

When Will the Expansion End?

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The United States is now in its ninth year of economic expansion and third longest since the Civil War. If the expansion lasts another year, it will be the longest on record. With the 2008-09 recession a distant but still painful memory, investors are rightly wondering when it will all end.

In a sign of confidence in the outlook, the Federal Open Market Committee (FOMC) last week agreed to raise rates for the fourth time since December 2015. Although interest rates remain low by historical standards, the Fed's efforts to restrain inflation by raising the cost of borrowing are often what presage the next downturn. So is it time to batten down the hatches in advance of a recession?

Economic cycles are notoriously difficult to predict. The old Wall Street adage that the stock market has predicted nine of the last four recessions is symbolic of the futility of this effort. Nonetheless, there are a number of economic indicators that have historically provided a warning sign of economic troubles ahead. No single one has been perfect, but taken together they can provide a measure of an early warning system for investors.

One important indicator is the message from the markets themselves. Equities remain near all-time highs and complacency near record lows, so there is no apparent sign of anxiety from stock investors. But long-term bond yields in the US have been trending down, and the yield curve (the difference between 2-year and 10-year Treasury bond yields) has been flattening. While still well in positive territory, an "inverted" yield (2-year yields above 10-year) sends a strong message that bond investors are anticipating a recession. We are still far away from an inverted curve, but the trend is worth watching.

Other warning signals that typically preview a recession are: 1) a sharp rise in energy prices –currently going the other way; a decline below 50 in the Purchasing Managers Indices (PMIs) – both manufacturing and service remain well north of 50; and 3) a rapid tightening of financial conditions caused by the Fed's attempts to restrain inflation by hiking interest rates. Fortunately, the Fed has maintained its intention to pursue a gradual path of tightening, and other factors (such as the recent weakness in the US dollar) are helping to keep financial conditions "accommodative".

In our view, the US economy remains on the same modest upward trajectory that it has followed since the recovery began in 2009. The roughly 2% annual growth rate in GDP has been frustrating to many seeking faster growth and a meaningful bump in real wages, but it has constrained the kind of over-optimism that leads to excessive capacity and falling prices. At the same time, we are seeing a pickup in economic momentum from other parts of the world, particularly Europe. This provides support for the expansion here in the US, clearly in its later stages.

When will it all end? No one knows for sure, but most of the signposts we monitor are not indicating a cause for concern. While the business cycle has not been repealed, it appears that the current upswing may go on for a while longer.

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Bruce is a Managing Director and Director of Portfolio Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.

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