Program #1348
Broadcast: May 19, 2017

In an exclusive interview, one of Wall Street's top economists, Nancy Lazar explains why the 8 year old U.S. recovery still has a ways to run.

Nancy Lazar
Head of Economic Team
Cornerstone Macro

COPYRIGHT, LEGAL NOTICE AND DISCLAIMER

CONSUELO MACK: This week on WEALTHTRACK, a rare interview with perennially top ranked economist Nancy Lazar on the prospects for the economic recovery, now the third longest on record. Nancy Lazar is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
How long can this economic recovery last without slipping into recession? The longest economic expansion in the U.S. lasted exactly 10 years or 120 months. That was from the trough in the economy in March of 1991 to its peak in March of 2001. According to the National Bureau of Economic Research, or NBER, the current recovery started at the bottom on the last recession in June of 2009 and is still going, 8 years or 96 months later, making it the third oldest on records kept since the 1850's. Does long in the tooth mean a short life ahead? Not necessarily says this week's guest.

She is Nancy Lazar, Co-Founder, Partner and Head of the Economics Team at Cornerstone Macro, an independent macro economic, investment and policy research firm she launched in 2013. She has been ranked one of the street's top economists by *Institutional Investor* magazine for the past 16 years, including being ranked Number One in 2015 and Number Two the prior 4 years, just behind her former business partner of 20 years, WEALTHTRACK guest Ed Hyman. Several years ago lazar identified some major structural changes in the U.S. economy which made her a believer in its staying power. One is the manufacturing renaissance, occurring in the old rust belt and other industrial areas, another is the revitalization of domestic energy production. Two other contributing factors, low interest rates and modest inflation have made the U.S. an attractive place to do business and create jobs.

I began the conversation by asking her if those favorable conditions are still intact as the economic expansion approaches record-breaking longevity?

NANCY LAZAR: Absolutely. It's not been smooth sailing. You had a big bump in energy particularly last year, '15 and '16. Even in the manufacturing space you've had ups and downs, but net there is a clear transformation going on globally where the United States is indeed increasingly energy independent through all of the shale and the investment companies are doing here, and on a manufacturing side China has pretty much almost put themselves out of business. They're no longer competitive, and so the bigger theme is if you sell it in the United States, you make it in the United States. So absolutely that is still very much a passionate theme that I have, and it's unfolding albeit up and down.

CONSUELO MACK: So tell me where you're seeing it unfolding?

NANCY LAZAR: Oh, absolutely. One way you see it in my world is when you look at U.S. imports from China as a share of our economy. They've actually peaked in 2010.

CONSUELO MACK:Wow.

NANCY LAZAR: And moved down some in ’15 and have come back a little bit, but our trade with China is already turning, so that is clearly one of the areas that you’re seeing it. We’re importing less at the margin from China, and so you are indeed making more stuff here in the United States. You’ve also certainly seen it in the stock market and individual companies that do tend to do more investing, build stuff here in the United States.

CONSUELO MACK: Because one of the criticisms and I guess the concerns about a lot of other economists has been the fact that business, that capital expenditures have not been as robust as one would expect and that, in fact, when companies let’s say ... I mean there’s been a lot of debt issuance by corporations because of low interest rates, and instead of spending it on investments, what they’ve been doing is they’re buying back stock, and they’ve also been paying dividends. So it’s more shareholder-friendly and less economy-friendly. How do you kind of balance those two trends?

NANCY LAZAR: So when we first started to talk about the renaissance back in 2010, I did think we were going to have an extended capital spending cycle in the United States, possibly breaking out on the up side, and it did not. With hindsight, I would say our very, very high corporate tax rate was probably one of the key reasons that just didn’t happen. It doesn’t pay companies to invest in the United States even though at the margin you’re seeing the shift with China. When you look at our tax rate, effective rate including states at 39 percent, it’s the highest in the world except for maybe one or two very small economies. Companies invest outside of the United States. So I think our very high corporate tax rate did come back to haunt us a little bit in this renaissance, and definitely has held things back.

CONSUELO MACK: So if you’re to look at the Trump agenda, would lowering the corporate tax rate actually give the boost to the economy that his people are saying it would?

