Business Cycle's Demise Greatly Exaggerated

May 2019

Lakshman Achuthan
Co-Founder

A proposition has taken shape that the Fed has eliminated business cycles through quantitative easing (QE) and unconventional monetary policy. As a result, we have credit cycles that can prolong the economic expansion – in theory – forever.

I've been studying business cycles for my entire adult life, and at ECRI our conclusion is that business cycles are part and parcel of every market-oriented economy, and that has not changed since the Industrial Revolution began in 1780s Britain.

Now clearly, the idea of no more business cycles is seductive. ▶ ▶

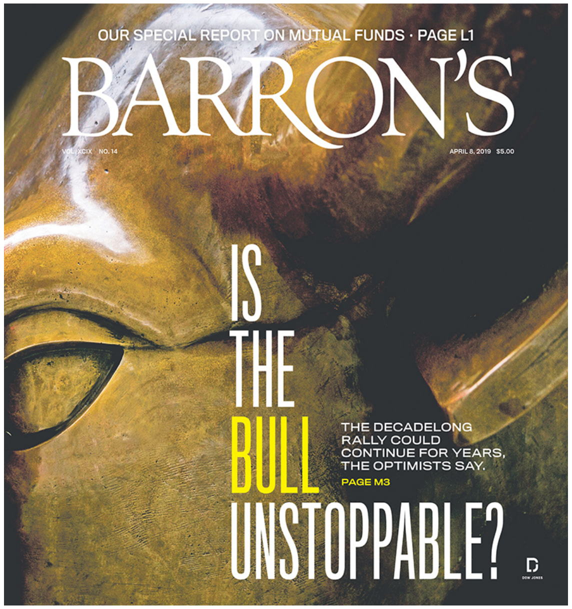
ECRI

"I don't see a world in which we have any form of meaningful contraction... We have completely taken away the toolkit of how normal economies should work when we started with QE. ... [T]he odds that there's a recession anymore in any Western country of the world is almost next to impossible now, save a complete financial externality that we can't forecast."

– Venture Capitalist Chamath Palihapitiya, April 30, 2019, CNBC

And arguments along these lines have been appearing more frequently of late.

Here's venture capitalist Chamath Palihapitiya on CNBC: "I don't see a world in which we have any form of meaningful contraction… We have completely taken away the toolkit of how normal economies should work when we started with QE… A recession in any Western country is next to impossible now." ▸ ▸



"We are all used to using the word 'cycle'; we're all used to looking at historical charts and graphs and equations and relationships… The reality is that maybe the word 'cycle' is no longer even relevant, given that we have so much unconventional central-bank involvement. … We have these little mini-cycles that are continuously occurring, and they seem to coincide with central-bank policy."

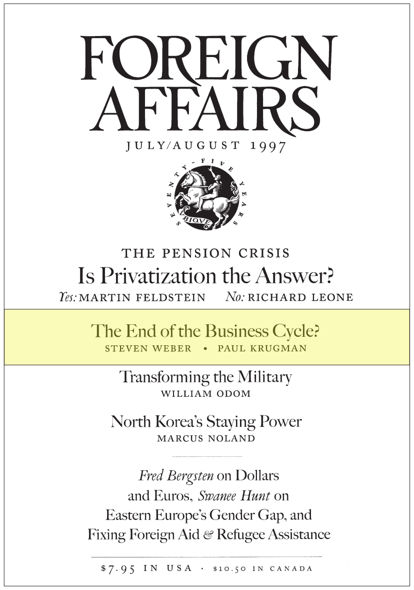
– Dubravko Lakos-Bujas, Chief U.S. Equity Strategist, J.P. Morgan *Barron's*, April 5, 2019

A recent *Barron's* cover story explained how a J.P. Morgan strategist now questions the very "existence" of the business cycle, saying, "maybe the word 'cycle' is no longer even relevant." Because, for the past decade, central banks have kept policy accommodative as inflation has remained low, he says, "We have these little mini-cycles, and they seem to coincide with central-bank policy."

In a sense, he's saying, the Fed's role these days is to do "whatever it takes" to encourage so much borrowing that it subverts the normal business cycle.

In other words, debt overrides all other drivers of the business cycle.

Of course, this isn't the first time the durability of the business cycle has been questioned. ▸ ▸



FOREIGN AFFAIRS

JULY/AUGUST 1997

THE PENSION CRISIS

Is Privatization the Answer?

