ECONOMIC OUTLOOK

REGIONS
October 2015

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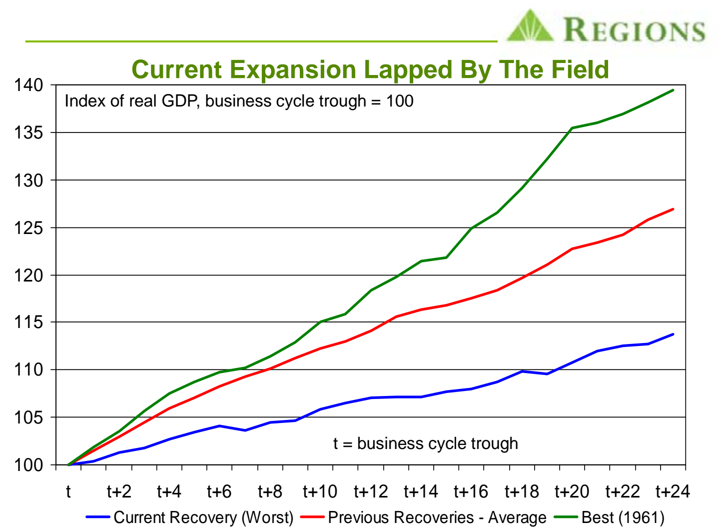
The Low Mileage Recovery Keeps Rolling Along . . .

The U.S. economy recently celebrated a milestone, though "celebrated" may be too strong of a word. With the end of the deep and painful 2007-09 recession coming in June 2009, per the Business Cycle Dating Committee of the National Bureau of Economic Research, the current recovery/expansion turned six years old as of this past June. While the BEA's late-September release of their third estimate of Q2 real GDP didn't exactly unleash our sentimental side (we do have one of those, at least we think), with the book now closed on Q2 2015 it did at least get us to thinking about where the current expansion stands relative to those that have gone before.

Actually, making this comparison doesn't require a lot of thought, as by now it is well documented how tepid the current expansion has been, in both an absolute and a relative sense. There has, for some time now, been a chorus of those eager to remind us, with varying motivations for doing so, how weak the current expansion has been. This chorus has only grown louder of late as, depressingly enough, the 2016 Presidential campaign kicked off way before, you know, 2016. This has offered a whole herd of candidates countless chances to remind us how bad things have been so they can then tell us how they'll make them better.

What is often missing from the narrative is an explanation as to why that is the case, at least one that is remotely plausible. This absence doesn't come as a great surprise, as in order to fill in the blanks one would not only have to dig through the data but also string together a coherent story and, really, it's so much easier to just scream about how bad it is and who's to blame. But, as digging through the data is what we do, we thought it would be interesting to try and at least shed some light on the "why" to go along with the "what." After all, as we often point out, knowing where you are is one thing but knowing how you got where you are also matters (though, admittedly, navigating the economic data does not reinforce this point nearly as effectively as being totally lost while out on your bike).

In what follows, we present a series of comparisons between the current expansion and the 8 prior post-1950 expansions (leaving out the 12-month long "expansion" that began in July 1980) via a series of charts using the same format. On the horizontal axis, we measure time in terms of the number of quarters since the end of the prior recession, denoted as time "t" on the horizontal axis and go 24 quarters ("t+24") out as our basis of comparison. In each chart we show the average of the 8 prior expansions, the best performing expansion, the worst performing expansion, and the current expansion. Of course, in many of the metrics shown the current expansion is also the worst performing expansion, so that there are three, not four, lines on many of the charts is not an oversight on our part. Additionally, as previously noted not all prior expansions lasted six years as has the current expansion, so going 24 quarters out from the trough of one cycle can, in some cases, mean two cycles overlap. While our point is to compare the metrics at the six-year mark, there are instances where the overlaps skew the comparisons, which we note as we proceed.



As seen in the above chart, the current expansion has seen real GDP growth significantly lag the average seen at the 24-quarter point of prior expansions. As of Q2 2015, real GDP had grown by 13.7 percent since the Q2 2009 trough, compared to average growth of 26.9 percent across all other expansions from 1950 on, and well below the 39.4 percent growth seen in the expansion that began in Q1 1961. Ironically enough, the second poorest performing expansion in our sample is the one that followed the brief and shallow 2001 recession, a/k/a the expansion that sowed the seeds of the 2007-09 recession from which the economy has yet to fully recover. In the 24 quarters that ended with Q4 2007 real GDP grew by 18.0 percent, growth that was not only below average but which was also concentrated amongst relatively few sectors of the economy. In hindsight this seems an obviously bad omen, though one that, in all honesty, at the time we failed to fully recognize as such.