NANCY LAZAR: It would be a game changer.

CONSUELO MACK: Really.

NANCY LAZAR: It would be so I think exciting for the United States. Now the question is, when would it be a game changer? I’m not at all convinced it will be a game changer in the next year or two. Hopefully it does indeed take place next year, but it would be a game changer for the next expansion sometime ’20, ’21. There’s going to be a recession one of these days, and indeed the combination of the investment boom in China over and a lower corporate tax rate competitive globally here in the United States, I think we then really would see the manufacturing renaissance take off and a secular shift up in capital spending in the United States. Again, if you sell it here, you make it here.

CONSUELO MACK: Two years ago on WEALTHTRACK you told us that the U.S. was resuming its role as the driver of world economic growth and kind of overtaking China which had assumed that role. Why are we moving forward and China is not?

NANCY LAZAR: The easiest way to think about China is that it was a bubble similar to our housing bubble, similar to the tech bubble in the 1990s, i.e., they invested way too much. They spent way too much money. They over built, and now they're having to pay for that consequence, and after you've had a bubble in any industry – again our tech bubble or Japan in the '80s – you never resume that growth just because you can't. You have to unwind the excesses that you've put in place. China has had excess investment, excess debt, and now they're in the process of unwinding that, and so indeed the U.S. in dollar terms is growing faster than China, has taken over as the driver of global growth.

CONSUELO MACK: Yet obviously we had our huge housing and credit bubble ourselves. Are the excesses from that experience, have they been totally wrung out of the economy? I mean are we on much sounder footing now?

NANCY LAZAR: Well, unfortunately there always seems to be something else that pops up. Housing? This expansion has been slow to moderate, and that's a beautiful example of what happens once a bubble bursts. It's never exuberant again.

CONSUELO MACK: Never again in this cycle.

NANCY LAZAR: In this cycle. The next expansion it certainly could come back, but housing's had a healthy albeit slow to moderate I'd say compared to what most people would have expected, but there are other areas potentially that are now growing too quickly or are excesses that will help to contribute to say the next recession.

CONSUELO MACK: What are those areas where you're seeing excesses growing?

NANCY LAZAR: Well, corporate profit margins actually have started to deteriorate, and profit margins are obviously how much money you're making relative to your costs, and the cost of doing business has gone up a lot, and as a result it's more difficult for companies to make money. As profit margins start to deteriorate, you actually have to start cutting back on your spending, and so if there's an excess, I'd say there are two and it's in corporate America. One, it's too much debt as you were suggesting but, two, it's too many people. Companies have hired too many people, increased their labor costs contributing to the declining trend we're seeing in corporate profit margins.

CONSUELO MACK: Is that being reflected in the unemployment rate?

NANCY LAZAR: Bingo. The labor market is tight, and to be sure there are still plenty of people who would like to be employed, who can't be employed in part because they don't have skills, but at the end of the day the labor market is tight, and that is creating upward pressure on wage inflation which is great for the consumer. It's terrific that the consumer is finally getting a pay increase, but at the same time it's not so good for companies, and as a result their profit margins are getting squeezed, and that's classically in my world a sign of late stages of the business cycle, and so the business cycle is not dead as much as I think people today would like to think that it is.

CONSUELO MACK: So late stage of the business cycle we are nearly eight years into the economic expansion…it's the third longest on record. So how late are we in this cycle?

NANCY LAZAR: So one of my little pet peeves is that it's not age. It's when excesses start to show up, and that's when the business cycle starts to get too old and starts to fade and risks increasing a recession. So we have a statistical way of measuring where we are in the business cycle, and our best guess is a recession is two and a half years down the road. So it's not 2018, more like mid 2019, late 2019. If we got tax cuts from the administration, it might indeed extend it to be sure because obviously people, companies would hopefully have incremental more money in their pockets, but given where the unemployment rate is, given what wage inflation is doing, given what profit margins are doing, banks are tightening lending standards which is also a sign that there are credit issues, a classic late cycle phenomena. Another couple of years before we probably have the next recession.

CONSUELO MACK: What impact is the Fed starting to raise rates having on hastening us towards a recession?