Yes: MARTIN FELDSTEIN *No:* RICHARD LEONE

The End of the Business Cycle?

STEVEN WEBER • PAUL KRUGMAN

Transforming the Military

WILLIAM ODOM

North Korea's Staying Power

MARCUS NOLAND

Fred Bergsten on Dollars and Euros, *Swanee Hunt* on Eastern Europe's Gender Gap, and Fixing Foreign Aid & Refugee Assistance

$7.95 IN USA · $10.50 IN CANADA

FOREIGN AFFAIRS

ESSAY July/August 1997 Issue United States Economics

The End of the Business Cycle?

By *Steven Weber*

WAVES TO RIPPLES

Western political economy since the Industrial Revolution has been a vibrant world of rapid growth and development, at least for countries in the industrial "core." But it has also been a world of continuing and sometimes enormous fluctuations in economic activity. Business

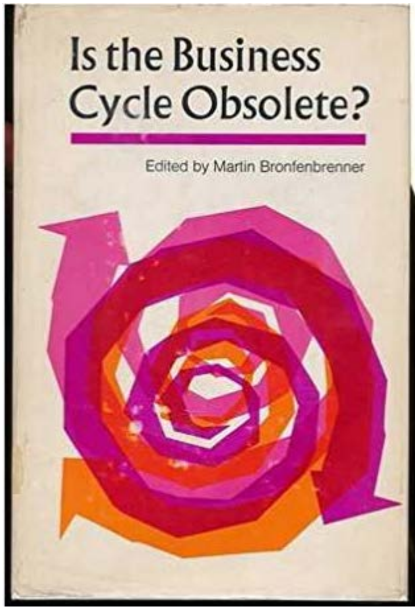
In the late 1990s, during what is still the longest expansion in U.S. history, the idea of the end of the business cycle went practically mainstream, being written up in *The Wall Street Journal* and *Foreign Affairs*.

Between globalization and the tech boom – which led to dramatic improvements in supply chain management, subduing inventory cycles – the argument went that we had arrived at the end of the business cycle, following the "end of history" proclaimed by Francis Fukuyama.

It may be hard to remember, but such thinking became so dominant that following the tech bust, Cisco CEO John Chambers asserted that "the brightest people in the world didn't see [the recession] coming."

Evidently, we at ECRI were not included in that group.

And during the previous longest economic expansion on record, in the late 1960s, similar views took hold. ▶ ▶



“The answer to the question ‘Is the business cycle obsolete?’ is, in general, affirmative … [In] contemporary cycles … economic growth rates oscillate, but seldom fall below zero.”

“[I]f the policy prescriptions of the [Keynesian] New Economics were applied, business cycles as they had been known would be a thing of the past.”

– Martin Bronfenbrenner, 1969

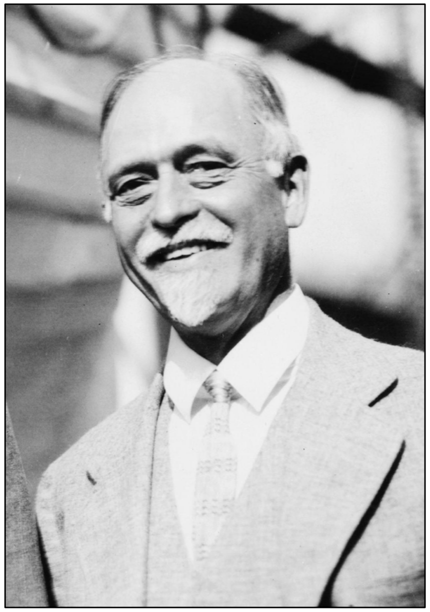
The idea that Keynesian fine-tuning could repeal the business cycle was so prevalent among economists that a whole volume on this theme was published in 1969.

It was not just academics.

A couple years earlier, the Commerce Department had started publishing the Index of Leading Economic Indicators, developed by my late mentor and ECRI co-founder, Geoffrey H. Moore. In that context, they introduced a monthly publication called “Business *Cycle* Developments,” or BCD for short.

But, with the business cycle supposedly obsolete, it soon changed the name of that publication to “Business *Conditions* Digest,” while retaining the acronym BCD.

On cue, in December 1969 the next recession began. ▸ ▸



"The nation is marching along a permanently high plateau of prosperity."