In any event, as to some of the factors behind the slow pace of the current expansion, the government sector has been a prime contributor or, if you prefer, culprit. Combined on the local, state, and federal levels, government spending on goods and services is considerably lower six years into the expansion than it was at the end of the recession in June 2009, easily making the current expansion the worst on record. This is illustrated in the following chart, which shows that, as of Q2 2015, real government spending was 7.7 percent below where it was as of Q2 2009.

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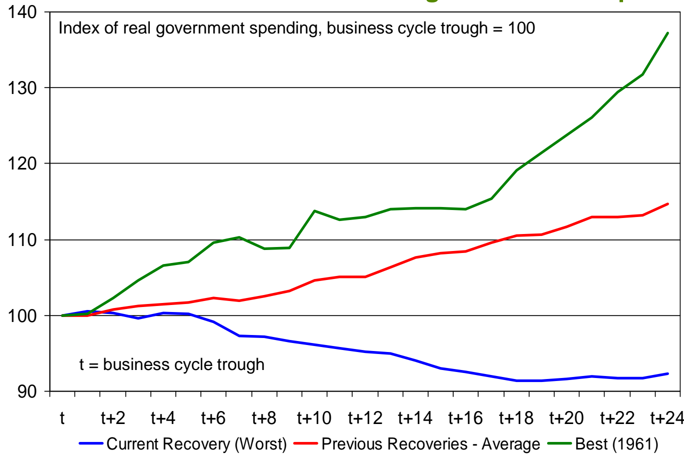
Government Sector Has Been A Drag On Current Expansion



To be perfectly clear, we use the terms "best" and "worst" simply in the context of the fastest and slowest cumulative growth over the six years following each cyclical trough, without imposing any kind of value judgment. Obviously there are some for whom the expansion that began in Q1 1961 is a nightmare, as this was the start of a decade that saw government funding, among other things, a space race, a war, and a wave of entitlement spending. By the same token, many would see the path of government spending in the current cycle as an assault on the government's ability to play its proper role in the economy. We are not about to wade into the middle of that debate, at least not here.

On the federal government level, six years into the current expansion real spending is 8.8 percent lower than at the end of the 2007-09 recession. That is not, however, the biggest decline on record. Six years into the expansion that began with Q1 1991 real spending had contracted by 14.5 percent, but this decline was concentrated in defense spending, i.e., the "peace dividend" that came about in the aftermath of the dissolution of the Soviet Union, while real nondefense spending rose through the decade. At the six-year mark of that expansion, real defense spending had fallen by 23.6 percent, compared to a 13.6 percent decline in the current cycle. The decline in both defense and nondefense spending in the current cycle largely reflects the sequestration cuts enacted by Congress in lieu of them actually doing their job.

It is, however, worth noting what sets the current cycle apart from others is that spending is lower at the six-year mark not only on the federal level but also on the state & local level (in the GDP data state and local government expenditures are reported on a combined basis). Adding to the drag from the federal government in the current expansion has been a contraction in real spending on the state and local levels – down 7.1 percent at the six-year mark. The current expansion is the only one of the nine post-1950 expansions in which real state and local government spending has fallen. This is largely a reflection of not only the severity of the 2007-09 recessions but also the lingering after effects in the labor market and the housing market.

For instance, over three quarters of local government tax revenues come in the form of property tax collections. With the severe decline in house prices associated with the 2007-09 recession and its aftermath, local government tax revenue collections were severely impaired. While house prices have been rising, in many locales they remain well below prior peaks and, moreover, there is typically a two year lag between changes in market values and changes in assessed values when it comes to real estate taxes. As such, local government tax revenue collections have yet to catch up with rising house prices, which continues to weigh on local government spending.