NANCY LAZAR: Probably not too much. I mean Roberto Perli, my colleague, highlights the Fed has no intention of derailing the economy. Odds are they're going to tighten rather slowly rather than quickly. They are tightening because they do see this tightness in the labor market which is longer term in an inflationary backdrop, so they're acting responsibly, but they're not going to pull the rug – those would be my words – out from underneath the economy and tighten aggressively. I would argue that the recession could indeed not necessarily happen because of the Fed maybe incrementally contributing to it, but come from companies actually cutting costs and affecting the employment backdrop and the unemployment rate and banks tightening lending standards, restricting credit and contributing to a slowdown in overall both business and consumer spending.

CONSUELO MACK: So the bank lending tightening. Is this because of regulation? Or you said it's credit deterioration. So are they seeing that in consumers, among consumers?

NANCY LAZAR: They are.

CONSUELO MACK: Or ...

NANCY LAZAR: They are. Banks are acting responsibly, and in talking to bank analysts, no, it's not really because of regulations. It is simply because they are seeing a deterioration in the quality of loans. Delinquency rates are going up. People are late in paying back their bills, and as a responsible business they're responding to that, and they are tightening lending standards.

The auto sector is where you're seeing it most clearly, and there's no debate quite frankly about what's going on in the auto sector. You had a very rapid credit cycle in autos for whatever reason. I'm not sure why, but the banks and the auto industry were very aggressive in making auto loans early in the expansion, and unfortunately they made too many. Sounds familiar. And now again as the employment backdrop, income backdrop starts to deteriorate, I have a saying. Weak links always crack first. That last borrower who was probably not high credit quality is now going delinquent and banks are pulling back, and you're seeing that in auto sales. Auto sales are actually down, and that's because banks are tightening lending standards.

CONSUELO MACK: You are predicting sluggish growth for the rest of 2017, so about, what, one and a half percent GDP?

NANCY LAZAR: One and a half percent.

CONSUELO MACK: Why?

NANCY LAZAR: So there was an expectation going into 2017 maybe in part because of hope that the administration would create a stronger economic backdrop. Growth would indeed accelerate. Instead we've been more cautious on growth. We have growth slowing down to about one and a half percent. First you did have an inflation spike earlier this year. A spike in today's' terms, you accelerated from about zero in '15, about one in '16, up to three percent in the first part of this year. So if wages are growing about two and a half percent, your real purchasing power as a consumer got squeezed, and so that helped to contribute to the slowdown in consumer spending in the first quarter, and on top of that what's going on in the auto industry, banks tightening lending standards. So we've been expecting this slowdown in consumer spending. We've clearly gotten it. Second, we've also been very cautious on China. China through the first quarter was stronger than I expected to be sure, but now you're starting to see China slow and at the end of the day that'll come home and hit U.S. manufacturing activity. Along with a slowdown that we're seeing in U.S. consumer will also hit U.S. manufacturing activity, so really those two forces.

CONSUELO MACK: On a recent report, I think it was hope versus reality, and so the hope was again new administration coming in with a pro growth agenda not happening as quickly. So what is the reality going to be in 2018 do you think?

NANCY LAZAR: Well, in 2018 I would still hope for corporate tax reform, corporate tax cuts, although my colleague, Andy Leperriere would say don't get too excited about that happening quickly. Here in '17 I think the hope trade is deflating albeit slowly. It is deflating, and that will just further contribute to a slower growth economy here in 2017. In '18 we'll be watching to see if Congress, the administration can get their acts together and actually put in place some fiscal stimulus through the tax cuts, and then hopefully in '18 we could see a pickup in economic activity at least in the first part of the year.

CONSUELO MACK: How dependent is the economy again in the late stages of a recovery? How dependent is it upon stimulus from Washington? I mean it used to be dependent upon monetary stimulus. Now we're talking about fiscal stimulus. Right?

NANCY LAZAR: So it would definitely create a pickup in economic activity if individuals had their taxes cut and corporations had their taxes cut, so very dependent. I mean we would need that, but the problem is as the Fed actually has highlighted. Fiscal stimulus at this late stage of the business cycle doesn't give you a sustained expansion. It just temporarily pulls demand forward and, if anything, in the back half of '18 into '19 again the economy is likely to slow down because you have to deal with these business cycle headwinds like banks tightening lending standards.

