Principal Global Investors

Economic insights:
The long awaited pickup is here

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Recovery from the long economic downturn? We think it's almost here.

Economic data has improved. Stock markets have anticipated the new mood as major United States indices plumbed record highs.

This positive turn of events could last through 2020. The rebound will likely not be as strong (nor last as long) as those that followed the two other mini-recessions after the financial crisis.

Late next year might be a good time to turn more cautious, as problems could surface in 2021.

A never-ending slowdown: some background

Never-ending was certainly how it seemed. This latest economic slump began in China in late 2017 and world growth has gradually lost steam ever since. It hit first in developing countries that sold raw materials to China, then in developed nations that exported manufactured goods. Inventories built to excess and industrial production sank. But this was a manufacturing recession—tight job markets and rising wages kept household consumption resilient and avoided a more severe and broader slump.

Now surveys of manufacturing companies around the world are trending modestly higher and show improving output and better activity. Business leader confidence seems to have hit bottom. Inventories are shrinking. Industrial output and world trade are picking up. The true economic trough was likely in August, when long-term interest rates were collapsing, fears of recession were rampant, and headlines spouted dire forecasts.

A modest recovery from the long slump is taking shape.

It's already begun in the U.S., camouflaged by the General Motors strike and year-long problems at Boeing with its 737 Max airplane. Both subtracted significantly from industrial output, but the latest durable goods orders show improving activity. If Boeing restarts delivery of the grounded 737s, investment will snap back sharply. Regional business surveys for November show better growth on average. The national survey from Markit News hit its trough in August and has risen to the best level since April. Money growth has accelerated. Capital spending should re-emerge after several months of losses.

Households are in good shape and confidence stays healthy. Consumer spending remains robust, with strong wage gains and an excellent job market. Jobless claims have picked up slightly but remain extremely low. Most categories of joblessness are at or near record lows. As new workers stream back into the labor force, a very positive feature, the number of workers on disability has been falling after incessant climbing for nearly three decades. Job growth and wage gains have been the fastest for the lowest tiers of wage-earners. Housing activity is flourishing, with starts and building permits in solid uptrends as consumers take advantage of low mortgage rates.

The fly in this so-far sweet-smelling ointment is corporate profits. Surprisingly, profits have been mostly flat since 2014, according to July's sizeable downward revisions in the National Income and Product Accounts. Accelerating employee compensation, up 28% due to fast wage and benefit growth, has outstripped the 16.5% rise in revenue. Even with super-low rates, interest costs rose 38% over that period due to significant increases in debt.

This fall in profit margins better explains the plunge in business leader confidence in 2019 than trade uncertainty. It also bodes ill for the length and vigor of this nascent recovery. In addition, other signs suggest this historically long business cycle will end at some point. Banks are slowly tightening lending standards. Loan demand isn't robust. Job growth has slowed. The yield curve inverted.

End-cycle is likely a story, not for 2020, but for 2021.

For next year, we expect the U.S. economy to grow in the 2% to 2.5% range, with perhaps some fatigue early in 2021. Manufacturing will get a further lift as global growth recovers.

Activity in China

There are similar signs of modest improvement in China, where growth hit its nadir last spring. Our own economic momentum gauge for China has been improving all year. The leading indicator, published by the Organization for Economic Cooperation and Development, had a February trough. Retail sales, industrial production, and fixed asset investment all incrementally declined in October, but have trended higher in recent months. Railway freight and airline traffic increased. Vehicle sales and output are rebounding. Electricity production surged in October. Business surveys have been volatile, but the Caixin canvass of manufacturing businesses rose to 51.7 in October from a January contraction low.

The tax cuts, higher borrowing limits, and spending on infrastructure that stimulated China's economy this year have been rather timid compared to past slowdowns. Growth isn't surging up out of recent doldrums. Officials recognize the growth headwinds: Debt is already very high; the labor force will soon start to shrink; competitiveness is flagging.

Warning signs are evident in rising debt defaults and troubles with smaller lenders. China isn't allowing a major surge in credit growth. Economic growth should stabilize near 6% this year but will likely slow further in 2020.

Eurozone growth

Though lagging behind the U.S. and China, the Eurozone will avoid a recession. Activity there is stabilizing.

Germany eked out a bit of growth in third quarter and inventories are falling. Household and government spending, plus exports, have added to growth. Passenger car registrations are surging. Business sentiment bottomed then picked up a lot in Germany. Eurozone industrial production rose for a second straight month. Manufacturing surveys picked up too, but services surveys weakened. Employment growth has been decelerating but the unemployment rate remains near the lowest in well over a decade. While down from an early 2018 high, consumer confidence has been stable this year despite the plunge in business sentiment.

A tight labor market and rising wages have allowed consumers to help avoid recession spreading beyond manufacturing. Consumer confidence in France is almost back to the highs of 2017. Retail sales have been robust, up 3.1% over the prior year in October. We expect growth to pick up somewhat during the next few months, as better trade flows boost exports.

With less political uncertainty and improvement in China, Eurozone growth could surprise somewhat on the upside. Still, any rebound will pale in comparison to the near-boom in 2017.

