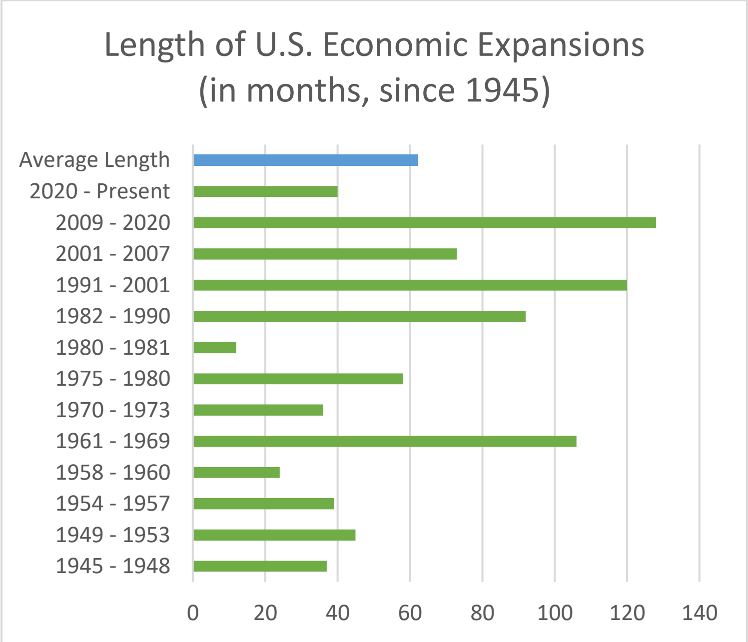
How History and Data Both Point to a Soft Economic Landing

The U.S. economy grew at a faster pace in Q1 and Q2 than just about everyone expected. History and some recent data suggest it could keep growing.

In the post-World-War II era, the U.S. economy has endured 12 expansions and 13 recessions, according to data compiled by the National Bureau of Economic Research. In the decades after the war, the economy followed a familiar pattern – recessions and bear markets were cyclical, typically driven by the Fed raising rates too far to tame growth and inflation.[1]

But starting in the 1980s through the present day, economic expansions have lasted longer, and recessions and bear markets have largely been event-driven or structural – consider the 2001 tech bubble, the housing crisis and financial meltdown in 2008, and the pandemic. It's worth noting that the Fed engaged in tightening campaigns in the mid-1980s and mid-1990s, but neither triggered a downturn. And stocks did well.

Looking at the graphic below, readers can see that before 1980, economic expansions were relatively short-lived (except for the 1960s). After 1981, expansions have gotten considerably longer, with the previous four lasting an average of 8.6 years. If a recession were to occur in the second half of 2023 – as many economists were and are projecting – then it would be less than half as long as the post-1981 average.

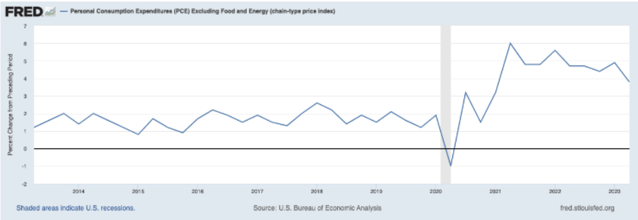


Source: National Bureau of Economic Research[2]

One of the key reasons expansions have become longer since the early 1980s is that inflation has not been much of an issue over the last few decades. In cycles prior to 1980, the Fed would work to choke-off economic expansions because of their objective to choke-off inflation, with the most relevant example of course being Fed Chairman Paul Volcker's engineered recession in the early 1980s.

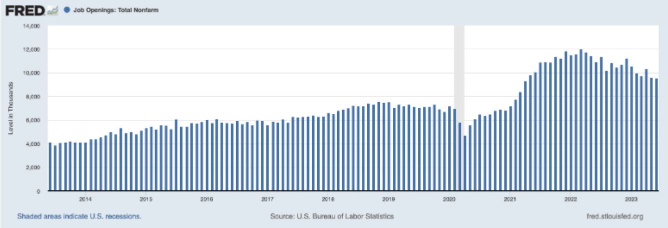
Just a few months ago, the narrative was that Jerome Powell's Fed would need to follow in Volcker's footsteps. But the thinking is starting to shift as inflation comes down meaningfully without much hint of strain in the broad U.S. economy. Consumer spending grew by a modest but still positive 1.6% in Q2, and business investment ticked nicely higher. The jobs market also continues to produce abundant openings and solid wages, which is the opposite of what we would see in a pending downturn. In Fed Chairman Powell's words, "*We've seen so far the beginnings of disinflation without any real costs in the labor market*," and "*that's a really good thing*."

The Fed's Preferred Measure of Inflation Fell Below 4%



Source: Federal Reserve Bank of St. Louis[3]

While Job Openings Remain Abundant



Source: Federal Reserve Bank of St. Louis[4]

The case for a hard landing (i.e., recession) is that the Fed today needs to do what it used to do prior to 1980, which is to engineer a recession to bring inflation down. But it looks increasingly like the Fed does not have to do that after all, which could make the current expansion look more like the previous four.

