VANDERBILT Ave.
ASSET MANAGEMENT

Emad A. Zikry, President and Chief Executive Officer

Risks That May Derail the Current Economic Expansion

As we approach the 9th anniversary of the end of the last recession, it is natural to ponder what, if anything, can interrupt this expansion? The expansion, coming up on its 105th month, is likely to surpass the expansion of the 1960s, which lasted 106 months. Accordingly, it seems all but certain that the current period will go down as the 2nd longest expansion in post-war history after the 1990s expansion. To put it into historical context, the average post-war expansion has lasted approximately 58 months with a standard deviation of about 35 months (NBER). In other words, by historical standards we're certainly experiencing a rather uncommon economic boom period, though not unprecedented. A popular narrative for the extent of this cycle has been the quality of the expansion. That is, the economy has been expanding at a below potential pace. The table below summarizes historical post-war expansions by duration and performance.

Table 1: Post-war Expansions

Previous Trough	Peak	Months	Average Annual Real Growth
October 1949 (IV)	July 1953(II)	45	7.11%
May 1954 (II)	August 1957(III)	39	4.01%
April 1958 (II)	April 1960(II)	24	5.58%
February 1961 (I)	December 1969(IV)	106	4.85%
November 1970 (IV)	November 1973(IV)	36	5.08%
March 1975 (I)	January 1980(I)	58	4.43%
July 1980 (III)	July 1981(III)	12	4.39%
November 1982 (IV)	July 1990(III)	92	4.33%
March 1991(I)	March 2001(I)	120	3.61%
November 2001 (IV)	December 2007 (IV)	73	2.76%
June 2009 (II)	**Current***	**105**	**2.14%**

*Source: Federal Reserve Economic Data and NBER expansion dates. Calculated as the annualized real growth rate of GDP from trough to peak. *through 4th quarter 2017.*

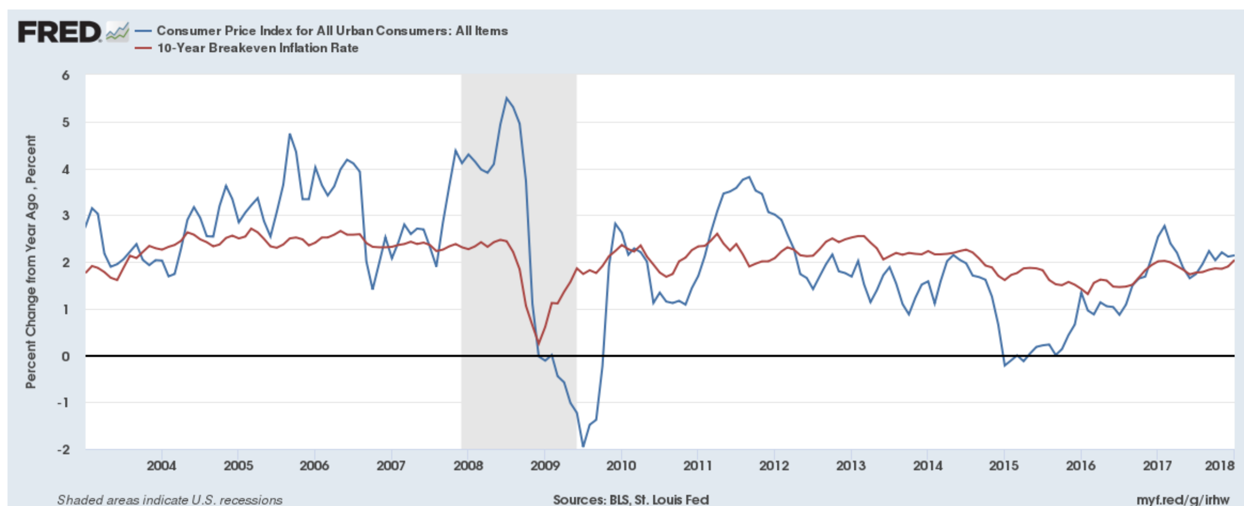
As demonstrated in the table above, the current expansion ranks the lowest in terms of real GDP performance and the third longest (second if including the first quarter of 2018) in terms of duration.

Nonetheless, economic expansions don't die of old age and the current one has been defying all naysayers by consistently delivering positive growth. With that in mind, we outline certain risks that may potentially derail the current expansion should they come to fruition.

Though there are a number of potential scenarios, some of which we have yet to even imagine, that would lead to a deteriorating economic environment, excessive tightening of monetary regimes and rising geopolitical concerns both appear to be real possibilities.

