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The Long Expansion (Yet all good things must come to an end!)

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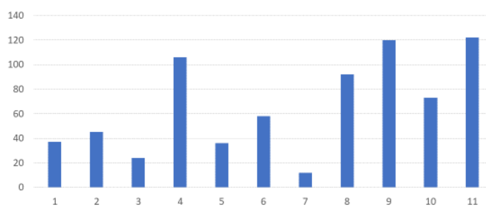
The longest not best expansion

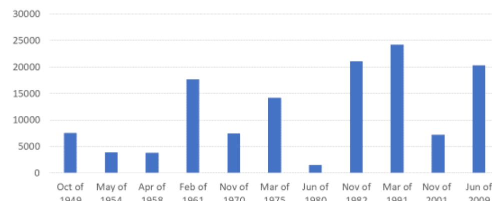
Just like all homo sapiens, business cycles are mostly similar, they start with a roar from an extremely low trough and end with a gasp after climbing quite high, but they all have small differences that usually highlight their indelible distinctions. The latest business cycle expansion is not critically different from its predecessors, but it does contain certain unique characteristics.



Perhaps most noteworthy is its length: it is the long expansion thus far. It has lasted 122 months and it is still adding length although it appears to be breathing very hard. Maybe its length is partly attributable to its relatively shallow labored beginning. Instead of sprinting forward like most past expansions have, it progressed ahead at a very measured pace perhaps anticipating its eventual longevity.

Many new jobs, but not many looking

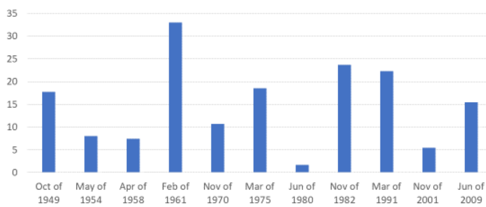
This expansion has produced over 20 million new jobs and has driven the unemployment rate down to its lowest level since the late 1960's. However, the present expansion's record with respect to its benevolent influence on the labor market is more mixed than these headline numbers infer.



As seen in the above chart, two past expansions that were shorter in length created more jobs. Moreover, this long

expansion fell short when comparing the amount of job creation relative to the level of employment at the trough of the past cycle, as seen in the next chart. Five past expansions produced relatively more jobs compared to the previous trough in employment.

Percent of new jobs created relative to existing labor force



Perhaps the biggest shortfall of this expansion's contribution to the labor market is in the number of people who have exited the labor market. The next chart highlights the dramatic decline in the unemployment rate while revealing that a tremendous number of previous job searchers have left the labor market.

The participation rate currently is hovering around 63.6 %, approximately 4 percentage points below its peak in 1999. Many demographic factors contribute to the ebb and flow of the participation rate in addition to the cyclical influences. The aging of the baby boom generation, perhaps is the largest demographic factor explaining the decline in the participation rate. This largest population cohort is now maturing into retirement. The decline in the participation rate appeared to level off in the late stages of the previous expansion and now is stabilizing again in this one before the next recession pushes it lower.

Employment rate versus participation rate

In spite of the solid advance in GDP over this extended expansion, labor productivity has not improved as rapidly as it had in previous expansions. Output per employee did expand over the past 10 years, but its average annual growth rate has been 0.79% compared with 2.1% in the previous expansion.

Real national product per employee has not grown as rapidly as in past expansions.

What happened to inflation?

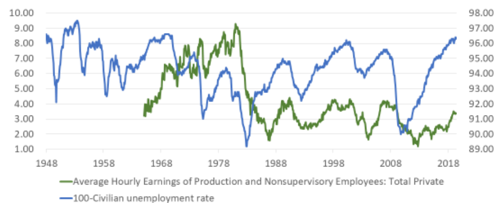
Theory indicates that inflation is expected to accelerate when the means of production become scarce toward the latter phase of business expansions. Inflation typically declines at the beginning of expansions as the means of production are plentiful and then it increases when they are utilized. In this expansion, inflation initially followed

tradition and then went astray when inflation began to decelerate over the past several months.

