Bull Market Monitor

This is not your parent's economic cycle

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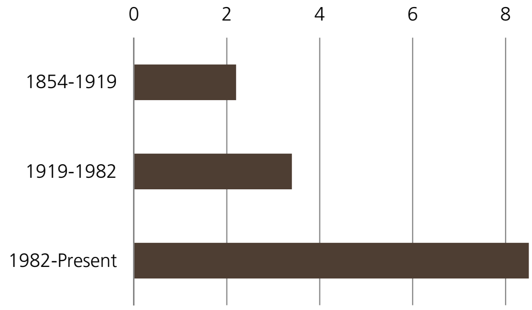
Jason Draho, Head Asset Allocation Americas, jason.draho@ubs.com

- US economic cycles have gotten considerably longer over the past four decades compared to the prior 130 years. This cycle elongation suggests that the current expansion, now at a record-setting 10 years, may not be that old.
- Expansions have lasted longer since the 1970s because of increased policy flexibility, a shift towards a more services-based economy, globalization, positive demographics, disinflation, and reduced oil dependency.
- Cycles getting ever longer may not continue and could even reverse because policy is becoming less effective, debt levels are near record highs, the economy is more prone to financial crises, and the globalization and demographic tailwinds have likely ended.
- The economic and social benefits of avoiding recessions are obvious, but there are negative consequences too, including encouraging the build-up of debt and diminished economic vitality as the economy by impairing the creative destructive process.
- The current cycle may last longer than many expect because of these secular trends. But the economy has also changed such that pockets could experience contractions without causing a full recession. Instead, the outcome might be periodic "growth scares" during a very long expansion.

The US economy set a record this July for the longest expansion in US history, 10 years and counting. This durability naturally raises concern that such an old expansion can't last much longer. Our assessment of current economic conditions suggests that the economy is slowing, but towards a soft landing that could persist for an extended period.

The fear of cycle old age may be unwarranted for another reason, which is that US expansions have been getting longer. The average duration of the last four expansions, including the current one, is 8.5 years versus 2.8 for all previous cycles dating back to 1854 (Fig. 1). Moreover, the last four are in the top six in terms of longevity. Consequently, from November 1982 until July the economy was in recession less than 8% of the time, compared to 35% from 1854 to 1982 (Fig. 2). Thus, an expansion that looks old compared to 170 years of economic cycles is suddenly spry in light of the secular trend of increasing cycle longevity.

Fig. 1: US economic cycles are getting longer
Average expansion length in years, 1854 - present



Source: NBER, UBS, as of 18 July 2019

Why has the cycle gotten longer?

A number of factors have likely contributed to this trend, which could continue, though some of these factors could shift from tailwinds to headwinds. It's easy to think that longer cycles are a positive—longer expansions should be an unqualified positive given the harm recessions impose on individuals and society. But there are negative consequences to having longer expansions that can periodically overwhelm the benefits, and those costs are becoming more apparent.

Below we consider specific factors that have contributed to longer US expansions starting in the 1970s:

Policy flexibility: After going off the gold standard in 1971, US policy-makers and the Federal Reserve gained flexibility to respond to deteriorating economic conditions. Previously the dollar had a fixed conversion rate into gold. If government deficits were large or monetary policy was loose, higher inflation was a risk. That would devalue the dollar, which risked the outflow of gold from the country, thereby jeopardizing the currency management system. Unleashing this policy constraint enabled the government to run larger deficits to combat slowdowns and for the Fed to aggressively cut rates, which has been most evident post-Global Financial Crisis.

Changing economy: The composition of the economy has continually evolved to being more information and services-based and less reliant on manufacturing and goods production. This has smoothed the business cycle because swings in the capex investment cycle have a smaller impact on the overall economy. In addition, inventory cycles have become less volatile because of better supply management, dimming the amplitude of the overall cycle. By their nature, services are provided on demand and there are fewer unused services that have to be worked down when the economy slows, again dampening cycle volatility.

