What Will End the U.S. Expansion?

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The current U.S. expansion will become the longest on record if it lasts until July 2019 (*Chart 1*). By then, a decade of steady growth will reduce the jobless rate to a half-century low of 3½% from a post-recession high of 10%. We would wager that the odds on this scenario are much better than even—but far from a lock.

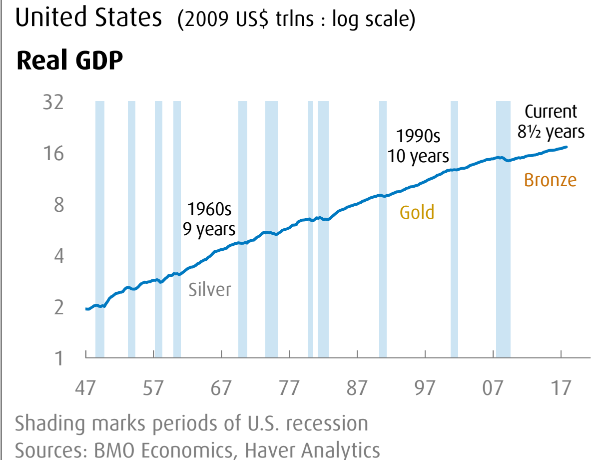
Expansions don't die of old age. And, they don't end because of political uncertainty at home or abroad. To be sure, a government shutdown, political turmoil in Italy or Spain, failed Brexit talks or a repeal of the NAFTA would likely slow the U.S. expansion. But none of these threats is likely to derail a $20 trillion economy growing soundly with a boatload of stimulus in its sails.

Expansions end because of imbalances in credit, asset or product and labour markets. Households and companies take on too much debt, investors push asset prices far beyond fundamental value, or goods and labour shortages stoke prices and drive up interest rates. The 2008 recession was caused by all three imbalances: a credit crisis, a housing bubble and an inflation-led jump in interest rates. That explains why it was the worst economic crisis since the Depression. The bursting of the dot-com bubble, coupled with rising inflation and interest rates, led to the 2001 downturn.

Prior to 2001, the primary cause of recessions was **tighter monetary policy** (*Chart 2*) **to subdue wage and price pressures** (*Chart 3*). Inflation spiked after a prolonged expansion eventually spawned worker shortages (*Chart 4*). It was sometimes fanned by soaring oil prices, as before the 1974 and 1980 downturns. In each of the past seven recessions, the Fed was forced to raise policy rates above long-term rates, inverting the yield curve (*Chart 5*). This led consumers, the expansion's workhorse, to break down in the stretch and cut spending, as occurred in nine of the past 11 downturns. A flagging consumer and contracting economy eventually lassoed inflation.

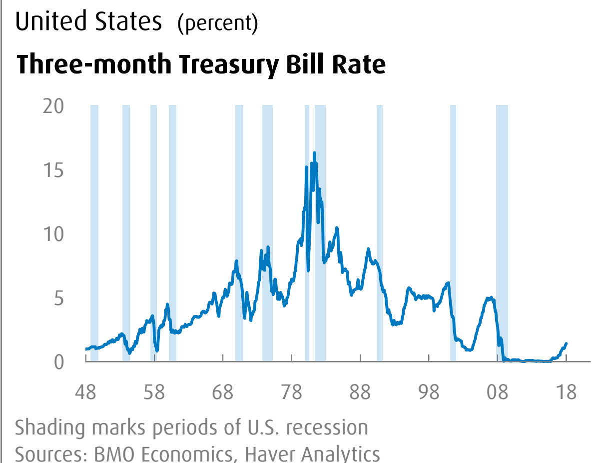
Of the three main causes of recession, **a credit crisis is the least likely to spur the next downturn**. Private sector debt remains well below its trend line (*Chart 6*). A sustained correction in asset prices is a somewhat greater risk, but likely only if equity and house values climb sharply further. To be sure, house prices have outrun family incomes for several years amid solid demand and lean listings. But affordability remains healthy in most regions. According to the National Association of Realtors, mortgage payments on a median-priced house consume less than 16% of family income, compared with a quarter-century mean of 18%. Sure, equities are expensive,

Chart 1
Going for Gold



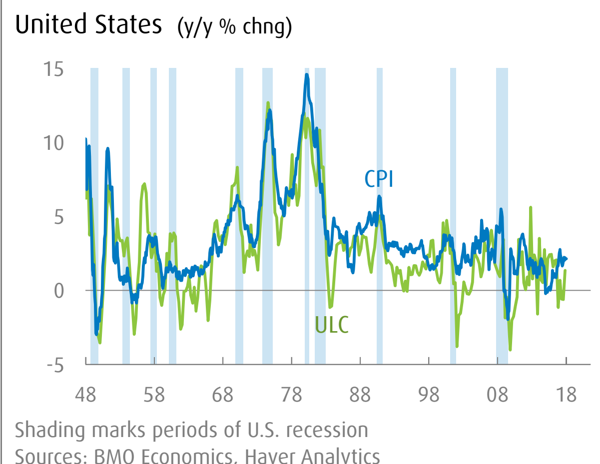
Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

Chart 2
Leading Cause of Recessions



Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

Chart 3
Inflation Calm, for Now



Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

but that alone is not sufficient to end a bull market, let alone trigger a recession.

