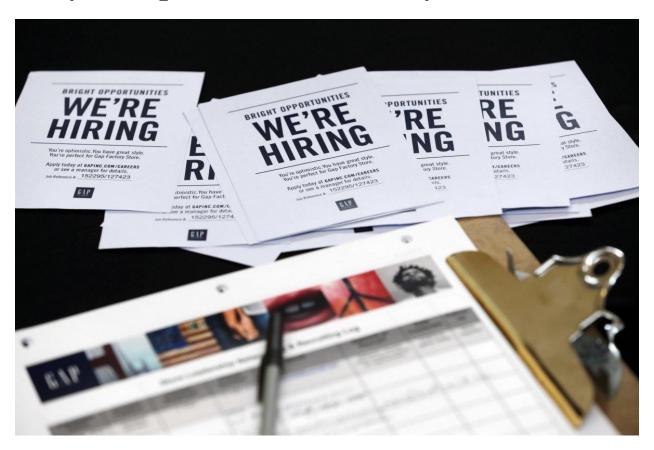


Moody's Zandi: Upbeat on the economy, but wary as expansion nears nine years



Updated: DECEMBER 28, 2017 — 6:29 AM EST

AP / WILFREDO LEE

The clearest evidence of the current economy's strength is in the job market, an impressive and consistent 2 million jobs and more created each year. This October 2015 photo reflected hiring efforts at a job fair at Dolphin Mall in Miami.

by Mark Zandi, For the Inquirer

These are good economic times. The current expansion is closing in on nine years; it's already the third longest in U.S. economic history and is still in full swing. The longest was the 10-year expansion of the 1990s, fueled by the dot-com boom and bubble. There are no bubbles today.

The clearest evidence of the economy's strength is in the job market. This economy is a job machine, creating an impressive and consistent two million jobs and more each year. Even the recent devastating hurricanes could not disrupt the longest string of job gains on record.

Nearly all industries, occupations, pay scales, and regions of the country are enjoying solid job growth. Only the energy and agriculture-related industries are struggling, given the collapse in commodity prices a few years back, and online competition is weighing on employment at brick-and-mortar retailers and print media.

The current pace of job growth is approximately double the growth in the labor force, and unemployment and underemployment continue to steadily decline. Sub-4 percent unemployment is likely in coming months, something the economy rarely experiences. Businesses' biggest problems will soon be finding qualified workers. And wages are finally on the rise as workers come to realize they are in the driver's seat.

Yet while there are good reasons to be upbeat, there are also plenty of threats to the optimism. Most concerning is the big, persistent disconnect between what policymakers at the Federal Reserve think the strong economy means for the path of future interest rates and what global investors think it means.

This disconnect is clear when comparing the Fed's forecast of the federal funds rate — the key interest rate it controls — and what investors think. Fed policymakers expect three rate hikes in 2018 and another three in 2019. By early in the next decade, the fed funds rate will settle near 3 percent. Investors expect only one or two hikes next year and one in 2019, with the fed funds rate barely getting to 2 percent.

Someone is wrong. The Fed appears on sounder ground, given prospects for sub-4 percent unemployment; developing wage pressures, which will eventually translate into more inflation; very easy financial conditions (record stock prices, for example); and a good global economy. Nearly everything the Fed considers when setting monetary policy suggests that it needs to raise rates in a more consistent way.

The gap in expectations should close gracefully — an assumption that underpins an optimistic outlook. The Fed will guide market expectations on higher rates slowly over time. However, there is a significant risk that it won't go well; financial markets have a penchant to overreact.

Also tempering optimism over the economic outlook is the understanding that there will ultimately be another recession. Even if this expansion becomes the longest in the nation's history, it, too, will end.

There are two preconditions for recession. First, the economy must overheat. That is, the expanding economy pushes unemployment and underemployment down so low that wage and

inflation pressures develop. The Fed responds slowly, at first, fearful of short-circuiting the recovery, but then needs to hit the monetary brakes hard to forestall rising inflation and inflation expectations.

This dynamic played out prior to each of the 10 recessions since World War II. Indeed, it takes just about three years after the economy reaches full employment for the economy to overheat and recession to ensue. Since the current economy recently passed through full employment, if history is our guide, the next recession will hit in summer 2020.

The second precondition for recession is that there must be a serious imbalance in the economy reflected in the financial system. For the Great Recession, the obvious imbalance was in the housing market and subprime mortgage lending. In the early 2000s recession, it was the dot-com boom and the bubble in tech stocks.

Identifying the imbalances that did in economic expansions of the past isn't too difficult, but figuring out what will end this one is. There's no obvious existential threat to the economy. However, that's probably because the imbalance is likely to emanate from the opaque part of the financial system known as the shadow system — the mélange of financial players including fintech firms, insurance companies, asset managers, derivative exchanges, and credit bureaus.

It's difficult to know how long it will take for this imbalance to develop and undermine this expansion. However, three years is a good estimate.

So when will the next recession hit? Let's pick a date: June 20, 2020.

Mark Zandi is chief economist at Moody's Analytics. help@economy.com