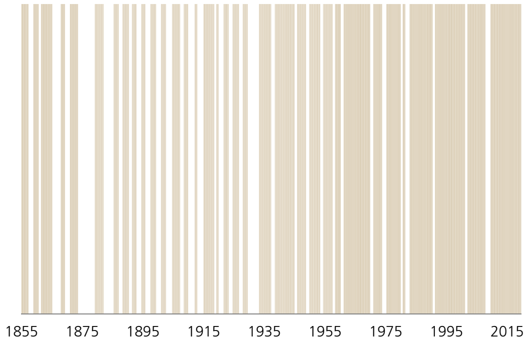
Globalization: The increasing flow of goods, capital, and labor across borders over the past three decades has lowered the production cost of goods by relying on cheaper labor and more efficient economies of scale. The effect has been a disinflationary supply shock on the cost of core goods, which has allowed the economy to expand longer without overheating. That in turn has enabled the Fed to wait longer before tightening policy that would slow the economy.

Demographics: Starting in the 1970s two positive labor supply shocks have enabled longer expansions without generating significant inflation or being constrained by a worker shortage. The first was the wave of baby boomers entering the US labor market in the 1970s coupled with the surge in female participation in the labor force. The second shock began in the 1990s when China started to become integrated into global supply chains, which accelerated after it entered the World Trade Organization in 2001.

Disinflation: Inflation has been structurally declining since the early 1980s for a variety of reasons, including globalization and demographics. By the late 1990s inflation had fallen to low single digits, and since then long-term inflation expectations have been anchored in the 2-3% range. The decline in actual inflation and the anchoring of inflation expectations has made it possible for the Fed to maintain accommodative monetary policy in tight labor markets, and now

Fig. 2: Expansions are getting longer, recessions shorter

Shaded areas are expansions, from 1854 - present



Source: NBER, UBS, as of 18 July 2019

may even ease in such a situation. This has allowed for longer expansions.

Oil dependency: Oil price shocks in the 1970s were catalysts for recessions, but since that time oil's impact on the cycle has diminished. Oil's share of consumer spending has steadily declined, so a jump in oil prices has a smaller impact on the rest of consumer spending. Related, the economy's energy intensity—the amount of energy required to produce a unit of GDP growth—has also declined. Offsetting this to some extent is the growth of domestic shale oil production. While it has made the US less susceptible to external supply shocks, investment in the energy sector has grown as a share of total investment. Consequently, falling oil prices tend to curtail US investment, as it did in 2015 and 2016, which offsets some of the consumer benefits.

Will cycles stay long / keep getting longer?

In 2004, former Fed Chair Ben Bernanke gave a speech in which he tried to explain why the US economy had experienced the Great Moderation that began in the 1980s. The term was used to describe the decrease in macroeconomic volatility, to the point that some economists conjectured that the business cycle had been tamed. The Great Recession of 2008/09 showed that was a tad premature. Yet a 10-year expansion that could easily continue for a few more years means there is merit to the argument.

While the growing importance of services and information technology to the real economy should make it more stable, there are also valid reasons why a continual elongation of the cycle is not only unlikely, but could easily be reversed:

Diminished policy effectiveness: Barring the introduction of negative interest rates, the Fed is limited to 240bps of rate cuts, much less than the over 500bps in cuts it did in each of the past four recessions. The effectiveness of quantitative easing (QE) and other policy measure is also likely diminished, and monetary policy in other major economies is effectively exhausted. That puts the onus on fiscal policy as the primary tool to combat future recessions. While it can still provide stimulus, with the current Federal budget deficit already over 5% and a total federal debt-to-GDP ratio of 105% the scope for sustained fiscal expansion is limited.