On the state level, personal income taxes and sales taxes are the dominant sources of government revenue. Given the magnitude of job losses during and after the 2007-09 recession, the still tame growth in labor earnings, and what over much of the current expansion had been a restrained pace of growth in consumer spending, state government revenue from income and sales taxes has risen at a slower rate than in past expansions. To be sure, the past few quarters have seen the rate of growth in state tax revenue collections pick up, but many state budgets are still impaired and, for those states facing pension shortfalls, growth in spending on goods and services will likely remain slower than was the case in past expansions. Thus, while real state and local government spending rose at an annualized rate of 4.3 percent in Q2 2015, we see this as a one-off occurrence and not the start of a sustained period of such rapid growth.

While the drag from the government sector has contributed to the muted pace of the current expansion, it is by no means the only cause. Our back of the envelope calculations show that, had growth in real government spending in the current expansion matched the average of the prior 8 expansions, cumulative real GDP growth at the six year mark would have been 18.5 percent, better than actual growth to date but still well below the average growth seen in prior expansions. Note, our figure leaves aside the questions of how this government spending would have been financed and also leaves aside any "multiplier" effects many claim are associated with each dollar of government spending (estimates we, for the most part, find highly dubious), but, the point remains the same – while the government sector has been a drag on real GDP growth in the current expansion, growth in private sector spending has also lagged behind historical norms.

This can be readily seen by looking at what we refer to as real private domestic demand, which is basically combined business and household spending. As it leaves out inventories, trade, and government, which are the prime sources of quarterly swings in top-line real GDP growth, we see private domestic demand as a useful indicator of the underlying health of the private sector of the economy. But, as seen in the chart at the top of the following page, growth in real private domestic demand in the current expansion is also badly lagging growth seen in past expansions.

As of Q2 2015 real private domestic demand had grown 17.5 percent since Q2 2009, well shy of the average growth of 28.4 percent during the other 8 post-1950 expansions. As if to show there was more to government spending behind the economic expansion of the 1960s, real private domestic demand grew by 37.2 percent in the first six years of the expansion that began in Q1 1961, the most of any of prior expansion, which is closely followed by the expansion that began in Q4 1982. It is worth noting that during the six years of expansion that began in Q4 2001 and came to a crashing halt in Q4 2007, real private

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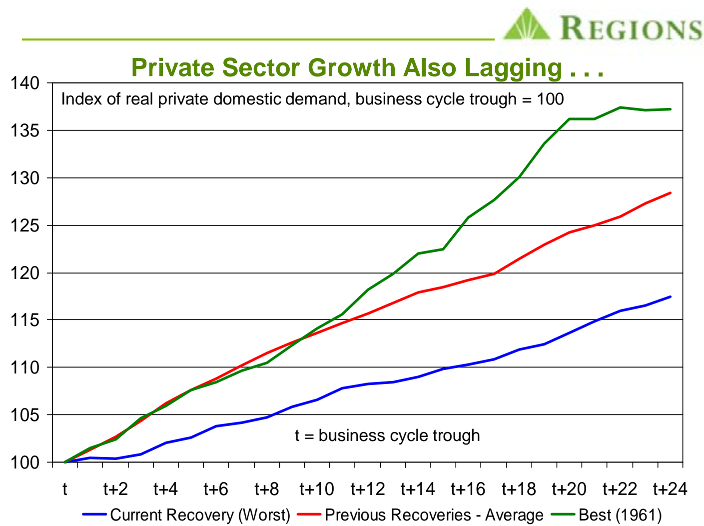
domestic demand grew by 18.1 percent, only barely edging out the current expansion.



In addition to being slow, growth in real private domestic demand over the course of the current expansion has been notably uneven. Indeed, one of the most frustrating aspects of this expansion is that there has basically been no time at which the various components of private domestic demand – consumer spending, business fixed investment, and residential investment – have been in synch. For instance, in the early phases of the expansion the manufacturing and energy sectors stood out. The latter, while relatively small, posted growth in capital spending and hiring that significantly outpaced other sectors of the economy. At the same time, however, consumer spending was posting only anemic growth and housing was still reeling from the excesses built up during the prior expansion. Fast forward to today, however, and these roles have been largely reversed, with growth in consumer spending picking up pace and the housing market steadily improving as the energy sector contracts and manufacturing, at least those non-auto manufacturing industries with export exposure, is fighting to stay upright. In the interim, various industry groups have seen time at the front of the pack but, again, we have yet to see the private sector firing on all cylinders.