– Prof. Irving Fisher, October 23, 1929

As you may recall, 40 years earlier in October 1929, Yale economics professor Irving Fisher proclaimed that the nation was marching along a permanent plateau of prosperity.

That was just days before the crash of '29, and a couple of months into what turned out to be the Great Depression.

In the current iteration of this theme – that we'll never see another recession again – the idea is that debt conjured up by the Fed will override the business cycle.

But people seem to be forgetting the Red Queen Effect. ▶ ▶

The Red Queen Effect

"Now, *here*, you see, **it takes all the running *you* can do, to keep in the same place**. If you want **to get somewhere else, you must run at least twice as fast** as that!"

– The Red Queen in *Through the Looking Glass* by Lewis Carroll

Where it takes all the running you can do to stay in the same place – and you need to run twice as fast to get anywhere.

But it's more than that.

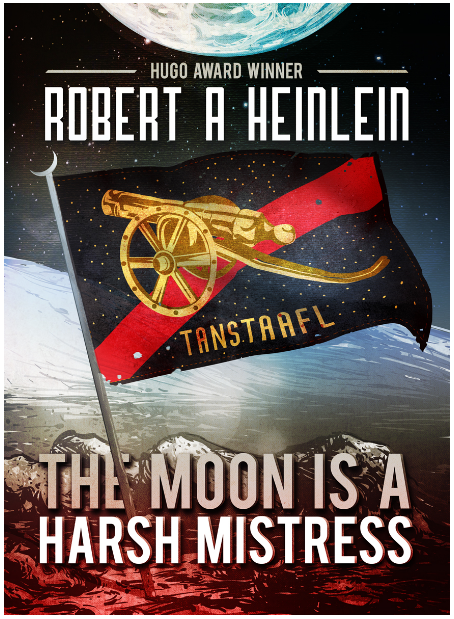
The situation today requires running faster and faster – twice as fast, three times as fast, four times as fast, and so on. It just keeps ratcheting up.

This is why the combined debt of the U.S., Europe, Japan and China has risen more than *ten times* the rise in their combined GDP over the past year.

In the next round, we'll need even *more* debt growth to get the same GDP boost.

Eventually, incomprehensible amounts of debt growth may be needed to sustain growth, supposedly with no payback or consequences.

And I can't help recalling another classic book. ▸ ▸



TANSTAAFL: "There ain't no such thing as a free lunch."

"[A]nything free costs twice as much in the long run or turns out worthless."

Robert Heinlein's *The Moon is a Harsh Mistress*, which introduced TANSTAAFL, meaning "There ain't no such thing as a free lunch."

Because, as Heinlein makes clear, "anything free costs twice as much in long run or turns out worthless."

Milton Friedman later corrected Heinlein's grammar when he titled his 1975 book, *There's No Such Thing as a Free Lunch*.

I think we can all agree that the idea of staving off recession indefinitely by pulling demand from the future, with no payback, essentially amounts to a free lunch.

But here's the thing. Over the course of a century, our research group has been investigating the very question, under what circumstances are business cycles eliminated?

I'll tell you what we've found.

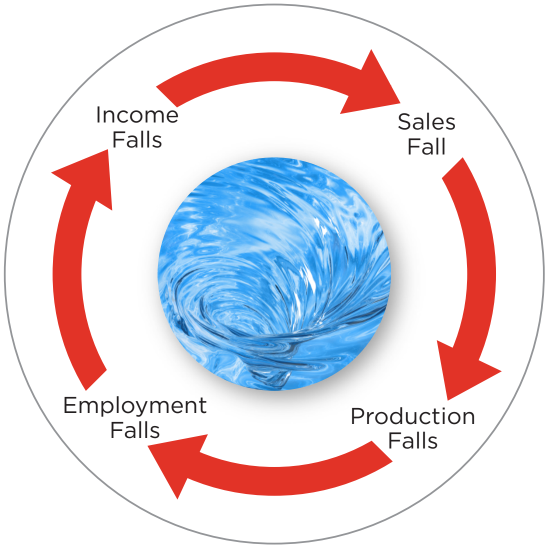
First, business cycles don't exist outside of market-oriented economies, so centrally-planned economies, like the former Soviet Union, didn't have them.

But, the business cycle can also be overridden in certain circumstances where the primary driver is weather, like the monsoons in India half a century ago when agriculture dominated, or when the economy is dominated by war and peace, like Jordan in the 1960s and '70s, or Syria today.