CONSUELO MACK: The rest of the world. Let's talk about Europe, what is the shape of Europe these days? What's your assessment?

NANCY LAZAR: The easy answer on Europe, it's okay, but there's a lot of enthusiasm and hope right now actually for Europe. Policy uncertainty may be fading, and as a result we hear from the investment community that the euro zone markets are likely to outperform the U.S. markets. We again though fear that hope is too extended in Europe, that the underlying trend in economic activity there also will be on the somewhat softer side. They are very tied to China, Germany in particular let alone France and Italy on the luxury side, Germany on the industrial side. Their exports were driven very, very sharply by China, and now those exports are going to start to fade. So a little bit of a slowdown in Europe, and we would be more cautious on Europe than I think consensus is. Not bearish but just a little bit more cautious on Europe.

CONSUELO MACK: The central bank effect in Europe with the ECB, are they starting to pull back a little bit?

NANCY LAZAR: No question that they're at the end of their stimulative policy too, not that they're going to tighten anytime soon. Again central bankers around the world have no intention of derailing the global economies, and that's why it's going to be more of I would argue a private sector potential headwind to growth that actually puts economies down into recessions. Europe's going to be behind the United States for a couple years, but they're growing more slowly. They still have a very high unemployment rate. They don't have the tight labor market that we have today, and so they're not facing the business cycle headwinds that we are.

CONSUELO MACK: How much attention are you paying to populism, obviously to Trump? Theresa May in the U.K., and obviously Marine Le Pen did not win, and she was defeated pretty soundly by Macron in France, but how do you figure that into your economic and market outlook?

NANCY LAZAR: Well again I look at it very much from an economist perspective. Why are you having these rumblings say particularly in the United States and in Europe? I would argue a lot of it has to do with the lack of investment in countries. In the United States what's impeded us is our high corporate tax rate. In Europe it's regulation. It's not the same as it is in the United States. Some of those countries have lowered their corporate tax rates. It hasn't made much of a difference because they have other headwinds to businesses actually growing in those countries, particularly France. Even in Germany with the high unions, high labor costs, and so I think the lack of investment in the developed world in general for individual reasons has created a working class growing up in Flint, Michigan. People just haven't been able to get jobs. Not everybody needs to go to college, shouldn't have to go to college to get a job, should be getting other training programs to get a job. So I'm quite excited longer term with this recognition that you have to make it easier for businesses to grow. With that, hopefully you can start to employ more and more people and ease some of this populist turmoil.

CONSUELO MACK: Because one of the interesting things is popular wisdom, or not wisdom but kind of a very prevalent opinion is that because of technology that we can't create jobs in the developed world for people that aren't college educated, highly skilled, whatever, and you're saying that's not the case. Right?

NANCY LAZAR: I'm a huge fan of this creative destruction idea, and that you have to allow industries to die, and though that you get new industries, new skills. If I can make a plug for a movie, *Hidden Figures*, one of the most exciting things in that movie for me was the women recognizing that they needed a new skill, and she needed to learn how to run the IBM. Indeed she learned it. Otherwise, their jobs were going to disappear. That to me was one of the most exciting things about that movie, and so they grew. They became stronger, more key in the development of the space program, and I would use that as a great example of how indeed creative destruction created smarter people, and they grabbed it and were major parts of the space program in the United States.

CONSUELO MACK: So education that's not necessarily a liberal arts education, but certainly the kind of skills that can meet the needs of a high tech society doesn't require a college degree.

NANCY LAZAR: No. Trading programs. When I graduated from high school, most of my high school graduating class went to a trade school. Good for them. That's what they wanted to do. That's where the jobs were, and so we need a broader footprint of jobs in this country instead of the narrow footprint we've had, and so that's why again the manufacturing renaissance idea to me and the energy renaissance idea to me create jobs, albeit not the same jobs back in the '70s or '80s. Quite frankly they're better jobs today, and creative destruction has been going on for centuries.