Against the backdrop of a tightening monetary policy, fiscal policy in the United States has turned expansionary. The passage of the recent tax reform is likely to increase deficit spending and provide a stimulus to the economy. The issue, however, is that the stimulus is arriving towards the latter stages of the economic cycle. This has renewed fears of potentially accelerating inflation. The major concern among market participants is that a prolonged surge in inflation, above the Fed's target of 2%, could force the central bank to act more aggressively in order to preserve credibility. By all measures, inflation expectations in the US have remained well anchored. That is, while realized inflation experiences frequent gyrations, expectations remain relatively stable. Evidence for this can be seen in graph 1 below, where we plot the yearly inflation rate (realized inflation) and the 10-year breakeven rate (expected inflation).

Figure 1



Source: Federal Reserve Economic Data

The academic literature often points to central bank credibility as the major reason for this phenomenon indicating that the Fed would likely act to protect its credibility should it be forced to by rising inflation. Unfortunately, there is a trade-off. In order to combat inflation, the Fed needs to raise rates. However, raising rates has the potential to adversely affect the economy. The market will react to any sight of higher than expected inflation. In short, the economy may move towards recession if the Fed raises rates faster than anticipated and chokes the recovery. Furthermore, a coordinated effort on behalf of global financial authorities may exacerbate this risk.

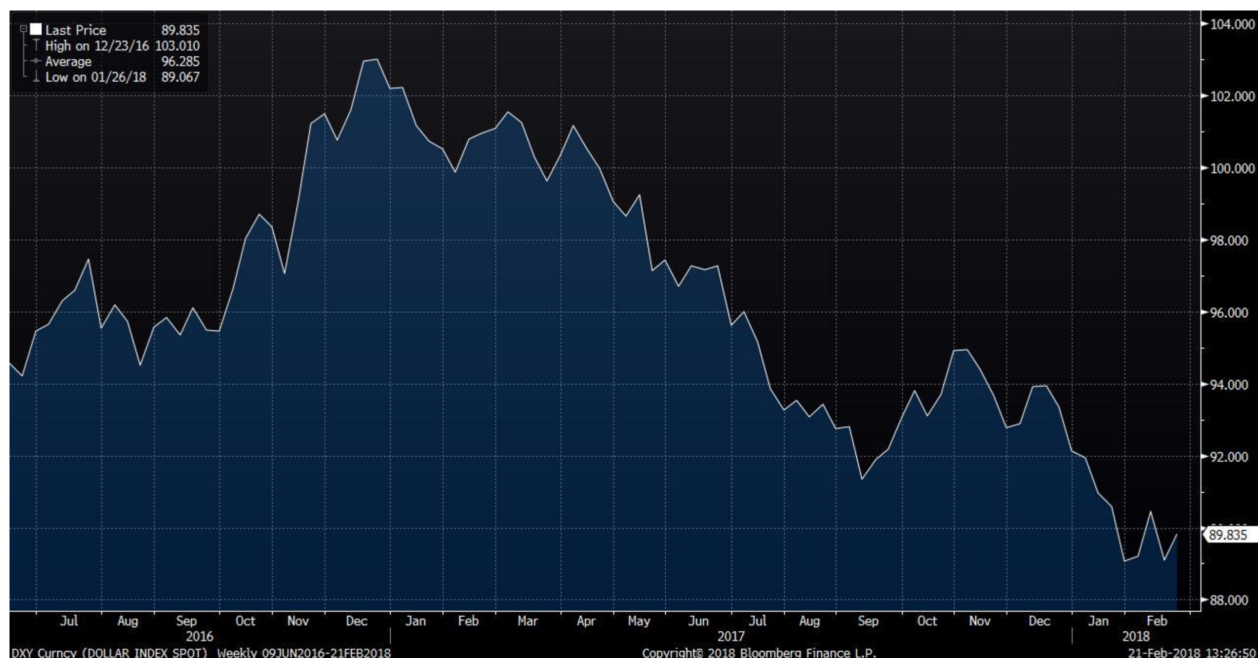
A less quantitative risk is the one posed by growing geopolitical concerns. Geopolitical threats to the expansion are difficult to identify and even harder to predict. Similarly, their impact on the economy may be ambiguous. For this reason, we'll limit our list to broad topics that have grown in significance globally. We view the following topics as significant enough to negatively impact the current expansion:

1) global trade disruptions due to protectionist policy rhetoric
2) escalation of tensions in Asia
3) coordinated tightening by global central banks

A hallmark of the current administration's economic rhetoric has been its' focus on protectionist trade policies. Officials have unnerved markets by their frequent references to renegotiating existing trade deals and the outright pulling out of previously negotiated agreements. Moreover, the administration has made clear its' preference for bilateral trade agreements over multilateral ones. These positions certainly stand in contrast to the status quo on global trade. A potential threat to the expansion lies in the manifestation of this rhetoric into actionable policies that would hinder global trade. A major risk would be to what extent affected countries would retaliate should protectionist policies be pursued, echoing the post-great depression Smoot-Hawley Tariff and its consequences. The act is widely seen as exacerbating the depression by igniting a trade war and diminishing global trade.