With these exceptions, the business cycle remains part and parcel of every market-oriented economy.

We know this because we've looked at cycles in dozens of economies around the world. ▸ ▸

A Recession Is a Vicious Cycle



- Under recessionary conditions, a weakening economy triggers *cascading declines* in output, employment, income, and sales.
- Two back-to-back negative GDP prints is *neither a necessary nor a sufficient condition* for recession.

But first, let's answer a basic question, what is a business cycle?

That was addressed by Geoffrey Moore's mentor, Wesley Mitchell, a century ago. Business cycles consist of alternating periods of economic expansion and recession. So what's a recession?

A recession is a specific sort of vicious cycle. Under certain circumstances, a decline in, say, overall sales in the economy triggers a decline in overall output, like GDP and industrial production, which, in turn, under certain circumstances, sets off a decline in employment and in turn income, which feeds back into a further decline in sales. These cascading declines spread like wildfire from industry to industry and region to region.

This vicious cycle is what we call a recession, and often times, it's accompanied by two successive quarterly declines in GDP, but that's neither a necessary nor a sufficient condition for recession. For example, the 2001 recession saw millions of jobs lost, but not two back-to-back negative GDP prints.

But at some point, with or without the help of the Fed, the cycle flips and becomes a virtuous cycle – a self-feeding economic expansion. ▶ ▶

ECRI

Business Cycle Peak and Trough Dates, 21 Countries, 1948-2018

Period	Peak or Trough	AMERICAS				EUROPE								
		United States	Canada	Mexico	Brazil	Germany	France	United Kingdom	Italy	Spain	Switzerland	Sweden	Austria	Russia
1948-1950	P	11/48												
	T	10/49												
1951-1952	P													
	T							8/52						
1953-1955	P	7/53	5/53											
	T	5/54	6/54											
1956-1959	P	8/57	10/56				11/57							
	T	4/58	2/58				4/59							
1960-1961	P	4/60												
	T	2/61												
1962-1966	P					3/66			1/64					
	T								3/65					
1967-1968	P													
	T					5/67								
1969-1973	P	12/69							10/70			10/70		
	T	11/70							8/71			11/71		
1973-1975	P	11/73				8/73	7/74	9/74	4/74		4/74	7/75	8/74	
	T	3/75				7/75	6/75	8/75	4/75				6/75	
1976-1978	P													
	T										3/76	11/77		
1979-1980	P	1/80				1/80	8/79	6/79	5/80	3/80		2/80	2/80	
	T	7/80					6/80							
1981-1983	P	7/81	4/81	3/82			4/82				9/81			
	T	11/82	11/82	7/83	12/83	10/82		5/81	5/83		11/82	6/83	1/83	
1984-1986	P			10/85										
	T			11/86			12/84			5/84				
1987-1988	P				2/87									
	T				7/87									
1989-1991	P	7/90	3/90		8/89	1/91		5/90		11/91	3/90	6/90		
	T	3/91												
1992-1994	P			10/92			2/92		2/92				4/92	
	T		3/92	10/93	3/92	4/94	8/93	3/92	10/93	12/93	9/93	7/93	6/93	
1994-1996	P			11/94	3/95						12/94		5/95	
	T			7/95	9/95						9/96		3/96	11/96
1997-1999	P				10/97									12/97
	T				4/99									1/99
2000-2001	P	3/01		8/00	2/01	1/01					3/01		1/01	
	T	11/01			12/01								12/01	
2002-2003	P				10/02		8/02							
	T			8/03	6/03	8/03	5/03				3/03			
2004-2010	P	12/07	1/08	4/08	8/08	4/08	2/08	5/08	8/07	2/08	5/08	4/08	2/08	5/08
	T	6/09	7/09	5/09	1/09	1/09	2/09	1/10	3/09		5/09	3/09	6/09	5/09
2010-2011	P						4/11		4/11					
	T													
2012-2016	P				1/14									12/14
	T				10/16		11/12		10/14	7/13				5/16

SOURCE: Economic Cycle Research Institute (ECRI) **www.businesscycle.com** NOTE: Shaded cells represent periods for which data are not available.

February 2019

Economic Cycle Research Institute

1/2

It's on the basis of this definition that Geoffrey Moore single-handedly determined U.S. business cycle dates for 30 years through 1978, on behalf of the National Bureau of Economic Research, and was then the senior member on its Business Cycle Dating Committee until he passed away in 2000.

