

WEEKLY ECONOMIC COMMENTARY

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- **A “Glass-Is-Half-Full” Perspective on the Outlook**
- **A Guide from History About the Two-Track U.S. Economy**
- **RGD, the Doyen of Economics at Northern Trust**

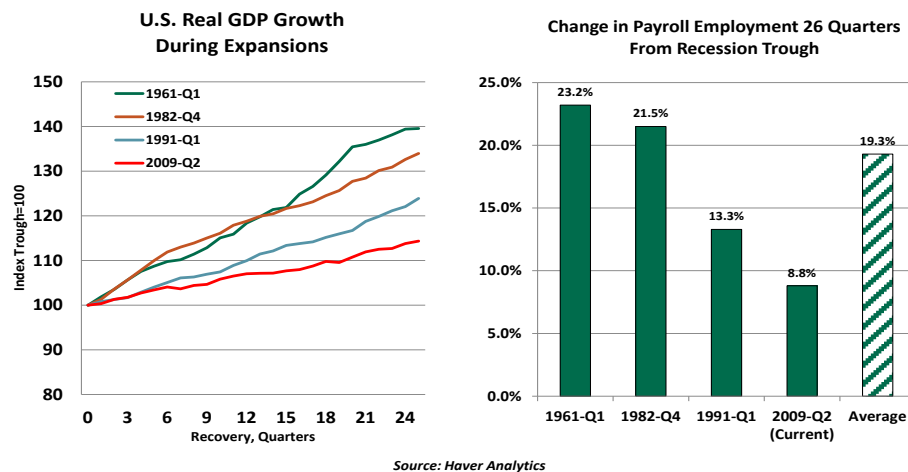
My children all stayed with us for a while during the holidays. No matter how long they’ve been living on their own, they still make themselves at home: dirty laundry everywhere; unwashed plates and glasses piled in the sink; and bathroom Armageddon.

The kids really enjoy doing things together, but one of them is chiding me for being “old.” The subject comes up when I take special care in lifting heavy objects or wish everyone goodnight at 9 p.m. The younger set has concluded that I am getting frail and my best days are behind me.

I’ve been getting a lot of comments about aging and frailty at work, too. The inquiries are not personal; they refer to the U.S. economic expansion, which began in the second quarter of 2009. Some suggest that the best days of the current cycle are behind us and that the American economy is vulnerable to a potential market Armageddon caused by oil and Asia.

Yet there are reasons to reject such a dark prognosis. While old chronologically, the expansion is somewhat young at heart. Recent maladies may be transitory and not chronic. And the financial system is far healthier than it was 8 years ago, making a repeat of global contagion far less likely. Let’s not rush to panic on the basis of three difficult weeks in the financial markets.

It isn’t so much age as mileage that creates limitations for economic expansions. By the latter measure, the period since 2009 has not been nearly as taxing as past analogs.



Growth during the current phase has been by far the weakest of the four long expansions the U.S. has enjoyed during the past 50 years. Employment gains have also lagged past precedents.

Among the reasons for the relatively tepid performance are some important headwinds. Chief among them is the deleveraging of American households, necessitated by the credit crash of

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As headwinds ease, the expansion will gain renewed vigor.

2008. That process has evolved nicely: the ratio of household debt to household income is now at a 15-year low. Families are finding room in their budgets for additional spending, which should add momentum to growth.

The same can be said for U.S. governments. The deep recession required substantial belt-tightening. While public finances are still challenged, the public sector has been accretive to gross domestic product (GDP) growth for the past two years.

The American housing sector endured a severe correction, with property values falling sharply and mortgage credit constrained. The industry is enjoying a modest renaissance, though, as the inventory of homes for sale dwindles and financial conditions become less-inhibiting.

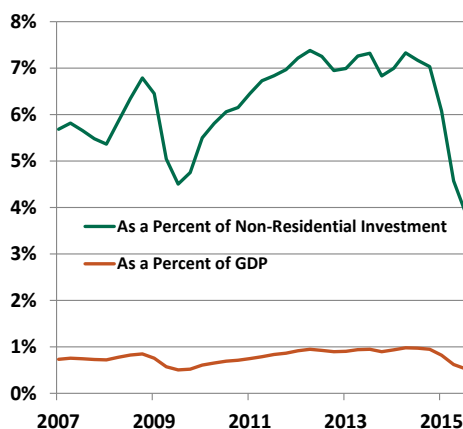
There is great momentum in U.S. employment. Job creation has accelerated over the past two years, deepening and broadening the spending base on which the world economy depends.