The risk of global trade disruptions have yet to manifest themselves in higher dollar index values, which has been on a downward trend since December 2016. This is demonstrated in figure 2 below. Nonetheless, the market has reacted to the administration's statements, with temporary increases typically following increased protectionist policy talk.

Figure 2: Dollar Index

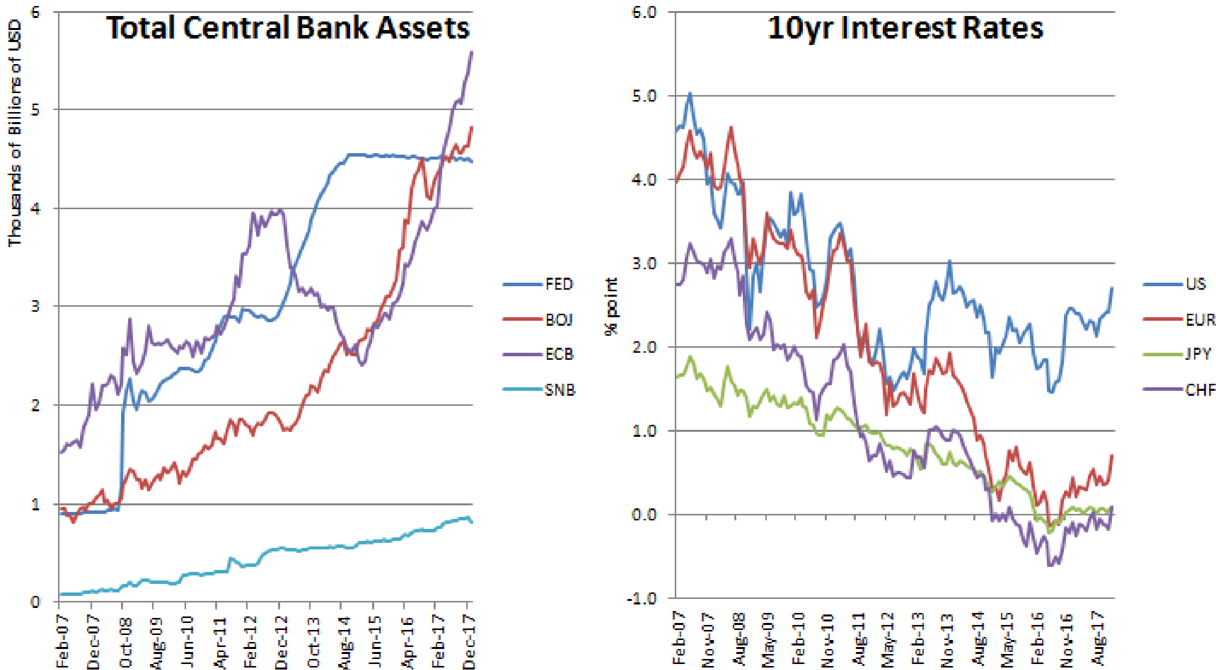


Source: Bloomberg Data

In addition to the impacts from global trade disruptions, rising tensions in Asia pose a threat to the recovery. These tensions could come in the form of potential conflicts due to competing sovereignty claims by Asian States in the South China Sea and/or a deteriorating relationship between the US and North Korea. These risks would potentially be exacerbated by the US' waning influence in the region as a result of its increasing protectionist and isolationist rhetoric. While it is unlikely that State actors would intentionally seek to destabilize the region, it is certain that regional powers will likely fill the vacuum. Accordingly, China's influence in the region may expand to supplant that of the United States. The extent to which this derails the recovery is ambiguous, as they depend on the impact to global trade and investment. Notwithstanding, leading geopolitical risk firm, The Eurasia Group, has listed "China Loves A Vacuum", as its top risk for 2018 (EURASIA 2018[1]).

Lastly, a major global risk to the recovery is related to the extraordinary monetary expansion experienced during the last recession. As the world economy sank, major central banks across the globe began large scale asset purchases and undertook major monetary interventions in an attempt to stimulate their domestic economies. Figure 3 shows the unprecedented scale of the stimulus pursued.