And for decades, ECRI has used the same approach to date cycles for all the major developed and developing economies.

So, we know that it's not uncommon for economic expansions to last a decade or more.

And not only in Australia, which everyone talks about. In the post-World War II period, Japan and the major European economies also had multi-decade expansions.

Subsequently, they've also had plenty of recessions. ▶ ▶

ECRI

Business Cycle Peak and Trough Dates, 21 Countries, 1948-2018

Period	Peak or Trough	ASIA-PACIFIC							AFRICA
		Japan	China	India	Korea	Australia	Taiwan	New Zealand	South Africa
1948-1950	P								
	T								
1951-1952	P					6/51			
	T					9/52			
1953-1955	P	1/53				12/55			
	T	12/54							
1956-1959	P								
	T					8/56			
1960-1961	P					12/60			
	T					9/61			
1962-1965	P			11/64					
	T			11/65					
1966-1968	P			4/66				6/66	
	T			4/67				3/68	
1969-1973	P			6/72					
	T			5/73					
1973-1975	P	11/73		11/73		6/74	12/73	4/74	
	T	2/75		2/75		1/75	1/75	3/75	
1976-1978	P							3/77	6/76
	T							3/78	11/77
1979-1980	P			4/79	3/79				
	T			3/80	10/80				
1981-1983	P					6/82		4/82	11/81
	T					5/83		5/83	1/83
1984-1986	P							11/84	6/84
	T							3/86	2/86
1986-1989	P		8/88					9/86	2/89
	T		12/89						
1990-1991	P			3/91		6/90			
	T			9/91		12/91		6/91	
1992-1994	P	4/92							
	T	2/94							8/92
1994-1997	P			5/96					
	T			11/96					
1997-1999	P	3/97			8/97			10/97	4/97
	T	7/99			7/98			5/98	11/98
2000-2003	P	8/00			12/02		8/00		
	T	4/03			9/03		9/01		
2004-2010	P	2/08			7/08		2/08	11/07	4/08
	T	3/09			12/08		1/09	5/09	4/09
2010-2011	P	8/10						5/10	
	T	4/11						10/10	
2012-2013	P	1/12							
	T	1/13							
2014-2015	P	3/14							
	T	8/14							

SOURCE: Economic Cycle Research Institute (ECRI) **www.businesscycle.com** NOTE: Shaded cells represent periods for which data are not available.

February 2019

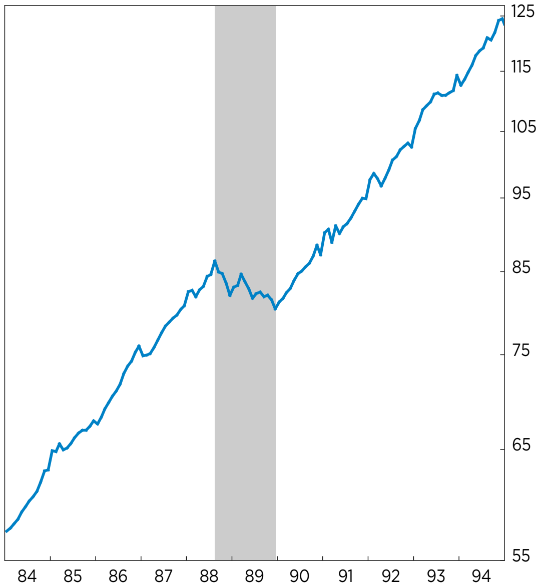
Economic Cycle Research Institute

 2/2

It's hard to see, but you can download a PDF of all these cycle dates from businesscycle.com.

This next slide shows that China had a recession three decades ago. ▸ ▸

Chinese Coincident Index



China experienced a full-blown business cycle recession in 1988-89.

