Midyear Outlook, Part 1:

A Different U.S. Economic Expansion

Our investment experts discuss why the decade-long stretch of U.S. economic growth could last longer than forecasters expect.

Contributing Managers

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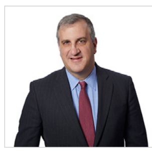

Daniel Solender

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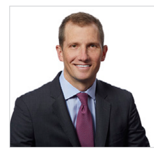
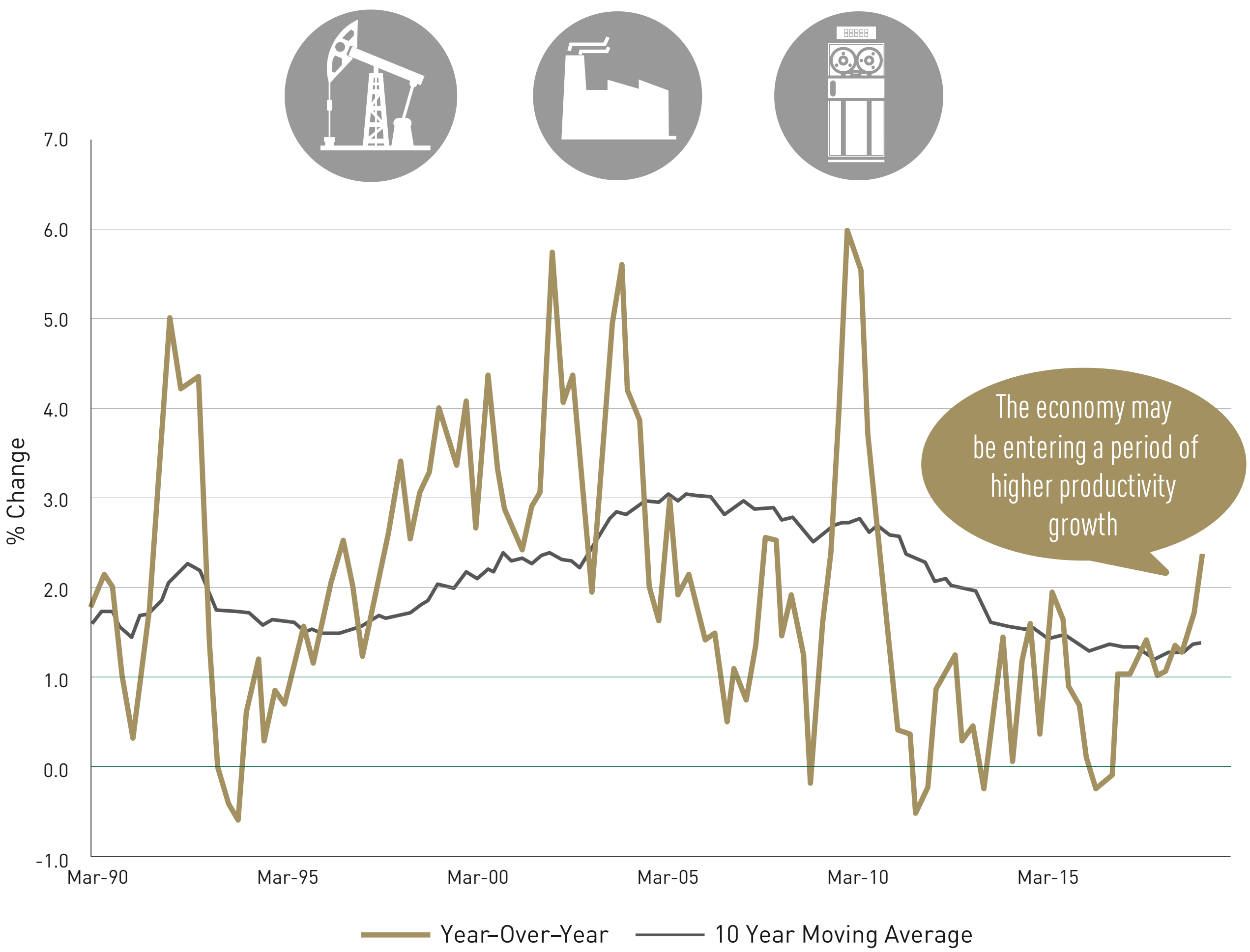