Inflation falls at start and rises toward the end of expansions

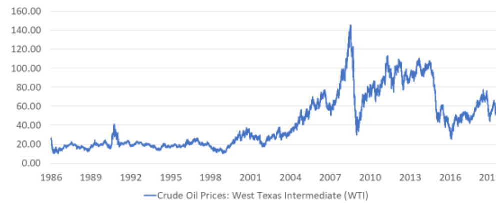
Surely, the 50-year low in the unemployment rate is signaling a growing scarcity of labor, however, there hasn't been an accompanying acceleration in labor costs. Historically, this has been a critical factor in the rise of past inflations. The following chart reveals the very high contemporary correlation between labor cost changes and the inverse of the unemployment rate. This correlation has manifested again in this expansion however, it has been relatively muted thus far.

The high correlation between labor cost and the inverse Unemployment rate



Moreover, commodity prices have been quite well behaved, especially crude oil. Prices of crude oil rose in the first years of this cycle, and then fell in subsequent years. Uncharacteristically, crude oil prices are now at similar levels to what they were at the beginning of this expansion.

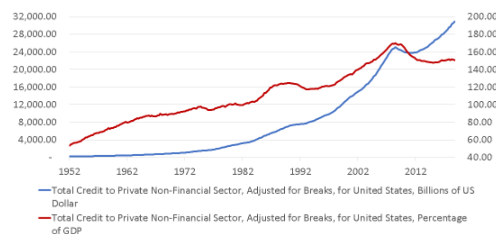
Oil prices are at the same level as at the start of this expansion



Credit is cheap and not maximized

Borrowing costs for all maturities and quality ratings of credit instruments are dirt cheap. Interest rates for corporations and households have remained uncommonly low because the Fed has kept their official rate uncommonly low throughout this expansion, and because inflation has been so subdued. Thus, benign rates of inflation have contained inflation expectations to atypically low levels.

Private credit has remained constant relative to GDP in this expansion



Consequently, private credit of all types has mounted to a new, staggeringly high level of US$31 trillion. However, unlike in the past expansion the amount of debt borrowed relative to GDP did not increase. Instead, it remained at a relatively high ratio of 151%.

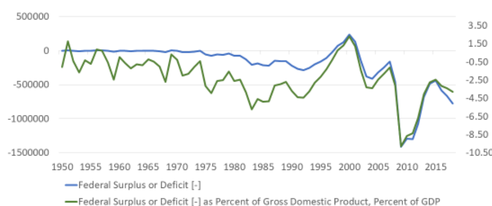
This ratio is slightly below the threateningly high level of 179% reached during the previous recession. Nevertheless, the level of private debt relative to GDP is significantly greater than at any other time in the past 70 years. Most corporate business institutions and households chose to take advantage of cheap financing costs to refinance their outstanding debt, rather than stretch their leverage.

Public debt has grown

Federal budgets usually follow a cyclical path with about a one to two-year lag to the business cycle. In past expansions budget deficits have gradually shrunk because improving economic fundamentals replaced the need for public financial support and the traditional cyclical growth in income greatly expanded tax revenue. As a result, the level of outstanding public debt relative to GDP usually dwindled and in one expansion (1990) actually turned positive.

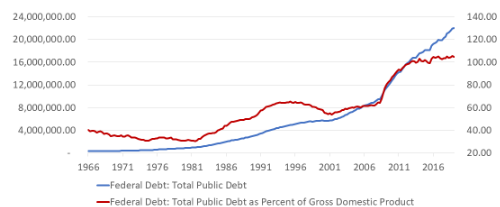
In contrast, in the present expansion the Federal deficit has not declined.

Federal deficits improve as expansion matures, not this one



Conservative strategies with regard to public debt have disappeared. As a result, the outstanding level of US public debt has climbed to more than US$22 trillion dollars. Consequently, outstanding public debt has swelled to 105% of GDP, a level which would violently violate European Union debt management criteria. Financial market participants are well aware of this breach of financial prudence and thus they have charged the US government 200 basis points, or more above the rates they have demanded from conservative EU member's debt.

Public debt is exploding and is now over 100% of GDP



The Fed has been boxed in

Decelerating inflation at the final moments of a business expansion and a historically low level of official interest rates places the Federal Reserve in a quandary. The monetary authorities in the US have little fire power to sustain continued economic growth and maybe miniscule force over flaccid inflation.

In the past three expansions the Fed lowered rates before the expansion peak

In the past, the Fed usually waited until after they had hard evidence of a recession before lowering their official rate. However, in the past three expansions, the Fed began lowering interest rates from a couple of months to an entire year before the peak. In each cycle their efforts appeared to be too little and too late to forestall the impending recession. However, in each of those episodes, the Fed had raised interest rates significantly more and to vastly higher levels than they have in this expansion.