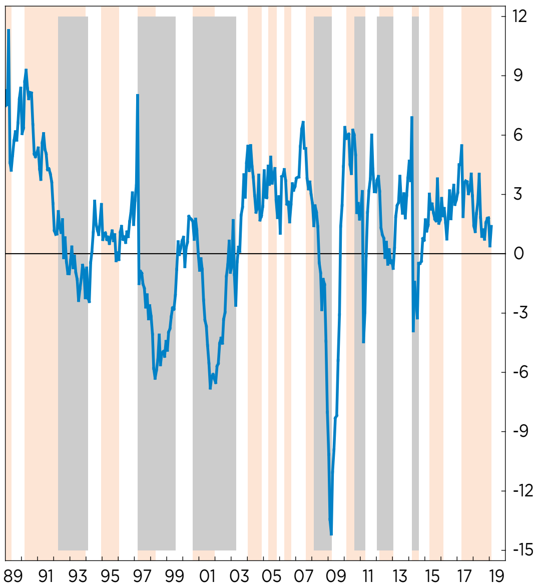
It may be no coincidence that the events of Tiananmen Square took place in the spring of 1989.

By the late 1980s China's economy was sufficiently market-oriented to have a full blown business cycle recession from August 1988 to December 1989.

It may not be a coincidence that the events at Tiananmen Square occurred in the spring of 1989.

Since then China hasn't had a recession, but Japan, which had been flying high, entered a period of frequent recessions. ▶ ▶

Japanese Coincident Index, Growth Rate (%)



Japan has experienced three recessions *after* the Global Financial Crisis.

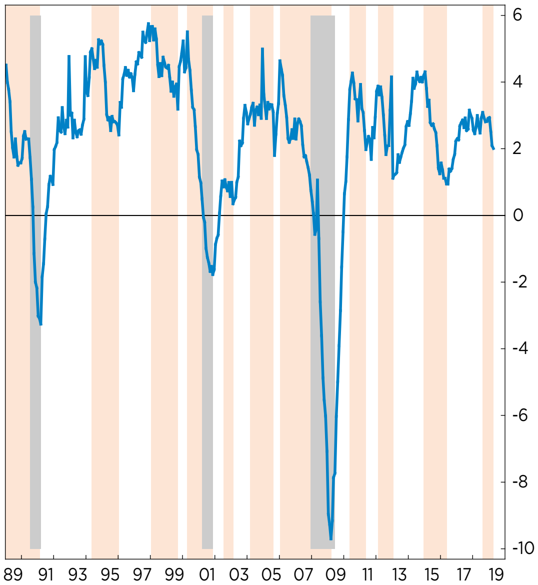
Gray-shaded areas mark off Japanese business cycle recessions. Orange-shaded areas are Japanese growth rate cycle downturns.

Following two recessions in the 1990s, it entered another recession in 2000, after which QE was first instituted in 2001.

After the Global Financial Crisis (GFC), QE was reintroduced. Despite that and QQE and Abenomics, Japan has since experienced three full-blown recessions, with the last one coming in 2014 – the year *after* Abenomics was launched.

Six years ago ECRI wrote about how the U.S. and Europe were on the road to "becoming Japan," and that looks even more likely today. ▶ ▶

U.S. Coincident Index, Growth Rate (%)



The U.S. is in its *fourth* growth rate cycle downturn since the Great Recession.

Such growth rate cycle downturns that did not end in recession were not uncommon before the Great Recession.

Gray-shaded areas mark off U.S. business cycle recessions. Orange-shaded areas are U.S. growth rate cycle downturns.

Many don't realize that the U.S. is in its fourth growth rate cycle downturn since the Great Recession. Growth rate cycles consist of alternating periods of accelerating and decelerating growth – once again measured by output, employment, income and sales – marked off by these orange-shaded areas.

To be clear, a recession – marked off by the gray-shaded areas – occurs when a growth rate cycle downturn takes growth into negative territory, and that hasn't happened in a decade. But so what?

Remember, our work on international recession chronologies shows that multi-decade economic expansions in market-oriented economies are nothing new.

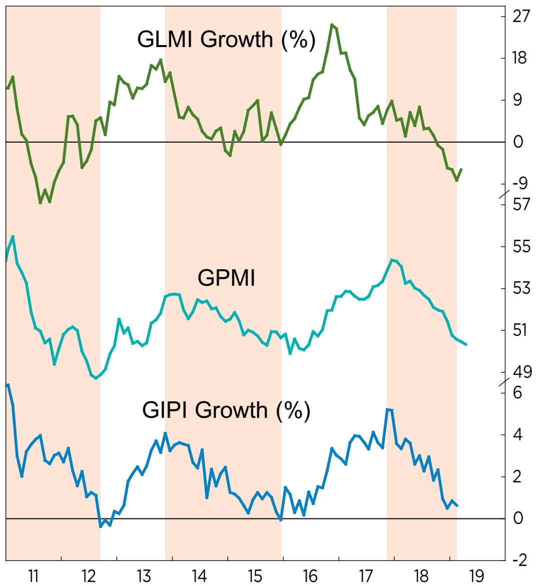
Before turning to ECRI's leading indexes, I'd like emphasize a key point. Human nature has not changed – in particular, fear and greed. And the institutional structure of market-oriented economies helps channel those emotions and impulses into economic cycles.