Of the components of real private domestic demand it is consumer spending where the gap between growth in the current and prior expansions is the largest. In the six years ending with Q2 2015 real personal consumption expenditures (PCE) had grown by 13.9 percent, compared to average growth of 26.0 percent in the prior 8 expansions. The fastest growth – 34.5 percent – came in the expansion that began in Q1 1961, edging out the expansion that began in Q4 1982. It is interesting, however, that growth in real spending on consumer durable goods over the course of the current expansion (45.5 percent) is right in line with the average over the first six years of the prior 8 expansions. It didn't start out that way, but since 2013 growth in real spending on consumer durables, led by motor vehicles and home furnishings, began to accelerate, to the point the gap between the current and prior expansions has been closed down.

This is decidedly not the case, however, with regard to spending in the other two top-level components of real PCE –nondurable consumer goods and household services. Growth in real spending in these two categories, 11.9 percent and 10.2 percent, respectively, lags significantly behind the average of the prior 8 expansions. As with spending on consumer durables, the past six quarters have seen growth in spending in these two categories accelerate but, unlike growth in consumer durables, not nearly to the extent necessary to close the gap to past expansions.

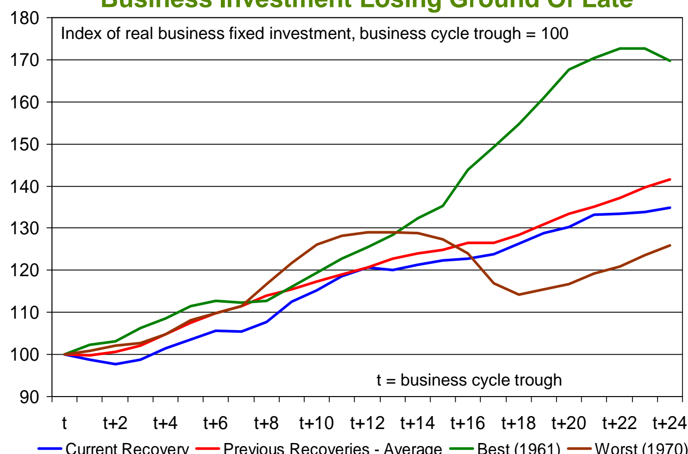
Though the degree to which growth in consumer spending has lagged past cycles may be surprising, the broad patterns should not really have caught anyone off guard. As with the housing market, this is an instance in which the excesses seen in the prior expansion have weighed on the current expansion. Growth in consumer spending during the 2001-07 expansion was, to a large degree, financed by the accumulation of debt in the household sector. This is a topic we began harping on in 2005, expressing alarm over the rising household debt-to-income ratio (which ultimately topped 130 percent in 2007), and a topic which we have discussed in detail in past editions of our monthly outlook.

In short, households rode expanded access to credit and the ability to borrow against rapidly rising asset values, particularly housing, as a means of financing consumption, while forsaking "traditional" saving. This led to faster growth in consumer spending than was dictated by the fundamentals, which meant it was not sustainable. Thus, in the wake of the 2007-09 recession households were, at least in the aggregate, significantly over-levered and bereft of savings. As a result, the early stages of the current expansion were marked by households deleveraging (which, at least early on, was more a matter of lenders writing off bad debts) and building up savings.

This was all happening under the shallow cover provided by sluggish growth in labor earnings, far and away the largest component of personal income, during a time in which consumer confidence was, not surprisingly, notably low. It was to have been expected that, in such an environment, growth in consumer spending would come at only a grudging pace. By the same token, however, it was to be expected that over time, as household balance sheets were in better repair and the rates of job and income growth improved, growth in consumer spending would pick up. Indeed, over the seven quarters ending with Q2 2015 real consumer spending had grown at an average annualized rate of 3.10 percent, compared to average annualized growth of 1.85 percent over the first 17 quarters of the expansion. Recent declines in retail gasoline prices as well as prices of many non-energy goods have given consumers the wherewithal to increase spending, increase saving, or pare down debt – if not some combination of all three – and when we get the first print on Q3 real GDP later this month we expect growth in consumer spending to be easily above 3.0 percent. While we do not expect this pace to be sustained over the longer-term, we do expect trend growth going forward to remain above the pace seen in the early stages of the current expansion.