Looking ahead … the third wave

This has been the third mid-cycle slowdown since the world expansion began following the financial crisis. Like 2015, it was a manufacturing recession. This third upturn is bringing better activity in China and the U.S., and stabilization to Japan and the Eurozone. October industrial output jumped in Singapore and Taiwan, often a leading indicator of world growth. More broadly, there's no widespread economic or financial crisis. Central bankers are hugely accommodative, with more rate cuts to come in high interest economies such as India. There's little stress in credit markets. The typical imbalances that make economies vulnerable to recession are absent. Stock indices are on the uptick. Labor markets are tight and wages rising nicely in developed countries.

This recovery, though, will likely be neither lengthy nor especially vibrant. Some end-cycle trends are already evident and U.S. profit margins are suffering. Super-low interest rates created an explosion in corporate debt issuance and investors searching for some sort of acceptable yield lapped it up. Falling margins and high debt levels hint at problems by 2021. The rebound in China will be lackluster, too, compared to others since the financial crisis.

For now, enjoy the upturn as it materializes. Other signs of a downturn may not be apparent until early 2021.

Does an inverted yield curve predict recessions?

Well, it's been almost infallible. In the past, whenever short-term rates moved above long-term rates, a recession followed within six months to two years. The curve did invert this year: yields on both three-month U.S. treasury bills and two-year bonds topped yields on 10-year U.S. treasury bonds for several weeks. That makes a recession certain, right?

Probably at some point, although this time was different (famous last words). In the past, when short rates rose above long, inflation was rising and the Federal Reserve (the Fed) was hiking the fed funds rate to slow economic growth and control inflation. Eventually, a recession ensued as monetary policy tightened. Industry jargon calls that a "bear flattening," as short-term bond prices fell when their yields rose. This time, the inversion occurred not from surging short rates, but because long-rates plummeted. Investors were buying long-term treasury bonds as a flight to safety amid recession fears.

So have the three Fed rate cuts engineered a soft landing and prevented a recession even after the curve inverted? Time will tell. It's clear the August recession panic was overdone. The yield curve steepened, which ended the dreaded inversion. Because of the long lag time for that signal, the coast isn't necessarily clear.

U.S. job gains have slowed. Profit growth is nil. Both are long-leading indicators of an economic tumble. Past-due payments are rising on auto loans and credit card debt. Companies are borrowing without offering many covenants to protect repayments.

These signs aren't at worrisome levels yet, but this trend is not a friend.

Investment ideas

The economic backdrop always sets the stage for what investors will experience in stock and bond markets. Positive underlying fundamentals would generally provide some upward impetus for both equities and interest rates.

Monetary policy, however, is the biggest downward influence on interest rates today. As a result, yields will struggle to rise much from here. With U.S. inflation expectations so low and inflation stable, the Fed won't be raising the fed funds rate anytime soon. In addition, the Fed's summer review of its inflation-fighting framework will likely institute a "make-up" policy, such that the Fed will allow inflation to run above target for a while.

The mild boost in world growth, if it materializes, should push up yields on long-term U.S. treasury bonds to 2% or beyond, but any uptrend will be slow and tedious. Negative yields on long-term Japanese and European government bonds will limit any upward move in the U.S. as money flows into the U.S. to take advantage of higher yields. Yields on 10-year U.S. treasury bonds of 2.25% might be worth accepting, as yields would likely fall and bond prices rise if economic troubles develop in 2021.

For bond investors, short-term bond yields aren't much lower than those on longer maturities. So investors with a one-year perspective should stick to corporate or municipal bonds with two- to four-year maturities. Given that the potential cyclical upturn could weaken into 2021, we'd also stick to highly rated securities. That would apply to any risk class—investment grade, high-yield, or emerging market debt. Just stay with the highest quality.

Stock investors enjoyed the enormous equity rally from March 2009 through early 2018; it was hugely profitable. Almost nine years of more than 17% annual compound gains with dividends reinvested in the S&P500 Index, it was one of the best rallies of all time. It created a love affair with passive management. Just jump on the trend and stick with it for wonderful gains, that was the thinking.

That long trend, though, is likely over. Except for the last couple months, stock markets have struggled. Valuations peaked in January 2018. The big tech stocks led the long rally, but that leadership peaked in June last year. Even the outperformance of U.S. stocks over the last decade has weakened.

From here, the outlook is for a modest upside. In the last two months, stock markets have anticipated the coming growth pickup. Major U.S. indices have made record highs and robust uptrends are evident in other world indices. With improving growth, the equity rally should last a while longer, but the reward-to-risk ratio is shrinking. Trying to get the last 5% out of a rally can be hazardous. It's a time to be cautious.

For now, keep equity portfolios balanced, both among sectors and U.S. versus international. As the growth upturn materializes, cyclical sectors should continue to outperform more defensive ones. And U.S. indices may weaken versus international, both compared to other developed markets as well as emerging.

A pickup in world growth usually means the U.S. dollar weakens, as money flows out of the U.S. into countries with faster growth. That trend may have already started with the U.S. dollar peak in September.

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