For all the unconventional policy choices, this underlying architecture remains intact. How do we know this?

We know this because we continue to see these growth rate cycles – accelerations and decelerations in U.S. economic growth – despite all the departures from conventional policy. Even before the financial crisis, growth rate cycle downturns that *didn't* end in recession were not uncommon. So this isn't really new.

Moreover, as before, our leading indexes are able to see these cyclical downturns coming. ▶ ▶

Indicators of Global Industrial Growth



Because the PMI data started looking weaker around the time the trade war began in early 2018, many blamed the global slowdown on the trade tensions.

But Global Leading Manufacturing Index growth turned down *well before* the Global PMI and Global Industrial Production Index (GIPI) growth.

Orange-shaded areas represent cyclical downturns in GIPI growth.

The received wisdom today is that the key determinants of the economic outlook are Fed policy and, over the past year or so, the trade war with China.

So, while the trade war certainly hurts economic growth, the consensus believes that, given the Fed's policy U-turn, not only is any recession risk off the table, but also a second half reacceleration in growth is supposedly assured – meaning that global and U.S. growth prospects are all about these two things. And that's at the root of this year's risk-on trade.

ECRI's leading indexes tell a different story.

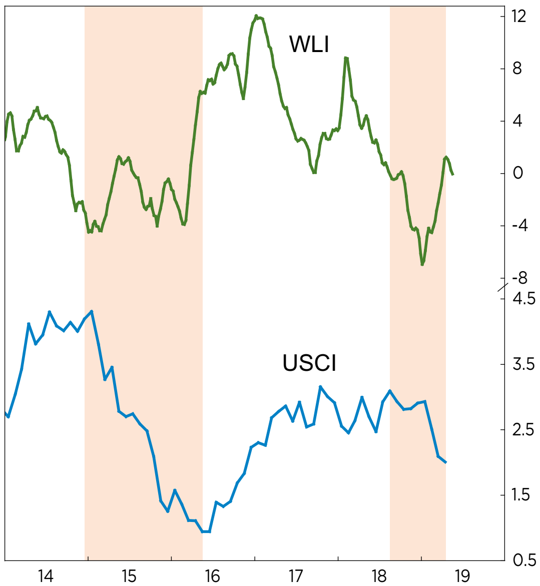
Please note the Global Manufacturing PMI – that's the middle line in this chart. Around when the trade war started early last year, it also started looking weaker, so most people misattributed the global industrial slowdown to the trade war.

But ECRI's Global Leading Manufacturing Index (GLMI) growth – that's the top line – turned down well ahead of the Global PMI and the hard data – Global Industrial Production Index growth – that's the bottom line.

In other words, the GLMI shows that the cyclical downturn in global industrial growth was baked in the cake *before* the trade war. And GLMI growth is still in a cyclical downturn.

Zooming in on the U.S. ▸ ▸

Weekly Leading Index & U.S. Coincident Index Growth (%)



U.S. Coincident Index growth has declined to a 29-month low.

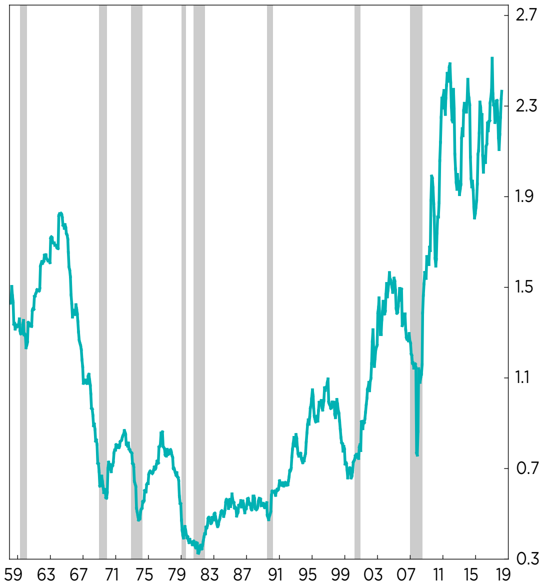
Its downturn followed the downturn in Weekly Leading Index growth, which has firmed on the back of this year's risk-on trade, but may be rolling over.