Recovery from recessions that are accompanied by a banking crisis takes extra time. The financial foundation in the United States has largely been repaired. Credit conditions are much more supportive of growth than they have been in some time. The Federal Reserve has been exceptionally helpful, banks are very well-capitalized, and loan growth has been strong. All of this suggests that the current expansion has plenty of room to run.

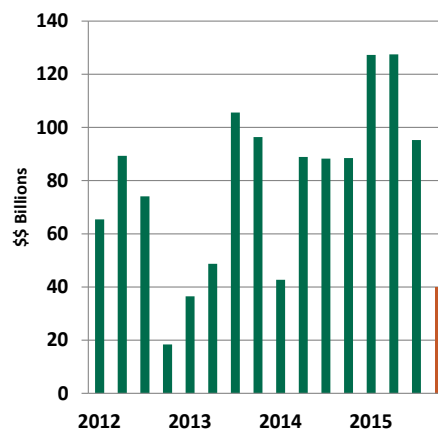
The U.S. economy has been hindered by two other short-term headwinds. The first is the steep retreat in the energy industry. Demand for the equipment and expertise that fuel exploration and extraction has diminished substantially. This has been harmful to the petroleum industry, but that sector accounts for a modest portion of U.S. economic growth, and the worst of the correction is likely behind us.

Further, it appears that we've gotten a lot of pain and little gain from low oil prices. While we have seen only limited evidence of an "energy dividend," the benefit of cheaper gasoline has certainly been a boon to household finances and may yet boost consumption on other items.

Energy-Related Investment



U.S. Inventory Growth



Source: Haver Analytics

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Volatile markets
do not always
presage recession.

The second constraint is an excess of inventories, which has been building since the end of 2014. Signals suggest that firms are working those down instead of sustaining new production; this will be a big negative when economic growth for the fourth quarter is announced later this month. But once inventories align better with sales, that negative will turn to a positive.

There are certainly voices who think that the relative sluggishness of the current expansion is due to structural factors. The aging of the global labor force and poor productivity may have reduced our potential to grow; if so, we may be close to running out of steam. We addressed this secular stagnation hypothesis in [earlier work](#): the data seem much more consistent with cyclical repair than long-term decay.

Recent market trends may suggest global economic weakness that had not been fully appreciated. And the negative psychology that might emerge could lead to cautious business behavior. But market corrections have not always foreshadowed fundamental problems, and might even be seen as healthy events in the midst of long bull runs.

There are certainly risks in the outlook that bear watching, and we'll endeavor to keep you apprised in this space. But our view remains that the U.S. expansion should be able to continue along solidly as long- and short-term hindrances recede. As I tell my children, judging health solely by age is a mistake.

Is Slowing Factory Activity Likely to Derail the U.S. Economy?

Those concerned about the future of U.S. economic growth have pointed to troubling signals from heavy industry. Manufacturing is certainly moderating, but soft factory conditions by themselves are unlikely to derail the expansion.

The setback in oil industry activity has left industrial production (IP) down 0.8% from a year ago. But IP excluding energy continues to advance, albeit at a slower pace (+1.5%) in the second half of 2015 compared with the first six months of last year (+2.5%). And as discussed above, the worst of the oil-patch correction may be behind us.

Factory employment fell in August and September, but there has been a mild pickup in hiring during the last three months. Job losses in oil-related areas continue, but should diminish when oil prices bottom.

Apart from the correction in the energy industry, the combination of a strong dollar and weak economic conditions abroad have hurt U.S. trade. The greenback rose about 10% in the past year, and U.S. factories account for roughly 50% of total U.S. goods and services sold overseas. Overall exports have fallen by more than 4% over the past 12 months, and goods exports are down by more than 8% over that same interval.

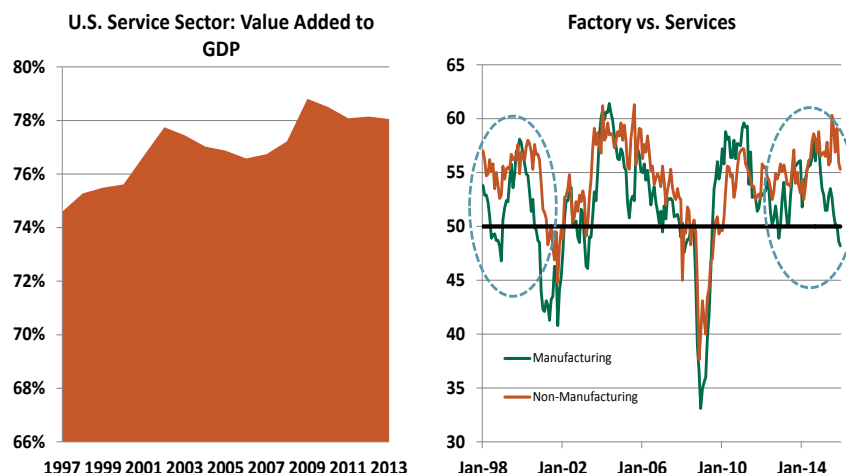
This may be a hindrance for another quarter or two, but there may be limits to how much the dollar will rise. The U.S. Treasury Department has been largely silent on the value of the greenback, but that could change if foreign exchange markets continue along their recent path.

