From Business Cycle to Stretched-Out Expansion

David Kelly

Chief Global Strategist at J.P. Morgan Asset Management

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Financial reporters and market strategists often argue about whether we are “early-cycle”, “mid-cycle” or “late-cycle”. However, these perspectives are based on an outdated model of how the U.S. economy behaves. In a pure “business-cycle” paradigm, the U.S. economy would, today, be in the late innings of an economic expansion that must naturally end rather soon. However, a more realistic model of today’s economy suggests that this expansion could continue for some time more and that, when it ends, it will be because of some financial, environmental or geopolitical shock rather than the inevitable result of the age and stage of the expansion. This doesn’t negate the need for diversification. However, it does suggest that a portfolio should be stress-tested mostly against how it would react to a downturn triggered by non-economic shocks.

The Traditional Business Cycle

The traditional business cycle can be described as a one-act play with four scenes. In the opening scene, set, say, sometime in the 1950s, the economy is growing at a steady pace due to natural increases in population and productivity. In the second scene, the pace quickens. Based on a foundation of steadily growing income, families buy new homes and cars, banks extend new loans, industrialists build new factories, stocks surge and shop windows are festooned with help-wanted signs, as shopkeepers mark up prices.

In the third scene, central bankers become alarmed about inflation and try to cool things down by raising interest rates. At first, everyone ignores the threat and the party continues. Then loan defaults rise, some banks fail, credit tightens and spending slows. Consumers get more worried and decide to postpone buying new homes and cars and furniture and appliances. Unsold inventory piles up and factories shut down production. The help-wanted signs disappear as shopfronts are shuttered and unemployment soars.

Finally, in the grey misery of recession, central bankers cut rates and some consumers begin to buy again. The industrialists who had shut down production to clear inventory have to restart the factories just to stop inventories from falling away to nothing. The stores slowly reopen, new enterprises emerge, unemployment begins to decline and the economy beings to recover.

The Modern Stretched Out Expansion

This traditional business cycle model served as a pretty good description of the bumpy path followed by the U.S. economy up until the 1980s. According to the National Bureau of Economic Research, between the late 1850s and the early 1980s, the U.S. economy experienced no fewer than 30 separate recessions, lasting an average of 18 months, with expansions between the recessions averaging just 33 months.

However, by the 1980s, the economy's vulnerability to the traditional business cycle was waning. The U.S. economy had generally become less prone to inflation due to diminished union power, greater use of information technology in transactions and increased inequality that diverted demand from goods and services to financial assets.

The economy had also become less vulnerable to recession. FDIC insurance, introduced in the 1930s, sharply reduced bank failures. Better information on inventories tamed the inventory cycle. Rising international trade acted as an offset to slowing domestic demand, and the growth of the service sector, relative to the more cyclical manufacturing and construction sectors, made the economy more stable and, importantly, less sensitive to interest rates.

Given these structural changes in the economy, rising consumer demand is now less prone to cause runaway inflation and Fed tightening is less likely to trigger deep recession.

As a consequence, since the early 1980s, we have seen just four recessions, lasting an average of 9 months, divided by long stretches of expansion that have lasted an average of 104 months each, not counting the current expansion that is now in its 47th month.

The Economic Outlook in a Stretched-Out Expansion

Any economic forecast in early 2024 should start by recognizing this new framework. The economy is still moving forward in the shadow of the pandemic recession and the inflation sparked by the pandemic, the policy response and Ukraine. However, in the aftermath of this disruption, seemingly aggressive Fed tightening has not been enough to sink economic growth while inflation has eased even without the weakness the Fed was trying to induce.

In this new framework, the economy could still be derailed by a shock but is much less vulnerable to demand-driven overheating or a recession induced by policy tightening. Consequently, a baseline economic forecast should be relatively benign for investors. In particular:

On Growth: The latest data suggest real GDP growth of between 1% and 2% annualized for the first quarter of 2024 and roughly 2% year-over-year for 2024 and 2025. Consumer spending should grow at a solid pace of close to 2%, buoyed by gains in real wages and surprisingly strong payroll job gains. Home-building is unlikely to boom but is currently at a sufficiently depressed level to make recovery more likely than a renewed slide in activity.