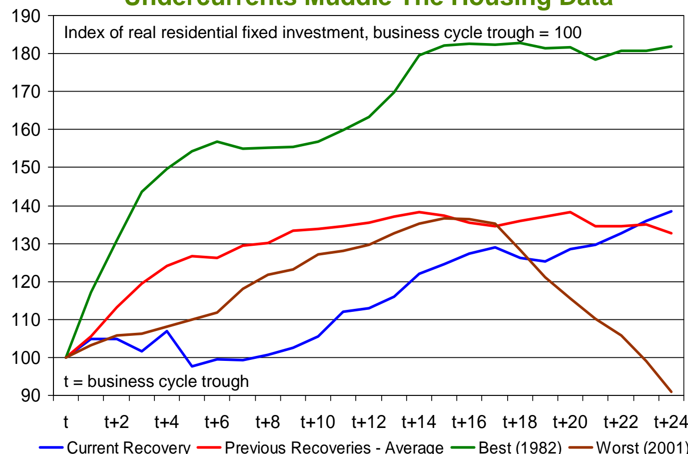
Growth in business fixed investment in the current expansion has come much closer to the average of prior expansions than has growth in consumer spending. Over the six years ending with Q2

2015 real business fixed investment had grown by 35.0 percent compared to average growth of 41.6 percent. That gap was even narrower as recently as mid-2014 before growth in business fixed investment slowed over recent quarters.



As with consumer spending, though, there is considerable variation across the individual components of business fixed investment as well as variation in growth over time. For instance, cumulative growth in real business investment in structures is lagging well behind the average of past expansions, but this is primarily a function of such spending having contracted over the first several quarters of the current expansion. Once again, payback for the excesses of the prior expansion. While these excesses have been largely worked off, growth in such spending remains fairly slow. As an interesting side note, the expansion that began in Q4 1982 is the poorest performer in terms of growth in real business spending on structures, with such spending modestly lower at the six-year mark than at the beginning of the expansion. This, however, is mainly a reflection of changes in the tax code that resulted in far less favorable treatment for commercial real estate than had been the case. This change in the tax code combined with a downturn in oil prices to cause a great deal of havoc in the Texas economy over the latter part of the 1980s.

Real business investment in equipment & machinery has grown by 65.5 percent over the past six years, ahead of the average growth of 52.7 percent in the prior 8 expansions. Over the last three quarters, however, business spending on equipment has slowed sharply, which in part reflects the severity of the decline in spending on mining & oil field machinery. In terms of absolute dollars this component is rather small, but such have been the rates of growth (earlier in the expansion) and contraction (more recently) that it is impacting the growth of the entire broad equipment & machinery category. Investment in computer equipment, industrial equipment, and transportation equipment are key drivers of overall business investment, but growth in each of these components has been highly uneven over the course of the current recovery. The final component of business fixed investment, intellectual property products, has performed worse in the current expansion than in any of the other post-1950 expansions, with growth of 27.7 percent barely half of the average growth seen in the prior 8 expansions. As with other types of private sector spending, however, growth in this category of spending has picked up over recent quarters. This is encouraging for longer-term growth, as investment in intellectual property products (a broad category but which includes corporate R&D spending) is key to growth in labor productivity over time.



On the basis of growth over the first six years of expansion, the current cycle is slightly above average when it comes to real residential fixed investment. At least on the surface, as shown in the above chart. But, when it comes to housing, wading through the data should be done only under the cover of a Hazmat suit, or at least the intellectual equivalent of such a suit. From the above chart, it may seem puzzling the current cycle looks to be an above-average performer, and it may seem even more puzzling that the expansion that began in Q4 2001 is shown to be the worst performer of any of the post-1950 expansions. This, of course, is puzzling only to the extent one remembers the housing "boom" without recalling the housing "bust," which started well ahead of the recession in the broader economy.

There are actually several points worth noting in the context of the above chart starting with the expansion that began in Q4 1982, which saw the fastest growth in real residential investment of any of the nine post-1950 expansions. The early stages of that expansion saw an explosion in multi-family construction, in large measure due to favorable tax treatment as noted earlier. But, when multi-family construction faltered after the changes in the tax code, single family construction ramped up. Additionally, the basis of comparison, i.e., the level of residential investment at the end of the 1981-82 recession, was so low due to the severity of the downturn that it made the growth rate seem better. So, again, the term "best" needs to be taken in context here.

