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U.S. Macro Outlook: A Long Expansion

BY MARK ZANDI — MARCH 16, 2015

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- Job gains span all industries, regions and pay scales.
- There is no indication that households, businesses and financial institutions are overleveraged.
- The banking system is on stronger financial ground.
- If there is a fissure in the financial system that could pose a risk to the economic expansion, it is in the shadow system.

The U.S. economic expansion is approaching its sixth birthday. It is already longer than the average expansion since World War II but shows no sign of significant wear and tear. Prospects are good that this will be one of the longer expansions in the nation's history.

A strong performance

The economy's recently strong performance is a reason for such optimism. Job growth is rarely ever as strong; aside from energy, job gains span all industries, regions, and pay scales. GDP growth has been more pedestrian, and the first quarter looks soft, but abstracting from the vagaries of the quarterly data, real growth appears close to a respectable 3% pace.

Expansions generally end when the economy overheats—that is, the labor market is at full employment and businesses are operating beyond their capacity. Inflation pressures develop and interest rates surge, exposing overextended households, businesses and financial institutions.

This expansion is far from any of this. It is debatable how much slack remains in the labor market, but judging from still-dormant nominal wage growth, it is still considerable. We estimate the slack, including the unemployed, marginally attached, and part-timers who want full-time work, at just over 1% of the labor force.

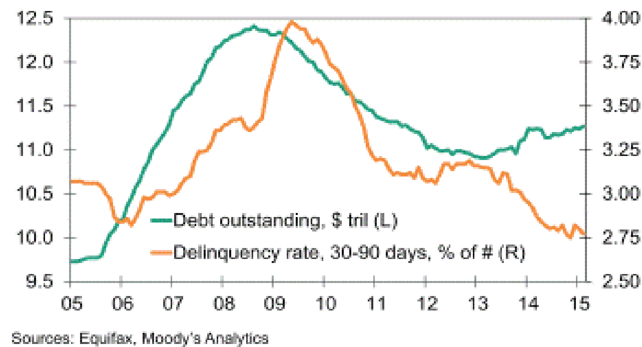
Moreover, even after wage growth revives, it will be a while before this translates into a significant increase in inflation. Core inflation is very low at just over 1%, and it is not likely to pick up any time soon given the ongoing pass-through from the collapse in oil prices and the surging U.S. dollar.

And although interest rates are set to rise as the Federal Reserve begins to normalize monetary policy in the next few months, under most scenarios it will be a long while before rates are back to where they are in typical times.

Deleveraged households

There is also no indication that households, businesses and financial institutions are overleveraged. Indeed, households have dramatically deleveraged. They owe approximately $1 trillion less today, or almost 10% less, than at the peak of their indebtedness during the Great Recession.

Households Fix Their Balance Sheets



Less debt combined with low interest rates has significantly lightened household debt service burdens. The share of disposable income that households must pay to make timely interest and principal payments on their obligations is as low as it has been since the Federal Reserve's calculations begin in 1980.

Households have also diligently locked in the low interest rates. After several major mortgage refinancing waves, most homeowners have paid off their adjustable rate mortgages with long-term fixed rate loans. Only one-fifth of household liabilities have interest rates that change within one year of a change in market interest rates. This compares with a peak of more than one-third of liabilities in the early 1980s.

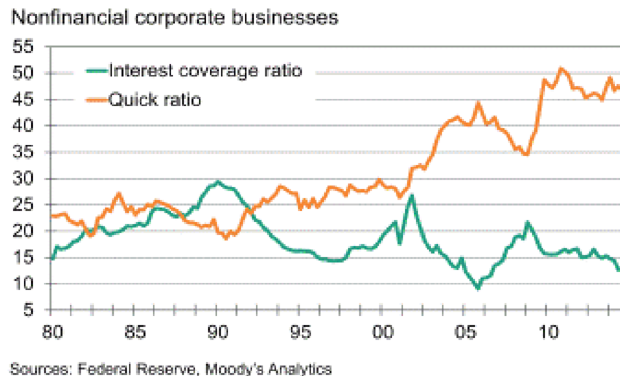
While much of the household deleveraging occurred via financially painful foreclosures and defaults, balance sheets are now in excellent shape. Delinquency rates on household debts are about as low as they ever get. Even 30- to 90-day delinquency rates on first mortgages are close to where they get in the very best of economic times.

Households have resumed borrowing, but only cautiously. Debt outstanding is still increasing more slowly than household incomes. Auto and student lending is strong, but credit card, consumer finance, and home equity lending is soft. This is unlikely to change soon, as households are expected to use the savings on their gasoline bills, and not more debt, to finance their spending.

Businesses are sturdy

Businesses are also in very good financial shape. Corporate profitability has never been stronger, and nonfinancial corporate leveraging hasn't changed much since the late 1990s.

Moreover, businesses' capacity to service their debts couldn't be better. The quick ratio—the ratio of liquid assets to short-term liabilities—is hovering near 50%, about double its long-run average. The interest coverage ratio—the ratio of interest payments to corporate cash flow—is still falling and is already near record lows.