Bottom Line for Investors

When the Fed successfully raised rates in 1984 and 1994 without triggering an economic recession, the labor market was not nearly as tight as it is today. In other words, the Fed was not worried back then about wage pressures driving inflation like they are now. This might be aptly categorized as the "x-factor" that could influence the Fed to go too far in raising rates.

I've argued before, however, that there are several supply-side factors that could arguably neutralize any wage-price pressures, like falling producer prices, the removal of stress from global supply chains, falling shelter costs, and the plummeting of M2 money supply which tend to lead to inflation. If these other supply-side drivers effectively offset the effect of wages that are running higher than the Fed wants, then I think it's entirely possible that the Fed will firmly conclude a recession is not needed to get inflation back down to the target. And that could give the current expansion a lot more runway from here.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. July 27, 2023. https://www.wsj.com/articles/could-a-recession-still-be-years-away-soft-landing-could-deliver-another-extended-economic-cycle-e7e2c4ee?mod=economy_more_pos2

[2] National Bureau of Economic Research. March 13, 2023. https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions

[3] Fred Economic Data. July 27, 2023. https://fred.stlouisfed.org/series/DPCCRV1Q225SBEA#

[4] Fred Economic Data. August 1, 2023. https://fred.stlouisfed.org/series/JTSJOL#

Weekly Market Update

Important Market News We Think Worth Considering

STEADY INVESTOR WEEK

- **The U.S. credit downgrade**
- **The fall of the American mall**
- **The shifting environment in small business loans**

The U.S. Gets a Credit Downgrade

The ratings giant Fitch Ratings made a splash this week when it downgraded the U.S. government's credit rating from the highest possible AAA to AA+, which is a single step down. In stark terms, Fitch said the downgrade reflects an "erosion of governance" in the United States, pointing to infighting over important measures like raising the debt ceiling, and also the government's decades-long track record of running budget deficits. Fitch spelled out in fairly harsh terms that the U.S. government has spent too much and also cut taxes too much, making the problem with creditworthiness very much a bipartisan issue. This is the first downgrade by a major ratings firm since the brinksmanship tied to the 2011 fiscal cliff, where the U.S. came close to defaulting on obligations much like it did earlier in the year. This downgrade likely seems like a big deal on its face, but a bit of context is needed. First, when the U.S. received a downgrade following the fiscal cliff fiasco, government bond yields went down in the ensuing months – not up. This speaks to the lack of power a ratings agency has over the market's interpretation of the United States' creditworthiness. The second is that ratings agencies are much better at telling us what has already happened versus what is likely to happen in the future. The clearest example of this was in 2008, when ratings agencies failed to see any problems with Bear Stearns, Lehman Brothers, and others even as those banks were collapsing. Ditto for the recent stress in regional banks, which ratings agencies seemed to have no handle on. In short, ratings agencies tell the market what it already knows, well after the market already knows it.[1]

The Fall of the American Mall

It wasn't long ago that malls were the social and consumption centerpiece of many cities and communities. Today, many have shuttered and others usually have more empty parking spots than full ones. This has meant plummeting real estate valuations for many of these sprawling properties with large buildings. Older, lower-end malls are worth about half of what they were at their peak in late 2016, and about 20% of malls with commercial mortgage-backed securities are underwater. According to Moody's Analytics, some $14 billion of loans backed by these malls are coming due in the next year, and many are expected to default – especially given that higher interest rates mean refinancing will make them less affordable. Major department stores are also becoming a thing of the past. Large stores like Macy's, JCPenney, and Sears closed nearly 1,000 stores between 2018 and the end of 2020, which was several times more than the 175 that closed in 2016 and 2017.[2]

The Shifting Environment for Small Business Loans

Major shifts are underway in how small businesses can access loans needed for investment and growth. According to a recent survey published by the Federal Reserve, lending officers at U.S. banks said they were tightening their standards for lending and also saw weaker demand for commercial and industrial loans in Q2. The Small Business Administration is a key part of small business lending, as it is a federal program that is authorized to guarantee $34 billion in loans annually through its main lending program. Small businesses can generally borrow as much as $5 million to start, buy, expand, or run their small business, and they access the funds through banks. In the most recent fiscal year, lenders issued $26 billion of the guaranteed $34 billion, meaning there was $8 billion in unused loan dollars. That's where some of the key changes could make a difference – starting this month, the SBA is simplifying loan requirements *and* allowing more nonbank lenders (via expanded licensing) to issue SBA loans. This means more fintech companies will be allowed to provide loans to small businesses, which could ultimately expand their reach.[3]

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[1] Wall Street Journal. August 1, 2023. https://www.wsj.com/articles/fitch-downgrades-u-s-credit-rating-56c73b89?mod=djemRTE_h

[2] Wall Street Journal. July 31, 2023. https://www.wsj.com/articles/local-malls-stuck-in-death-spiral-plunge-in-value-a7998b7d?mod=djemRTE_h

[3] Wall Street Journal. July 31, 2023. https://www.wsj.com/articles/small-business-lending-is-about-to-change-with-simpler-requirements-8578a895

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