That "base" effect also comes into play with the expansion that began in Q4 2001. If one recalls all the discussion about how overbuilt the housing market was in the years leading up to the 2007-09 recession or just looks back at some of the data on housing starts, it may seem surprising that growth in residential investment was simply average, relative to past cycles, at the

cyclical peak of housing market activity. This is in part a function of what had been a prolonged period of steady and rapid growth in residential fixed investment in the 1990s – an expansion which was well above average in terms of growth in residential investment. So the growth during the 2001 expansion added on to an already high base.

As for the current cycle, the base effect is also relevant as Q2 2009 saw one of the lowest levels of real single family residential investment on record. So, the growth seen over the past six years has come from a historically low base, which leaves the current level of single family investment low absolutely and when compared to historical norms. Additionally, the past three years have seen exceptionally rapid growth in multi-family construction – not strictly a function of a low base – which has supported growth in total residential fixed investment and helped push cumulative growth in total residential investment above the average of prior expansions at the six-year mark. It is also worth noting that, as in other categories of private sector spending, recent quarters have seen stepped-up growth in single family residential investment.

What Does It All Mean?

Okay, by now you're probably wishing we had simply opted for the "scream about how bad things are and who's to blame" option as opposed to this detailed tour through the GDP data. As we noted earlier, however, while the former approach may feel better and take less time, we think it helps to have some context. For instance, it's a fair question to ask what the real issue is here – is it the performance of the economy over the past six years or is it what, in many instances, were unrealistic expectations of what the economy's performance should be. We find ourselves somewhere in the middle here. From the very start of the recovery and even as recovery morphed into expansion we cautioned that the many deep structural wounds inflicted on the economy prior to and during the 2007-09 recession meant the healing process would be slow. And, to be sure, the enormity of the hole left for the economy to dig out of has made that slow pace all the more frustrating.

But, by the same token, we would have expected that by this point, six years in, the economy's trend rate of growth would be better than what it is. That it is not is a function of some highly questionable and notably shortsighted policy and regulatory decisions, a weak global growth environment, and a series of one-off occurrences that would have made less of a dent in a sturdier domestic growth environment.

So mild has been the current expansion that, six years in, cumulative real GDP growth has barely kept pace with the average recorded in the prior expansions at the three-year mark. Still, as it turns out, the tepid pace of growth seen by many as this expansion's greatest flaw may instead turn out to be its greatest virtue. After all, at six years and counting the current expansion is already older than the average post-WW II expansion. This leads many to worry that a recession must surely be at hand, even if on no other basis than "we're due."

But, as we often point out, expansions don't simply die of old age, instead succumbing to excesses that have accumulated over their life or to the policy moves aimed at curing these excesses. So, in that sense, the current expansion has become the proverbial used car – sure, it's old but has had only one owner for all these years and, and since it has only been driven to church on Sundays, comes with very low mileage so has plenty of miles left in it.

The one caveat we will make here is that, while we may be far from the point of needing to worry about economic imbalances that have developed over the course of the current expansion, it remains an open question as to whether or not there are financial imbalances. It is possible that several years of extraordinarily accommodative monetary policy, at home and abroad, have distorted credit flows and asset prices. While at present no such imbalances may be apparent, our worry is that just because they may not be readily apparent does not mean no such imbalances exist.

Aside from this point, it is worth noting that focusing on the shortcomings of the current expansion as a whole can lead one to lose sight of the improvement seen over the past several quarters. Sure, headline real GDP growth is all over the map and the average growth rate doesn't look all that different, but this is in no small measure due to the inherent volatility in components such as inventories, trade, and government spending. This is one reason we find it useful to focus on private domestic demand. For instance, we'll repeat some numbers we stated earlier – over the first 17 quarters of this expansion average annualized growth in real consumer spending was 1.85 percent per quarter, while over the past 7 quarters average growth has been 3.10 percent (an average that will be higher once the Q3 data are released).

Yet, it is striking to us how frequently we hear people bemoaning how terrible consumer spending is. As we've noted elsewhere, this is in part due to the monthly retail sales data being reported on a nominal basis, meaning falling goods prices are making consumer spending look weaker than it actually is. This is simply an illustration of why economic growth is measured on a real, i.e., inflation adjusted, basis. The broader point, however, is whether they are so focused on the underperformance relative to prior expansions, are simply permabears, or genuinely do not believe things have gotten any better, there is a large and vocal group of people either unwilling or unable to acknowledge the current expansion has broadened and picked up pace as the deep imbalances of the prior expansion have been worked off.