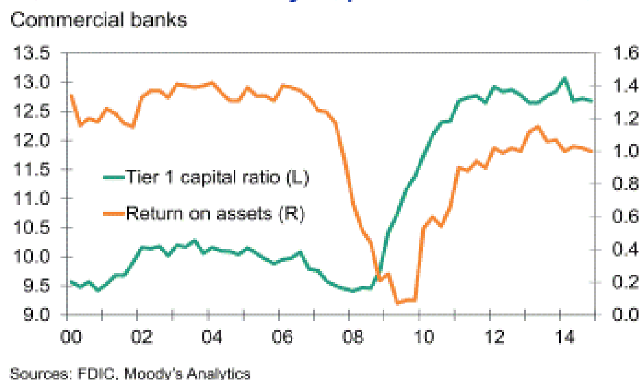
Businesses are borrowing more aggressively. Corporate bond issuance is robust and commercial and industrial lending by banks is expanding at a double-digit pace. C&I lending is among the most reliable lagging economic indicators. That such lending is so strong is proof positive that the economic expansion is firmly entrenched.

To be sure, there are reasonable concerns that leveraged corporate lending is getting overdone. Increased merger and acquisition activity and extraordinarily low borrowing costs are fueling this lending. Fortunately, regulators appear attuned to the heightened risks and have issued increasingly strong guidance to banks capping the amount of debt companies to which they lend are permitted to take on.

The recently completed 2014 round of Federal Reserve bank stress tests was also designed to determine how well the leveraged corporate lending of the nation's largest banks would fare in a very tough economy. The stiffer regulatory oversight of banks' corporate lending won't stop businesses from eventually overleveraging, but it has helped, at least to date.

Fortress banks

The nation's banking system has arguably never been on stronger financial ground. Bank capital ratios have soared since the financial crisis, as regulators have put enormous pressure on the largest banks particularly to raise sufficient capital not only to avoid another bailout, but also to have enough capital to remain as going concerns even in the darkest of economic times.



The stress-test results show that the banks have the capital they need, and then some. For the 31 big banks that took the test, the Tier 1 capital ratio—the ratio of high-quality capital to risk-weighted assets—fell from the current actual 13.5% to 7.7% at the low point in the stress scenario. The minimum capital ratio required to pass the test is 6%.

The stress scenario, also known as the severe adverse scenario, is an extraordinarily high bar. In some ways it is a more severe downturn than

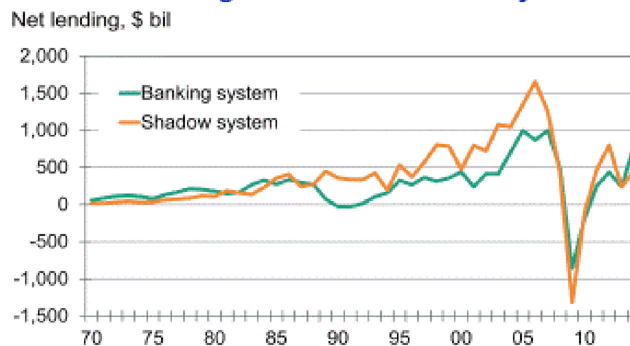
the Great Recession. Unemployment in the scenario rises as high as 10%, and remains there for more than a year. In the actual downturn, unemployment only briefly touched double digits.

Bank capital is also sure to continue increasing, as credit conditions couldn't be better. Charge-off rates are extraordinarily low across all types of lending. The charge-off rate on bank commercial real estate loans in the fourth quarter of last year was a single basis point. Bank profitability isn't what it was prerecession because of tougher capital and regulatory requirements, but banks are still making good money.

The stress tests are also preparing the banking system for higher interest rates. The Fed's alternative adverse scenario envisages what seems like an outside-the-box increase in both inflation and rates.

The shadow system

If there is a fissure in the financial system that could pose a risk to the economic expansion, it is in the much less regulated shadow system. The shadow system is largely composed of the money and credit markets, and collectively provides at least as much credit to the economy as the banks.



There is good reason to be focused on the shadow system. With regulators heavily tightening down on the banks, risk is moving out of the banks into the shadows. A good example of this is in first mortgage lending where the nation's largest banks, which have long dominated this industry, have been pulling back because of higher capital requirements and regulatory and reputational risk. Much smaller nonbanks ranging from mortgage brokers and finance companies to Real Estate Investment Trusts are filling the void.

While the financial system might appear safer since systemically important banks are downsizing to the benefit of small lenders, it is hard to know what risks these much less transparent institutions pose. The shadow system is opaque and difficult to track, especially given how quickly it appears to be evolving.

Expansion has a long way to go

Regulators were granted some powers in the Dodd-Frank regulatory reform to monitor and even intervene in the shadow system if need be. New bodies such as the Financial Stability Oversight Council and Office of Financial Research appear to be appropriately focused. They are standardizing and collecting more data, and they are examining key issues such as market liquidity and how to measure systemic risk. They are also appropriately questioning what is driving the most rapidly expanding parts of the shadow system, such as the junk corporate bond and collateralized loan obligations markets.

Identifying threats emanating from the shadow system to the broader financial system and macroeconomy will be difficult. And it wouldn't be surprising if it is a problem in the shadow system that ultimately does in this economic expansion. But that problem is likely still far off. This economic expansion has a long way to run.

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