LAWSON KROEKER

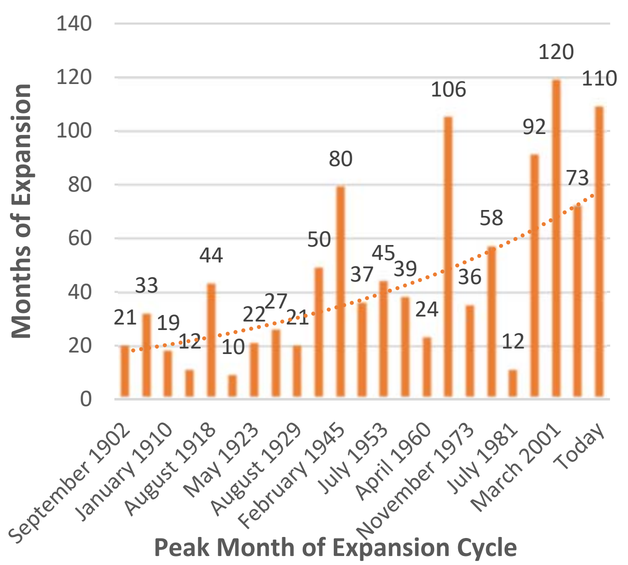
As we see it

"I think it's a myth that expansions die of old age. . . . So the fact that this has been quite a long expansion doesn't lead me to believe that . . . its days are numbered."

- Janet Yellen, Dec. 16, 2015

As we end another quarter, our country marches on for the 110th consecutive month of economic expansion—the second longest expansion since the 1850s. Interestingly, longer expansions have become less the exception and more the rule since the 1980s. But why are expansions going longer? The prior, persistent drivers of economic growth offer less of an explanation in recent years, though technological innovation and an accommodating Federal Reserve has filled in where defense and manufacturing spending once reigned supreme.

Looking at the chart below of prior U.S. economic expansions, the length of expansions has clearly trended up—but would have been even more pronounced if major global conflicts had not driven spending in the periods around major wars.



Whether during the world wars, Korea, or Vietnam, periods of conflict meant one of the economy's key inputs—labor—was often reallocated to other purposes abroad.

Periods of global conflict created a spring effect to the domestic economy—temporarily pushing down growth before its rebounding in the years ahead. Not only was human capital shifted to the wars—but in some instances—raw inputs and finished goods for the civilian economy were redirected to purposes abroad rather than at home. A common solution? Government stimulus to keep the economy moving in the form of defense spending during the war and economic incentives afterwards. Just as the labor supply reentered the market at the end of each war, it was met with years of pent-up demand in the consumer and housing sectors. Add in government stimulus from job creation acts and accommodating loan programs for multitudes of veterans and you have all the ingredients for an economy to move full steam ahead.

So what explains the longer cycles today? Technological innovation and a shift towards a services-based economy have certainly helped drive economic growth. Wars remain, but they have been smaller in scale and have been fought most recently by *labor* already dedicated to the defense sector as drafts have not been called on since the Vietnam War. However, the relative peacetime in the decades to follow the Vietnam War coincided with massive leaps in financial capital backing technological gains. Computers improved information efficiencies and technology increased productivity—whether manufacturing environments were re-tooled, crop yields increased, or computers employed to perform tasks with greater speed than man.

Another factor is undeniably low interest rates—especially stable ones. Lower rates drive economic growth in many ways. Businesses deploy capital, invest in growth, and are willing to finance longer-term projects when rates are low and stable. Jobs are created, and per capita GDP gains drive rising incomes which lead to a wealth effect where individuals not only spend but invest more. When the wealth effect sets in, people buy more goods and services, build bigger houses, and invest more in the stock market—creating a circular effect that reinvigorates itself at each turn. With stable low rates businesses and consumers settle in to a new normal where they worry less about the present and borrow against the future.

Has our economy changed enough that longer economic expansions are here to stay? Or have we stood on the shoulders of an accommodating Federal Reserve more than we realize? Historically, longer expansions were driven by buildouts after major wars rather than developments in technology or service industries. Low interest rates were certainly not present during the economic expansion coming out of the Vietnam War when inflation was rampant. Homes, manufacturing, and both commodity and capital goods were the needs of the time. Supply of those goods had to accelerate and continue to meet demand. Today, housing remains a consistent need—though consistently low mortgage rates have been a larger driver of development than new household formation. Technology continues to improve at ever faster rates, and the Fed's stimulus programs have kept business capital flowing at low rates. We wonder what happens next as the Fed continues rate increases?

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