The same pattern is evident elsewhere in the economy – the housing market and the labor market come to mind as areas in which there has been a prolonged period of steady improvement that nonetheless seems to have satisfied nobody. Sure, there is plenty of room for further improvement, but should that really be the focus, or should the focus be on the improvement seen to date. Moreover, having already outlived many of its predecessors, the current expansion will likely ultimately take a place amongst the longest lasting expansions on record. There are of course downside risks, such as a weak global growth environment and the seemingly inexhaustible potential for self-inflicted policy errors, but the current expansion is far from over. Perhaps in time it will come to be not necessarily praised but at least better appreciated for its tenacity and less criticized for its seeming lack of vigor.

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Q1 '15 (a)	Q2 '15 (a)	Q3 '15 (f)	Q4 '15 (f)	Q1 '16 (f)	Q2 '16 (f)	Q3 '16 (f)	Q4 '16 (f)		2013 (a)	2014 (a)	2015 (f)	2016 (f)
0.6	3.9	1.8	2.5	2.4	2.5	2.6	2.4	Real GDP[1]	1.5	2.4	2.5	2.5
1.7	3.6	3.9	1.9	2.5	2.4	2.4	2.3	Real Personal Consumption[1]	1.7	2.7	3.2	2.6
								Business Fixed Investment:				
4.3	3.5	4.1	4.3	4.8	5.2	4.6	5.1	Equipment, Software, & IP[1]	3.5	5.6	4.3	4.6
-7.4	6.3	3.6	3.2	2.4	1.8	2.6	3.1	Structures[1]	1.6	8.1	0.4	2.9
10.1	9.4	12.1	6.2	8.5	8.4	13.1	12.3	Residential Fixed Investment[1]	9.5	1.8	9.1	9.4
-0.1	2.6	0.7	-0.5	-0.6	-0.3	-0.3	-0.4	Government Expenditures[1]	-2.9	-0.6	0.5	-0.1
-541.1	-534.6	-546.8	-544.4	-546.6	-543.8	-541.8	-544.8	Net Exports[2]	-417.5	-442.5	-541.7	-544.2
0.978	1.158	1.138	1.094	1.130	1.160	1.200	1.240	Housing Starts, millions of units[3]	0.928	1.001	1.092	1.182
16.7	17.1	17.8	17.2	17.0	16.8	16.8	16.7	Vehicle Sales, millions of units[3]	15.5	16.4	17.2	16.8
5.6	5.4	5.2	5.2	5.1	5.0	5.0	4.9	Unemployment Rate, %[4]	7.4	6.2	5.3	5.0
2.3	2.2	2.0	1.8	1.7	1.7	1.7	1.7	Non-Farm Employment[5]	1.7	1.9	2.1	1.7
1.0	1.0	1.0	1.5	1.9	1.8	1.7	1.6	GDP Price Index[5]	1.6	1.6	1.1	1.7
0.2	0.3	0.3	0.7	1.5	1.4	1.6	1.8	PCE Deflator[5]	1.4	1.4	0.4	1.6
-0.1	0.0	0.2	0.6	1.8	1.5	1.7	2.0	Consumer Price Index[5]	1.5	1.6	0.2	1.7
1.3	1.3	1.3	1.4	1.6	1.5	1.6	1.6	Core PCE Deflator[5]	1.5	1.5	1.3	1.6
1.7	1.8	2.0	2.0	2.0	1.7	1.7	1.8	Core Consumer Price Index[5]	1.8	1.7	1.8	1.8
0.13	0.13	0.13	0.13	0.30	0.42	0.65	0.88	Fed Funds Target Rate, %[4]	0.13	0.13	0.13	0.56
1.97	2.17	2.22	2.09	2.33	2.42	2.59	2.59	10-Year Treasury Note Yield, %[4]	2.35	2.54	2.11	2.48
3.73	3.83	3.95	3.83	3.93	4.03	4.15	4.20	30-Year Fixed Mortgage, %[4]	3.98	4.17	3.83	4.08
-2.5	-2.2	-2.3	-2.4	-2.4	-2.4	-2.5	-2.5	Current Account, % of GDP	-2.4	-2.3	-2.3	-2.4

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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