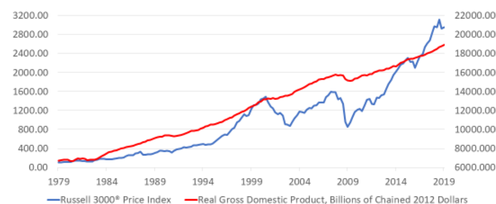
Judging from the forward guidance proclaimed by the current Federal Reserve Chairman Jerome Powell the Fed is locked into a rate reduction at their next FOMC meeting. Nevertheless, financial market participants have reacted more enthusiastically by betting in the futures markets that the Fed will lower its official rate several more times this year and next. This expectation is providing most of the forward thrust behind the present rally in the equity markets.

S&P 500 index climbs to new high in 2019

The stock market is driven by interest rates

A final feature of this expansion is the prolonged rally in stock markets. Stock market indexes such as the S&P 500 have more than doubled their previous peak achieved months before the end of the past expansion. While this has been a financially rewarding experience, broad stock price indexes such as the Russel 3000 index have soared well above the growth in the US economy. The lack of competitive returns from fixed income and phenomenally easy monetary policy have carried stock prices dangerously above their normal relationship to the economy. Unfortunately, this remarkable appreciation of equity investment over the current expansion has accelerated the staggering hiatus in wealth inequality in the US.

The Russel 300 stock price index has surged ahead of GDP



Conclusion: The signs are there, the end is near

It has been a very long business cycle expansion prolonged by relatively easy monetary policy and a late cycle burst of fiscal stimulus. There have been many notable abnormal developments during this long expansion that have also helped lengthen it such as: the mild level of inflation, significantly low interest rates that reduced borrowing costs for businesses and households, the plunge in the unemployment rate, a late cycle tax reduction, and until very recently the deeper penetration of the internationalization of supply chains and business connectivity. Presently, however, domestic and international economic evidence is building to an inevitable conclusion that the end of the long expansion is drawing near.

Once is not enough

Financial markets are riding high on the promise of easier monetary policy. To their peril they are ignoring the inescapable evidence that the present expansion is losing steam. Moreover, business cycle history has revealed that even when the Fed does lower interest rates before the expansion ended, it was not sufficient to prolong the expansion. This time will be no different even if the Fed lowers the funds rate down to zero. If lower interest rates are not sufficient to avoid a recession, then, as the Modern Monetary Theory advocates advise, fiscal policy will be required to avoid recession.

The contemporaneous political cycle

The end of the present expansion is looming closer and this time it is likely to be worldwide rather than US oriented. This apparent near-term peaking of the current business expansion is coinciding with the US presidential election cycle, and this coincident cycle could seriously impact the timing and severity of the next recession.

The incumbent President realizes his chances of re-election rise and fall with the state of the economy. Consequently, he will cajole the Fed into lowering interest rates, and promote additional spending legislation that would stimulate more jobs and income growth to sustain the flagging expansion. Of course, his Democratic opponents know this as well, and may choose to block new spending legislation in order to minimize the President's prospects of being re-elected. This fascinating interplay between politics and economics will dominate the next twelve months' headlines, however, whichever choice the politicos in Washington make, will not likely lead to a happy ending.

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	KEY INDICATORS TABLE (AS OF 28 JUNE 2019)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2941.76	7.05%	7.05%	10.41%	10.41%	3MO LIBOR	2.32	-0.68
FTSE	7425.63	3.95%	4.50%	1.51%	-2.33%	10YR UST	2.01	-29.89
NIKKEI	21275.92	3.41%	4.02%	-2.54%	0.08%	10YR BUND	-0.33	-208.47
HANG SENG	28542.62	6.69%	7.10%	2.53%	2.99%	10YR SPG	0.39	-70.11
STI	3321.61	6.54%	8.25%	5.76%	6.48%	10YR SGS	2.00	-21.09
EUR	1.14	1.83%		-2.66%		US ISM	51.70	-13.17
YEN	107.85	-0.41%		-2.63%		EU PMI	47.60	-13.11
CMCI	1217.02	2.70%		-5.52%		JP TANKAN	10.00	-25.00
Oil	58.47	9.29%		-21.15%		CHINA IP	6.30	-16.67

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency

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