package by early next year that may offset any potential negative impact from rising interest rates in the near-term.

It is easy to get comfortable when an economic expansion is extended. Economic indicators are not signaling a recession in the near term, however, economic activity, at current levels, is typical of what we have seen in more mature phases of past economic cycles. In light of our view on the economy, we continue to recommend exposure to equities and other risk assets, within the framework of long-term risk objectives. We favor a globally diversified allocation to equities, with a moderate overweight to U.S. stocks. An allocation to non-correlated investments, including alternatives, is also appropriate. Within fixed income, we continue to recommend limiting duration risk and remain constructive on exposure to credit risk.

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