Business fixed investment will continue to be aided by federal government incentives, despite the impact of higher interest rates, while inventory growth is close to a long-run equilibrium pace. Trade may be a slight drag on growth, given a high dollar. However, recent strong hiring by states and municipalities and increased spending on public infrastructure suggest that government spending will contribute to growth going forward.

On Jobs: The February employment report, released last Friday, was weaker than the headline 275,000 gain in payroll jobs would suggest. Notably, the report contained hefty downward revisions to super-strong job gains in the prior two months and showed an increase in the unemployment rate from 3.7% to 3.9%. That being said, still very elevated job openings and strong current and lagged GDP growth suggest solid payroll gains of roughly 150,000 to 200,000 throughout the next year. Given very weak growth in the native working-age population, this would seem to imply a steady decline in the unemployment rate. However, the current influx of asylum seekers is providing a fresh source of workers which could keep the unemployment rate within the narrow 3.4%-4.0% corridor that it has occupied over the past 27 months.

On Inflation: Despite a tight labor market, year-over-year wage inflation eased in February with average hourly earnings rising 4.3% year-over-year, down from a peak of 5.9% in March 2022 although essentially unchanged from October 2023. Some further wage growth moderation is possible over the next few months. The quits rate has fallen to pre-pandemic levels and the monthly jobs survey from the National Federation of Independent Business showed declines in plans to raise wages to their lowest level since March 2021. That being said, we expect wage growth to stick at close to 4% year-over-year given the continued tightness of the labor market. However, relatively strong wage growth should not prevent inflation from falling. While global energy prices have risen slightly in recent months, food commodity prices are continuing to fall and a slow global economy is unlikely to generate a surge in commodity prices generally. In addition, despite problems with Red Sea traffic, global purchasing manager surveys suggest that supply chains are not generally a problem. On top of this, we expect to see substantial declines in the government's measures of housing and auto insurance inflation in the year ahead, allowing inflation to drift down to close to 2% over the course of 2024 as measured by both consumer prices indices and consumption deflators.

On Profits: After a flat 2023, analysts are continuing to forecast robust double-digit profit gains for 2024 and 2025. This seems very unlikely, given a steady decline in nominal GDP growth to below 5% and continued margin pressure from tight labor markets. However, we expect that earnings will continue to edge higher from already very high levels until the economy experiences recession.

On the Fed: In his Congressional testimony last week, Fed Chairman, Jay Powell reiterated that the federal funds rate is likely at its peak and that the Fed will likely begin to cut it this year. However, he stressed that a first rate cut would have to wait until the Federal Open Market Committee had gained greater confidence that inflation is moving sustainably toward 2 percent. In other words, the Fed will need to wait for some further good news on declining CPI inflation and wage growth.

We expect that they will have this information by their mid-June meeting, triggering a first 25-basis-point rate cut and followed by further quarter-point reductions in September and December. However, for as long as this stretched-out expansion continues, the Fed will be in no hurry to provide greater monetary ease.

Investment Implications

For investors, this is a relatively benign outlook. However, it should be recognized that in a calm environment, markets will tend to get over extended, as investors continually increase their bets on what has worked recently. So far, this has boosted mega-cap U.S. growth stocks to pretty lofty valuations, although U.S. value stocks and international stocks don't look particularly expensive. Similarly, in the bond market, credit spreads have tightened while Treasury bonds no longer look cheap.

This still leaves plenty of opportunity in long-term assets and, for as long as this stretched-out expansion continues, a diversified portfolio of long-term assets should out-perform cash. However, investors should recognize that recent strong increases in portfolio values have been accompanied by increased portfolio risk, making investment discipline just as important today as when economic expansions were predictably short.