The Institute of Supply Management's (ISM) factory survey index has recorded two monthly readings below 50.0, implying a contraction in factory activity. Regional editions of this measure

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are even lower. This reading has historically been a reliable coincident indicator of business cycle turns, but it is not 100% accurate.

Historically, there have been points in time when the ISM factory index slipped below 50 during an expansion phase, only to turn around quickly. Further, there have been periods where the ISM index has been in contraction territory for several months without kindling a recession.



Sources: World Bank, Haver Analytics

Weak manufacturing results are not enough to bring the expansion down.

One such period was the second half of 1998. Back then, the Asian economic crisis brought about softness in U.S. factory activity. Then, as now, the dollar was strong, hindering exports. U.S. factories accounted for roughly 60% of total U.S. goods and services exported back then, about 10 percentage points higher than today.

But during this period, the non-manufacturing ISM index maintained readings above 50. The recent non-manufacturing ISM index has yet to slip below 50. This suggests that the service side of the economy is still performing well and should compensate for the slow manufacturing outlook.

Services – banking activities, educational instruction, car repairs, haircuts, dry cleaning, legal guidance, and so on – make up almost 80% of GDP, and the share keeps climbing. Service-sector employment (private and government) has grown from 81% of total employment in 1998 to 86% in 2015.

Within consumer spending, service expenditures are nearly 50% of GDP, and they continue to advance. Growth of these outlays averaged 2.3% in the first three quarters of 2015 compared with the median increase of 1.5% in the current expansion. Favorable employment conditions suggest that there is little to stop the consumer from maintaining a sustained trend of spending.

It is worth noting that world equity prices fell 4.3% between the fourth quarter of 1997 and third quarter of 1998, but they recovered soon after. Investors are certainly hoping for a repeat performance during the balance of this year.

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In sum, the woes of the nation's factories are holding back the performance of the U.S. economy, but the size of the service sector is too large to be overwhelmed by weakness in industrial activity. Recent manufacturing indicators are not overly encouraging, but they are not fatal, either.

A Fond Remembrance

The practice of business economics is not easy. Data shift in unpredictable patterns; alternative theologies compete for primacy; and audiences expect precision in an imprecise arena. Excellence is hard to establish – and hard to sustain.



One man who met this challenging standard was Bob Dederick, who served as Northern Trust's Chief Economist for many years. We lost Bob this week, but the tributes he's received from inside the bank and from around the world suggest that his spirit lives on.

Bob grew up in New Hampshire and studied economics at Harvard at a time when that university was known for its somewhat liberal leanings. Nonetheless, Bob served as an Assistant Secretary of Commerce in the Reagan Administration. (His stories from that era were very popular among his partners and clients.) He was challenged by the supply-siders who dominated that regime, but maintained a studied independence. In a discipline that has become increasingly dogmatic, Bob was always balanced.

Bob had a wry sense of humor, which he applied liberally to spice up what can be a dry topic. He used witty rejoinders to point out flaws in logic without antagonizing. Inevitably, his observations provoked productive reflection.

Economics has become increasingly mathematical, but Bob was always cognizant of the limitations of quantitative methods. He was an excellent forecaster, but relied on a blend of data and intuition as opposed to a black box. Thinking about interactions and ranges of outcomes was always more important to Bob than the final projection. And to him, the skill in using models sometimes was knowing when to turn them off.

Bob led a series of industry groups and was revered by his peers. He was a part of the Conference of Business Economists for 43 years and a long-standing member of the International Conference of Commercial Bank Economists. Through these associations, he elevated the level of discourse in our field and inspired many younger professionals. I was fortunate to be among the latter.

Finally, Bob was a true gentleman. His New England mien initially appeared stern, but he had an underlying warmth that made him many friends. As we celebrate his life, we remain inspired by his example and dedicated to the principles he embodied.

Bob Dederick set a high standard for the rest of us to follow.

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