Will the good times keep rolling?

We’re currently enjoying the second-longest economic expansion in modern U.S. history. In times of prolonged prosperity like this, it’s only natural for people to wonder: When will the good times end? Unsurprisingly, this question is coming up more often in my conversations with our field force and clients. As the saying goes, hope for the best, but prepare for the worst.

So, is this likely to become the longest economic expansion on record? There are many strong market signals to acknowledge, but there are also some troubling indicators. What should we make out of what we’re observing? And how are we investing in response?

The Good

Let’s consider the positive developments. Second-quarter annualized GDP growth was 4.1%, a better number than we’ve seen in a long time. Unemployment ticked up slightly to 4% and subsequently fell to 3.9%, a level we haven’t seen since 2000. In fact, there are more job openings than unemployed workers, and more workers appear to be comfortable quitting jobs in favor of better-paying ones, which are both indicative of a tighter labor market. Consumer confidence remains strong, and manufacturing surveys indicate that this optimism is broadly shared. Investor optimism remains high as well. Corporate earnings continue to exceed expectations (corporate earnings growth is trending above 20%, an uncommon occurrence).

And, widely used recession risk models are not signaling a recession in the near future. The consumer continues to be in good health financially, with debt-to-income levels below historical averages and inflation hovering around 2%, near the Fed’s expressed target.

The Bad

Despite our view that the country’s economy remains strong, we don’t believe future U.S. equity returns will match the double-digit returns achieved over the last five years. Federal Reserve actions (which are no longer driving investors toward risk as they did when quantitative easing was in full swing), higher multiples and valuations that already reflect a lot of positive economic news are good reasons to lower equity return expectations. Furthermore, since equity returns tend to be a leading indicator, it is possible that we are nearing an

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“It is possible that we are nearing an economic inflection point.”

Markets can move on perceptions and beliefs, even if the impact of contemplated tariffs is relatively small. Investors may still worry about escalation and indirect tariff effects that are difficult to quantify. Finally, investors note with some concern two conditions that have preceded many prior recessions: a flattening yield curve and Fed tightening. These are both related, and personally, I don’t see the Fed getting too aggressive. They are acknowledging real U.S. economic strength and acting accordingly. But they certainly don’t want to be the cause of a major market dislocation, and I believe Fed moves will be more measured if the curve continues to flatten.

The Not-So-Ugly

The bottom line: We are not expecting a recession in the next one to two years, BUT the probability of a downturn has increased and the compensation for taking risk has decreased. Put simply, investors are taking more risk for less reward! Credit

May not add to 100% due to rounding.

Lower-risk assets
For a stable foundation and current income

Higher-risk assets
For greater return potential and incremental diversification

1% Emerging market U.S. dollar debt
1% Commercial mortgage-backed securities
2% Asset-backed securities
4% U.S. government securities
7% High-yield bonds
5% Real estate equities
3% Private equities
2% Public common stock
41% Investment-grade corporate bonds
17% Commercial mortgage loans
18% Residential mortgage-backed securities

Includes investment income due and accrued, loans on policies and certain interests in subsidiaries and affiliates, joint ventures, and partnerships.
markets are a great example of this, where corporate leverage has been steadily increasing, credit spreads remain tight by historical standards, and corporate earnings are at the highest point of this business cycle. Historically, this combination has not existed together at the same time. Whether it’s getting paid for taking credit risk or moving out on the flattening yield curve to take interest rate risk, we believe that in the current market investors are not properly compensated for the risks they are taking. Many feel pressure to take those risks anyway. We don’t. Our long-term time horizon and strong liquidity have moved us toward assets that deliver more yield and/or total return potential, not from outsized credit bets or long-duration yield bets but rather from illiquidity in the form of private debt, private equity, essential infrastructure real assets, commercial mortgage loans and certain structured products. If the market turns, we believe that these securities should perform well while delivering value throughout. With recession risk being low, we remain slightly overweight in equity risk relative to our long-term policy, but only modestly so and in parts of the market that are out of favor and, we believe, offer both superior long-term upside potential as well as downside protection.

In addition, as our investment portfolio continues to grow, we will look across global markets for diversifying strategies that offer the potential for attractive long-term value. And with over $1.5 billion being invested each month and public security holdings of more than $100 billion, we have plenty of liquidity should conditions change. Finally, we will continue to employ smart security selection and active trading for the advantage of our policyowners.

The time-honored techniques of strong credit analysis and disciplined asset allocation can work throughout a credit cycle, and they are fundamental to how we invest at Northwestern Mutual. We may not know exactly when the good times will stop rolling, but your company is well positioned and ready if and when the cycle has run its course. Since the average policyholder is ultimately a client for over 40 years, we thank you for your loyalty and trust in Northwestern Mutual.

Ronald P. Joelson
Executive Vice President
& Chief Investment Officer

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