High debt levels: A limit on policy effectiveness is the increase in total debt-to-GDP of the economy, which includes debt of households, businesses, and governments. The ratio was about 150% in 1980, but is now around 350%. This is partly a by-product of policy flexibility, as governments have run bigger deficits and lower interest rates have encouraged private sector borrowing. But as debt has grown, the incremental GDP growth from a 1% increase in debt has declined. This will impair policy-makers ability to combat future growth slowdowns.

Financialization of the economy: The growth in debt and the rise in asset valuations over the past 40 years have made the economy much more sensitive to financial conditions. While the real part of the economy has become more stable, the financial economy has gone in the opposite direction. Some type of financial market excess was central to the last three recessions (the housing debt crisis in 2008, the dotcom bubble bursting in 2001, and the savings & loans crisis in 1990). This financialization of the economy makes it vulnerable to shocks and it constrains the Fed because of the risks tighter policy pose to asset valuations.

Ending of globalization and demographic tailwinds: Even before the current US-China trade tensions arose in 2018 the incremental benefits of globalization were already declining. The supply of low cost labor was falling and global supply chains had been fully deployed. If trade disputes get worse, then the benefits that globalization had on extending the cycle could reverse. Similarly, labor force growth will slow due to aging populations, and that could ultimately be inflationary.

Longer cycles can have negative consequences

The economic, social, and psychological costs recessions impose on a country can be enormous. But the cost of trying to delay or minimize a recession can also be substantial in ways that are not always readily apparent. For instance, loose monetary policy and ample fiscal stimulus sustained prior expansions, but at the cost of higher structural budget deficits and private sector debt as cheap money encouraged profligate behavior. This in turn hampers the economy's ability to grow faster. Another negative by-product is the fact that financial market instability has increased because of the growth in debt and reliance on policies that fuel asset price inflation, making the economy more prone to crises.

Extended expansions can also be detrimental to the real economy over the long term. Avoiding recessions may have the unintended consequence of sapping economic dynamism by keeping alive inefficient businesses and thereby diminishing the economy's "creative destructive" process. Regular recessions are a natural cleansing mechanism for these inefficiencies. Evidence that the US economy has become less dynamic over the past 25 years include a declining rate of new firms being started and increasing industry concentration.

Similarly, the increasing role of services in the economy may have dampened cyclical volatility, but services have lower productivity growth than the manufacturing sector. While technology and capital investment has allowed workers to produce far more goods per hour compared to 40 years ago, it still takes about the same amount of time for a haircut. This shift towards services is likely one reason why productivity growth and the economy's potential growth rate have fallen. Policy stimulus may have kept the cycle going over the past 40 years, but it hasn't changed the economy's potential growth rate.

What does this mean for the current cycle?

In terms of the current cycle, the secular trend of longer expansions suggests that this one has longer to run than many have assumed. But a consequence of changes to the economy that have extended the cycle is that typical indicators to gauge the expansion's potential duration may be less useful. An indicator level that may have been a clear warning sign in prior expansions could be more benign in the current cycle. So while there's reason to think the current expansion can have an extended soft landing, assessing that probability hasn't gotten any easier.

One reason for this is that the economy may have changed such that below the surface certain pockets can effectively experience a recession while the economy as a whole continues to expand. This was the case in 2015/16 when falling oil prices led to a significant contraction in energy sector investment and industrial production for the entire economy. Yet the economy still grew despite this industrial recession because the labor market and consumer spending were solid. As information and services-based activity increase their share of the economy, the likelihood that the more cyclical segments of the economy—capital goods orders, inventories, housing—trigger a full blown recession gradually declines.

The result could be an expansion that has a very long life, but periodically experiences "growth scares" as pockets of the economy contract. These scares are not enough to cause a full recession, but they do raise the risk on one happening. That's especially true with the economy only growing around the long-run potential rate of 1.5-2%. There's not much cushion against a negative shock tipping the economy into recession, even if only briefly and it's mild. Thus, these growth scares could happen regularly, which may be the price we have to pay for the cycle to live on a lot longer.

Appendix

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