The blue line at the bottom of this chart shows the current downturn in the growth rate of our U.S. Coincident Index, which includes the broad measures of output, employment, income and sales – the same indicators that determine recession. Please note that it's fallen to a 29-month low.

That downturn was anticipated by the downturn in ECRI's Weekly Leading Index (WLI) growth – the top green line. Having firmed on the back of the risk-on trade this year, WLI growth *may* be starting to roll over, but we'll wait and see what happens.

I've already made the case that the business cycle is alive and well. But I'd like to show you how the point about the role of credit in the markets also makes a certain amount of sense to us. ▸ ▸

Ratio, Capitalized Profits to GDP



Capitalized profits is the ratio of corporate profits to corporate bond yields – the net present value of future corporate profits.

Thus, it is a stock price valuation measure that accounts for the low interest rates.

With interest rates so low, the ratio of capitalized profits to GDP has been super-sensitive to interest rates in the years following the financial crisis.

Shaded areas represent U.S. recessions.

One measure of equity market valuation we use is capitalized profits, which is the ratio of corporate profits to corporate bond yields – a kind of net present value of the future stream of profits.

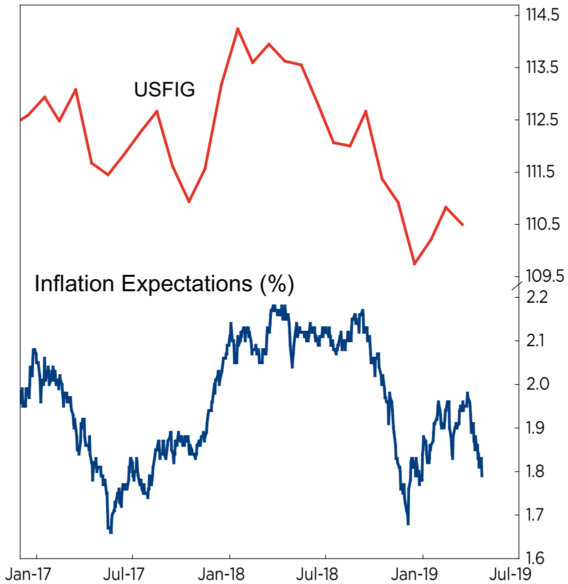
When you look at the ratio of capitalized profits *to GDP*, following the financial crisis it's become much more volatile, as seen at the far right side of the chart. In fact, it's been very sensitive to interest rates, and to what the Fed does because of how low rates have been over the past decade.

In this sense, we acknowledge the importance of credit cycles in the post-GFC period.

In other words, the Fed is a big deal for stock market *valuation*. But that is not the same issue as the business cycle outlook.

So, what insights can we offer about where the Fed is headed? ▸ ▸

Forward-Looking Measures of Inflation



The U.S. Future Inflation Gauge turned down in early 2018, before the downturns in both the hard data on inflation and inflation expectations.

It remains in a cyclical downturn, indicating that an inflation cycle upturn is not yet in sight.

ECRI's U.S. Future Inflation Gauge (USFIG) leads inflation cycle turning points – and in fact, it also leads inflation expectations.

As you see, the USFIG turned down early last year, and by summertime it was clear to us that a fresh inflation cycle downturn would soon take hold.

Certainly, that wasn't obvious to the *Fed*, which hiked in September and December.

And the fixed income markets were also caught flat-footed, with inflation expectations remaining high through late fall.

It's notable that today the USFIG remains in a cyclical downturn. ▶ ▶

Conclusion

- The business cycle is alive and well, despite central bank interventions.
- Those interventions are reactive, driven by cycles in growth and inflation.
- The global industrial slowdown is not over, and the inflation cycle is still in a downswing.

In conclusion, I'll say again that the business cycle is alive and well, despite central bank interventions.

But those interventions are reactive, and driven by cycles in growth and inflation.

On that score, please note that the current global industrial slowdown is not over – regardless of the course of the trade war – and the inflation cycle is still easing. ■

Thank you.

Economic Cycle Research Institute
businesscycle.com

Follow us on Twitter
twitter.com/businesscycle