The Daily Dish

The Next Recession

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Eakinomics: The Next Recession

On December 30, 2016, the Dow Jones Industrial Average was 19,762.60, while this past Friday it closed at 25,916.54 — a rise of 31 percent. (One could paint the same approximate image using the Standard & Poors 500, the Wilshire 5000, or any of a number other alternatives.) The sharp rise is in and of itself good news. But as is common, it has also engendered some doomsday commentary. At the same time, the economy has been expanding continually since June 2009, raising fears that the current expansion will falter. What is the right way to think about the near-term outlook?

There are three important points. The first is that there is an important difference between the outlook for financial markets — interest rates and stock prices, for example — and the outlook for the so-called "real economy" — the employment, production, incomes and spending that occur each year. Trying to value a stock on the fundamentals means having a judgment about the (potentially infinite) future of a company's earnings, corporate taxes on those earnings, dividend payout behavior, personal taxes on dividends, interest rates, and myriad other factors. The judgments are revised on a daily basis — that's why prices of financial products fluctuate so much — as investors respond to new hints about the future. One would expect that, over time and on average, financial markets and the real economy would move in the same direction, and they do.

So, point number two is that I prefer to look directly at the real economy. The economy has been accelerating steadily, with year-over-year growth in gross domestic product (GDP) up to 2.8 percent. Moreover, the combination of the Tax Cuts and Jobs Act and Bipartisan Budget Act of 2018 are pumping another 1.3 percent of GDP into spending in 2018 and 0.8 percent of GDP in 2019. On top of the pure spending push, the improved incentives to invest have sharply improved purchases of capital goods. This augurs well for future productivity and the durability of growth. For this reason, I find it unsurprising that a formal model of the probability of a recession based on real economy data currently shows a 0.32 percent probability using data through June. (By contrast, the best formal model that used financial market data — the yield curve — stands at 14.6 percent.) In short, there is not a recession in sight at the moment.

The final point is that predicting the future is not hard, but being right is. The Trump tariff folly could easily escalate into a significant negative. The Fed could make a mistake and tighten too abruptly. Or God-knows-what could transpire. The fact that there can always be bad news is one of the reasons it is so important to grow more rapidly, on average. If the economy is wobbling along at 1 percent growth, almost any bad news can create a recession. Raising the trend to something near 3 percent raises the capacity to absorb the inevitable bad news.