Figure 3: Global Central Bank Stimulus

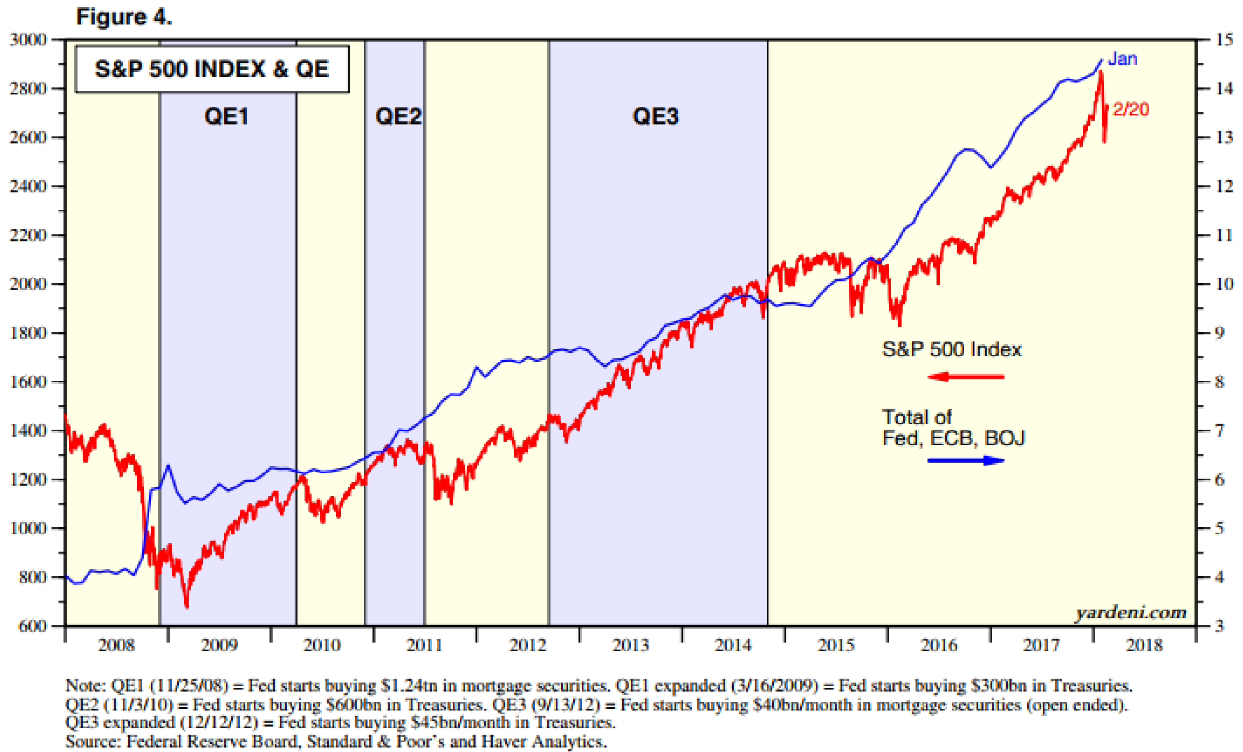


Source: Bloomberg Data

[1] https://www.eurasiagroup.net/issues/top-risks-2018

It is of no surprise that these interventions have coincided with the major rally in equities experienced since the recovery began. Figure 4 below demonstrates how the massive increase in central bank stimulus has been associated with rising equity values.

Figure 4: Central Bank Asset Purchases and US Equity index



Source: Yardeni Research

Accordingly, it is reasonable to think that the withdrawal of monetary stimulus may pose a threat to the economy via either restricting financial conditions or declining asset values inducing negative wealth effects. This impact would be especially pronounced if it is coordinated globally. If major central banks proceed to unwind their balance sheets simultaneously, it is conceivable that adverse impacts would be experienced. While we touch upon this in the previous section, we view the global dimension as an additional risk.

To conclude, as we enter another month of, what is likely to become, the second longest recovery in post-war history, we acknowledge that expansions don't necessarily die of old age. However, they do run the risk of being derailed by excessive monetary tightening and/or growing geopolitical concerns. It is important, as we continue along this expansion, to not lose sight of these risks and avoid overly complacent attitudes.

Elias Scheker
Portfolio Manager

Emad A. Zikry

Chief Executive Officer
Vanderbilt Avenue Asset Management

Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as *The Journal of Forecasting*, *The American Economist* and *The Journal of Fixed Income*. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.