SUMMARY

The economic expansion will turn nine years old this June and become the second oldest in U.S. history. But while this expansion may be old in years, it’s still young at heart. While it’s reasonable to start asking when this aging economy will slow down, we don’t see any signs that a downturn is likely within the next two or three years.

Of course, expansions don’t die of old age; there needs to be a specific cause. Economists look at many different trends to search for bubbles or other factors that could indicate slowing growth ahead. Here are five important indicators that show why we don’t think a downturn is likely within the next two or three years.

1. Wage growth is still low

Although unemployment is hitting record lows, American workers are still not seeing their wages rise very quickly. Wages grew by 2.5% as of the fourth quarter 2017 and by 2.9% in January 2018. In the past, annual wage growth has been in the range of 4% (and as high as 8%) before sparking a downturn. The Federal Reserve is unlikely to hit the brakes on the economy until wage growth gets closer to (or exceeds) 4%.1

There is also good reason to believe that the January 2018 year-over-year rise could ease in the next month or two since it was heavily influenced by one-time increases in minimum wages and by inclement weather that prevented some lower wage earners from going to work, according to the Bureau of Labor Statistics.

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1As of January 2018, wages for total private payrolls grew 2.9% on a year-over-year basis and grew 2.4% year-over-year for production and nonsupervisory workers (an alternative measure of wages). Data is provided by the Bureau of Labor Statistics (BLS).
2. Mortgage debt is reasonable

The total amount of U.S. mortgages is approaching levels last seen during the 2008–2009 recession, which makes some people fear that history is repeating itself. But the U.S. economy is much larger now. Compared to the size of our economy, total mortgage debt is more reasonable—just 76% of GDP, compared to more than 100% before the Great Recession in 2008.

![TOTAL U.S. MORTGAGE DEBT TO GDP, 1951–2017](source: U.S. Federal Reserve, February 2018)

3. Household debt is under control

Like mortgages, the amount of U.S. household debt (including mortgages, auto loans, credit cards and other personal loans) can be alarming at first glance. Americans now owe more than $13 trillion, which is more than during the Great Recession. However, household income has risen, too, making this debt more manageable. Household debt is just 80% of personal income, well below the previous peak seen in 2007.

![U.S. HOUSEHOLD DEBT TO PERSONAL INCOME, 1952–2017](source: U.S. Household Debt (Board of Governors of the Federal Reserve System); Personal Income (Bureau of Economic Analysis), February 2018)
4. Corporate debt is high but understandable

Somewhat more disturbing is the amount of bonds and other debt securities issued by nonfinancial corporations. There is now more than $6 trillion of U.S. nonfinancial debt outstanding. Even as a share of GDP, this is an all-time high. However, because interest rates are so low, interest payments haven't risen as much and many companies have extended maturities. So while high corporate debt bears watching, we don’t believe it presents an imminent threat as yet.

5. Housing prices do not appear to be in a bubble

Finally, some people are concerned about the run-up in U.S. housing prices, which played a major role in the Great Recession. Housing prices have risen 31% since the end of the recession in 2009. However, this doesn’t take into account the rising cost of living. Adjusted for inflation, housing prices have risen only 16%—far less than the 33% jump prior to the previous recession.
LATE-CYCLE INVESTING

Given the maturing age of the economic expansion, how should investors position their portfolios?

Even though we’re late in the economic cycle, we believe there is still money to be made in the stock market. Research shows the later stages of an expansion can see some of the biggest stock market gains, as much as 20%–30% of overall market growth. The front-loaded tax cuts passed last year should add up to 0.5% to U.S. economic growth and boost U.S. corporate profit growth by more than 10% above estimates made prior to the passage of tax reform in 2018. Gains will be offset to some extent by the Fed’s expected three interest rate hikes this year.

While U.S. price/earnings ratios may appear high, they merely reflect the strong fundamentals of a U.S. economy that shows no signs of slowing down. As valuations continue to rise, however, investors may want to transition away from companies with the potential for disruption in a recessionary environment.

ATTRACTIVE INTERNATIONAL MARKETS

This could be a good time to reposition your portfolio by shifting more of your assets overseas. Many developed markets such as Germany, France and Japan are in an earlier stage of recovery than the U.S. economy, which means their expansions could still have longer to run.

Japan’s economy grew 2.5% in the third quarter, which is particularly remarkable due to its aging population. Eurozone growth of 2.5% also exceeded expectations. The European Central Bank is expected to maintain its quantitative easing through 2018—and keep interest rates low even longer—which should continue to fuel Europe’s recovery.

Stock market valuations are also more attractive in many international markets than for S&P 500 companies—about 20% lower in Europe and Japan, and 30% lower in some emerging economies. This could potentially extend the duration of their bull markets and reduce the risk of market declines. Although China is currently tightening credit, its economy is still likely to grow by about 6.4% or more during 2018—which would be extraordinary growth for any other major country.

WHAT THIS MEANS FOR YOU

Now more than ever, international diversification may make sense. While the global “rising tide” is lifting boats around the world, some countries are at an earlier stage of the economic cycle than others. Gradually repositioning your portfolio could enable you to continue reaping the benefits of the robust U.S. expansion while anticipating future growth in other markets that are just catching up.
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