Joseph Graham

Chart 1. A Rise in Nonfarm Labor Productivity Has Been Supporting U.S. Economic Growth

U.S. nonfarm business sector labor productivity, output per hour worked (as of April 30, 2019)



Source: Bloomberg. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

In Brief

- The current growth phase is on course to beat the reigning champion of U.S. economic recoveries – the 1990s expansion, which lasted 120 months.
- The mere fact that productivity is not decelerating, as it normally would so deep into a period of economic growth, offers the potential for growth to be sustained.
- What's impressive to us is that U.S. inflation decelerated as the U.S. economy was growing at 3.2% in the first quarter of 2019—all while the rest of the world was slowing down.

"Acceleration in productivity creates the potential for the best of all possible worlds."
— Giulio Martini

We recently gathered six Lord Abbett investment leaders for a wide-ranging discussion of the current market and economic environment and to elicit their views on key investment themes for the second half of 2019. (Video and audio excerpts can be found on our Midyear Outlook page.)

In this first of a special three-part Market View, we focus on one critical segment of the discussion: the current U.S. economic expansion – soon to be one of the longest growth periods in U.S. history.

Our panel featured Lord Abbett Partners Thomas O'Halloran, Portfolio Manager for micro-, small-, and large-cap growth strategies; Giulio Martini, Director of Strategic Asset Allocation; Daniel Solender, Director of Tax-Free Fixed Income; Leah Traub, a currency expert and Portfolio Manager for Taxable Fixed Income; and Kewjin Yuoh, Portfolio Manager for Taxable Fixed Income. Joseph Graham, Investment Strategist, moderated the discussion.

One of the major topics for our panel was the extraordinary length and breadth of the current U.S. economic recovery, which began in June 2009 following the Great Recession, according to the National Bureau of Economic Research. At 118 months long (as of May, 2019), the current growth phase is on course to beat the reigning champion of U.S. economic recoveries – the 1990s expansion, which lasted 120 months.

On everyone's mind was the prospect for the recovery's continuation. How sustainable is an expansion that is already a decade long? Isn't it just getting a bit old?

Well, "business expansions don't die of old age," according to Martini. "They are either murdered or they commit suicide. When they're murdered, the Fed [U.S. Federal Reserve] is tightening monetary policy to combat the threat of inflation, and that forces the economy into a downturn to correct the excesses that led to inflation."

"When business expansions commit suicide," Martini continued, "it's usually because a financial bubble has burst, and that spills over to the economy by reducing household and business spending, causing a recession."

With neither a Fed-induced nor a bubble-led recession in view, according to our experts, panelists pondered the possibility that the current expansion may exceed investors' expectations in terms of its sustainability.

Martini points to the late-in-the-cycle appearance of productivity growth, which he says "has been missing in action up to now," as one indicator of the sustainability of this recovery. Labor productivity growth in the nonfarm business sector accelerated at an unexpectedly strong 3.6% in the first quarter of 2019. This took the year-over-year gain to 2.4%, by far the swiftest advance in the current expansion, according to Martini.

"Since the recovery began in 2009, we've had very weak productivity growth, and that's resulted in slow wage increases and, frankly, a lot of dissatisfaction as people just didn't really feel the benefits of the economic expansion," Martini said. "Then a couple of years ago, we started to see wage increases accelerate."

"Normally, wage increases could pose an inflationary threat," Martini continued. "But it's not doing so, because simultaneously productivity is picking up. That means production costs aren't going up, even though wages are. And in many ways, that kind of acceleration in productivity creates the potential to have the best of all possible worlds, because it means that households can have an improving standard of living, we can continue to have low inflation, businesses can maintain profit margins to the benefit of shareholders, and all of that coming together is something that we saw for extended periods of time in the 1960s, in the 1980s, in the mid-1990s, but we haven't seen for a while."

