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AT THE MARGINS

Current Expansion Could be Longest in a Century, But How Long Can it Last?

Continued Rate Raises May Push the Country into a Recession, or Bring About a Soft Landing

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The current economic expansion is one of the lengthiest in history. If the U.S. makes it to June of next year without a recession, the upturn will reach 10 years. That would exceed the 1991-2001 expansion to become the longest since at least the 1850s, according to records maintained by the National Bureau of Economic Research.

The consensus view of economists expects 2018 GDP growth to be the fastest yet in this cycle. The economy advanced at a 3.5 percent pace in the third quarter, following a 4.2 percent gain in the prior three months. Consumer spending, which accounts for about three-quarters of the economy, accelerated at a 4 percent rate, the best since 2014. Meanwhile, businesses continued to restock inventories, providing the biggest contribution in almost four years.

Purchasing managers are positive about business conditions, according to the Institute for Supply Management. Respondents to the institute's monthly survey say that order activity remains strong in industries such as retail trade, health care and metal products. A number of companies report that plants are running at full speed.

At the same time, cost pressures are rising due to tariffs and transportation capacity issues. In response, manufacturers and retailers are raising prices in an effort to maintain margins. The closely-watched core PCE index just reached the key 2 percent level for the first time since 2012.

The Federal Reserve has now raised rates eight times in quarter-point increments since embarking on a tightening campaign in late 2015, bringing the overnight rate to a range of 2 to 2.25 percent. The committee projects one more increase in December and three more moves in 2019, with the ultimate goal of taking the target rate to 3.5 percent by 2020. Its last policy statement said further gradual hikes are consistent with maintaining inflation near 2 percent.

Most economists see growth moderating in 2019 and beyond. The main culprits are higher interest rates, fading benefits of tax cuts and ongoing trade disputes. In a November survey of 75 forecasters polled by Bloomberg, GDP growth will log 2.6 percent in 2019 and 1.9 percent in 2020. This compares with 2.9 percent for 2018. These projections are similar to those of Federal Reserve Board members.

'A Long Way from Neutral'

Strategists are speculating about whether continued rate raises by the Fed will push the U.S. into a recession or bring about a soft landing. In past rising rate cycles, for example, the central bank often "overshot" its neutral level, causing demand to slow more than intended. Federal Reserve Chairman Jerome Powell said in October, "We don't need these really extremely accommodative low interest rates any more. We're a long way from neutral." More recently, however, he acknowledged the risks posed by slowing growth abroad and the lagged effects of previous tightenings.

With less benefit from both fiscal and monetary stimulus, the economy is likely to recede from its torrid pace. Some observers believe the Fed will actually be cutting rates within the next two years. Accordingly, financial institutions may wish to start considering strategies which provide earnings protection for a falling rate environment.

Funding. Longer term CDs and wholesale funding will crimp earnings if interest rates drop from current levels. Prior to the last recession, many depositories put on 10-year advances or other similar duration wholesale borrowings. These instruments proved to be a considerable drag on earnings for years. This time around, banks are typically offering CD specials for two years or less. These certificates as well as money market promotions can easily be priced down when conditions change.

Asset extension. Many institutions have transformed their balance sheets to become asset-sensitive and net interest margins have improved as a result. If the market turns, this hard work will be undone. Unexpected events could cause significant volatility in cash flows, potentially leading to faster prepayments that must be put back to work at lower yields. An allocation to fixed-rate, intermediate-term bullet securities can be appropriate, since the investor can retain the "higher yielding" asset throughout the cycle.

Lenders may find that some of their commercial borrowers are willing to pay a higher rate in order to extend their loan term to seven or even 10 years. The bigger coupon should be palatable to accommodate at least a modest allocation, with the extra income compensating for the interest rate risk. Lenders should ensure that prepayment penalties are included as part of the agreement.

Derivatives. An opportune time to buy "insurance" is when prices are low. As the bond market continues to expect that the Fed will raise rates well into next year, interest rate floors have become less expensive. Once sentiment changes, derivative solutions such as interest rate floors will become price prohibitive, taking this option off the table. By way of example, this vehicle produces a net payment to the holder when the reference rate such as LIBOR falls below a target level.

Evaluating these and other options in a timely manner can enable finance officers to proactively manage income over time. Of course, the institution must consider their asset-liability position before making large balance sheet decisions. It is incumbent upon management to maintain robust risk management practices, keeping interest rate risk exposure at comfortable levels.

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