CONSUELO MACK: What kind of jobs is technology creating when it seems like we're going into a robot society where everything's kind of going to be automated?

NANCY LAZAR: Well, Greg Ipactually wrote a great article in the Wall Street Journal today, saying if anything we need more robots, not less robots. Robots create new jobs. The classic retail industry, the brick and mortar retail industry should die. There are new ways in which we can all shop, and as a result there are new jobs that are created for those industries; i.e., look at what's going on with the delivery companies, Federal Express, UPS, the warehouse industry. So again if you stagnate, you die. You have to allow change, and through change you actually create new jobs. I don't know what they're all going to be but ...

CONSUELO MACK: No one does.

NANCY LAZAR: Right, and at the end of the day technology is a positive, not a negative for long-term growth.

CONSUELO MACK: Investment implications of relatively slow growth this year and depending upon what happens in Washington, maybe faster growth next year or not. What's your view at Cornerstone Macro of the levels in the market right now and what the outlook is?

NANCY LAZAR: So my other colleague, Francois Trahan, would highlight that indeed expectations are way too high right now, and I would totally agree with that as far as the confidence data did indeed expect stronger growth here in 2017, and you're not getting it. So now the way we describe it on the economic side is that the soft data, the confidence data, the NAHB, the PMIs, the consumer confidence, all now need to come down to the hard data, the reality. As a result we think the market's going through a period of digestion. It's likely to be weaker rather than stronger, although the overall market's not down within it as Francois has highlighted. You're clearly seeing the market become concerned about growth, and we think that continues for most of the year.

CONSUELO MACK: So for most of this year.

NANCY LAZAR: Yes.

CONSUELO MACK: Is there anything that he sees that's going to turn the market around that would give it another leg up?

NANCY LAZAR: For this year probably not. Into '18 that's where we actually view from the economic side the slowdown in the economy is good news, not bad news. As a result of the slowdown in the economy, all of a sudden inflation is slowing as we saw with the CPI data that we've seen for the first part of the year. After spiking into January and February, inflation is now starting to slow. That's good for the consumer. At the same time, bond yields, mortgage rates looked like they were going up significantly.

Now all of a sudden they've come down and have stabilized at a lower rate. That's good for the economy. So that will help growth as we go into 2018 even if we don't get a tax cut, at least some, and then that would also then help the market, but we're not there yet.

CONSUELO MACK: Which leads me to the final question of this interview, and that is the one investment for a long-term diversified portfolio. The last time you were on a couple of years ago, you recommended a dollar ETF which did extremely well. Thank you, Nancy Lazar. So what would it be now?

NANCY LAZAR: Well, I would go back to focusing on the U.S. economy in general and particularly the industrial space. The problem is they've run a lot lately, but you used the right word, long-term investment, and so companies that build stuff in this country specifically from the infrastructure programs that obviously will take place. Again some of these are maybe a little expensive right now and could come off here in 2017, but any weakness in these stocks we would view as buying opportunities, domestic construction-oriented companies.

CONSUELO MACK: All right. Really a treat to have you on, Nancy Lazar from Cornerstone Macro. Thanks so much for being here.

NANCY LAZAR: Thank you so much for you time. Appreciate it.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's Action Point is: **Beware of falling into a false sense of security about the economy and markets.** The slow and steady nature of the economic recovery has been reassuring, but as Nancy Lazar noted the business cycle is still very much alive and this expansion is well along in years. Investors have also become complacent. A widely followed measure of market fear, the CBOE Volatility Index or VIX recently touched nearly quarter century lows. Low market volatility is typical during expansions but again we are also in the late stages of a bull market. Some caution is warranted on both fronts and some precautionary measures such as increasing your rainy day funds or raising some cash in portfolios might be a good idea.

Next week we are going to search for income in the taxable and tax-free bond markets with managers from two highly rated mutual funds, Thornburg's Jeff Klingelhofer and Nick Venditti will join us.

To see this program again, more of our interview with Nancy Lazar and other WEALTHTRACK interviews please go to our website WEALTHTRACK.com. Also feel free to reach out to us on Facebook and Twitter. Thanks for watching.
Have a great weekend and make the week ahead a profitable and a productive one.