In all likelihood, the current **expansion will end because of the usual suspect: a material rise in inflation and interest rates. But not this year.** Borrowing costs are still well below neutral, while the yield curve is actually steeper than normal. The inflation pot will also take longer to boil today than in the past given the cooling effect of e-commerce, automation and the gig economy. We expect the core CPI rate to rise only moderately to 2.2% this year, slightly above the Fed's target. Even if inflation climbs faster, it will take time for the Fed to realize that the kettle is boiling over before it shuts off the gas, and some time for rates to increase sufficiently to invert the yield curve. Most likely, the expansion will keep going for another 1½ years, breaking the record for longevity set in 2001.

But **if core inflation pushes toward 3%, all bets are off**. While increased infrastructure spending and capex incentives could support productivity growth, the bulk of the fiscal stimulus will merely juice demand that is already outstripping supply. In fact, the lift from tax reforms and spending increases in the next two years is almost as large as in 2009, though this time hitting when the economy has no slack (according to the CBO), oil prices are above $60, the dollar is sagging and trade protectionism hangs in the air. The former two factors will heat up domestic prices, while the latter two drive up import costs. **If the Fed is forced to raise policy rates sharply to douse inflation (also boosting the dollar and hammering stocks), a recession could occur, possibly in 2020**.

Bottom Line: Don't fear the recession reaper this year. But if inflation heats up because of the extra fiscal coals tossed on the fire, the expansion could fizzle out late next year or in 2020. Investors would be wise to keep a close eye on the inflation embers for signs of sparks.

Chart 4
Working on the Next Downturn

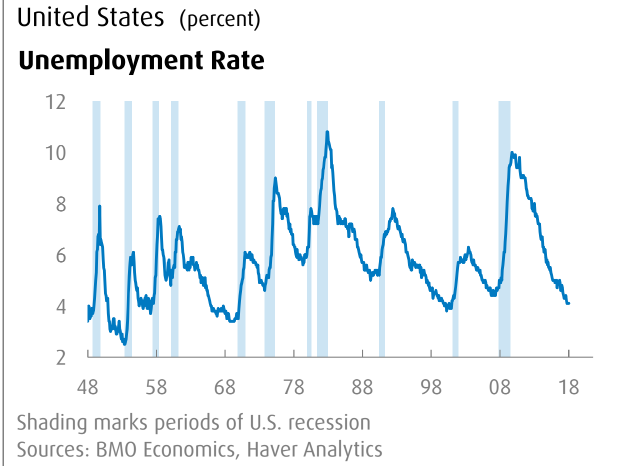


Chart 5
Yield Curve Far from Inverted

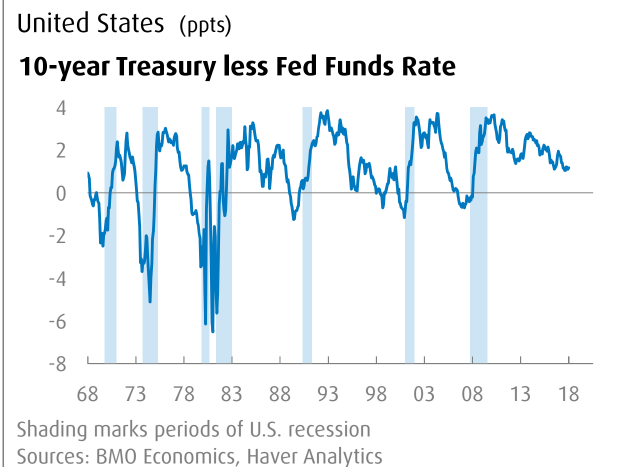
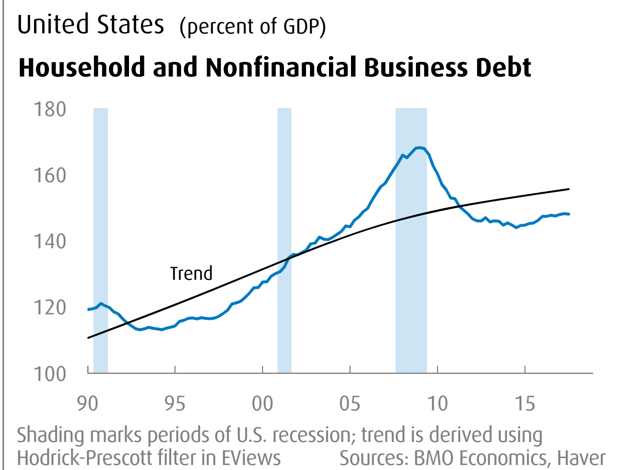


Chart 6
Debt Manageable



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