"And if in fact the economy is entering a period of higher productivity growth, it's a signal that we may continue to have low inflation and maintain this economic expansion for longer than investors might have been counting on," Martini said.

What's Different This Time?

Martini points out that it is unusual for this kind of productivity growth to occur so late in a business cycle. "Generally, the pattern is for productivity growth to be very strong in the early phases of an economic recovery, when you're coming out of recession, and then for it to slowdown in the latter phases of business expansion."

"The mere fact that productivity is not decelerating, as it normally would so deep into a period of economic growth, offers the potential for growth to be sustained," Martini says. "We saw this happen in the long expansion period in the 1990s, when [former U.S. Federal Reserve chairman] Alan Greenspan famously perceived that technological change was allowing an acceleration in productivity growth that hadn't shown up in the data yet, but that he thought would allow the Fed to maintain low interest rates for longer."

"In terms of the performance of the U.S. economy, that late-cycle acceleration and productivity growth was one of the things that really led to the longest period of uninterrupted economic growth (the 1990s) that we've ever had in history, at least so far," Martini says.

"And there's another thing that is unusual for a late-cycle environment," Martini said. "Typically, housing is weakening in the latter phases of a business expansion. But it's starting to strengthen now, and it's another factor that could sustain growth."

"There are a lot of good aspects about housing right now," Yuoh said, "affordability being one of them. Inventories are back to pre-housing crisis levels. Housing start numbers and existing home sales are comparable to the levels of the mid- to late-'90s. I think if we're going to have a significant recovery in housing, lending standards will have to ease up somewhat-- but that's something that will happen slowly. I don't see housing as a threat right now to the economic expansion."

O'Halloran agrees. "I don't believe that housing is going to be a big catalyst for growth, but it's not going to be a problem either."

O'Halloran is "very bullish" on the U.S. stock market, which he believes will break out to new highs soon. "And one of the main reasons is what we've been talking about: our economy continues to expand and inflation is very much under control." (We'll feature more investment views from our panel in Part 2.)

Solender also has a favorable outlook for the U.S. economy. "Consumer confidence remains strong. People today are working and making money. This year, most consumers feel comfortable with the current interest-rate environment (they weren't last year), and they don't seem to expect any move from the Fed to be a large one, either way."

"While it's true that the Tax Reform Act redefined wealth for many homeowners living in high-tax states, all of that has created demand for the tax-exemption that municipal bonds can provide," says Solender.

"There are a lot of good aspects about housing, affordability being one of them."

— Kewjin Yuoh

Finally, with her global perspective on the currency markets, Traub observed: "The United States, with 3.2% in gross domestic product in the first quarter of 2019, is where the growth is, and that supports the U.S. dollar," Traub continues. "It's hard to see where we will see dollar weakness unless global growth picks up. In that regard, Europe is struggling to exceed 1% and the Asian emerging markets are feeling the effect of the slowdown in China."

"In hindsight," Martini concluded, "the last year has been even more surprising than I thought it would be. China's economy slowed, Europe's economy slowed, yet U.S. GDP growth year-over-year in the first quarter turned out to be 3.2%."

"Most people think that potential output growth, a long-run kind of noninflationary trend, is something like 1.8%" Martini said. "So the U.S. did almost double its potential output in a year when the rest of the world was slowing down. That's pretty impressive. What's more impressive to me is that inflation decelerated as the economy was growing at 3.2%."

"What that really suggests, to me at least, is that those estimates of potential output are probably too low, that the economy's real potential in the medium term is growing more rapidly than we thought it was. And that's exactly what accelerating productivity would suggest."

Next: Lord Abbett investment professionals assess prospects for key asset classes in the second half of 2019. ■

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