Principal Global Investors

Economic Insights:
What bond bear market?

Monthly update: March 2019

Commentary by Bob Baur and the Principal Economic Committee

There aren't any signs of one yet. The consensus for both interest rates and inflation is that both stay "lower for longer," a view that's been right on target for years. That belief became ingrained in investors from thirty years of disinflation as falling tariff barriers allowed global companies to produce their products at lower costs by employing hundreds of millions of low-wage workers from China and other emerging countries. That disinflation was followed by a near-decade of slow growth and intense fears of deflation from the global financial crisis and its aftermath. So, modest inflation and the low interest rates that accompanied it still seem permanent.

But, the manufacturing cost advantage of many emerging markets has been narrowed by years of fast wage growth, especially in China. One consistent theme that echoes the shift is tight labor markets and accelerating wage growth across major developed countries. Robust productivity growth in the United States, though, is keeping business' unit labor costs tame, so there is less current need for raising prices to protect profits. However, if wage gains persist and spare capacity gets utilized, eventually, inflation will work its way higher. At that point, long-term interest rates will need to contain an inflation premium and yields will rise. That may not come until sometime in 2020.

Looking ahead

The current fed funds rate is near some estimates of neutral, (i.e., the rate that neither boosts, nor restricts, economic growth). With inflation so tame, there is little need for more rate hikes from the Federal Reserve (Fed). As the dot plot indicates, the Fed is done for 2019; and we'd concur. Super-low yields on long-term government bonds suggest that bond investors fear world growth will slow even more. If that happens, or if stock markets

Powell at the Bat

December wasn't pretty for the Powell team last year.
The rate hike brought a plunge in stocks. "Recession Next!" the fear.
The Powell presser made it worse; his hawkishness was plain.
Restrictive rates and more bond sales would propagate the pain.

But, global growth was slowing, and the stock dive shocked the Fed;
And business saw recession near: investment cuts ahead.
Then retail sales in January shrank the most in years;
And European business surveys brought us all to tears.

So, just a month was all it took, and Powell changed his mind.
The Fed would pause its hiking rates, await a better time.
Its sales of bonds would also slow, let long-term yields contract;
With lower mortgage rates, there'd be more home sales to transact.

The market cheered; investors bet that Powell's put had worked.
As long rates fell, the dollar dropped, emerging markets perked.
The tailwind blew through February, markets caught a bid;
As economic data bottomed, growth would stop its skid.

And then in March when pundits thought that no more could be done,
Committee doves came out in force; the dot plot hikes showed none.
Powell's change-around had worked, and confidence is mending.
Market optimism's strong; consumers keep on spending.

The problem's where to go from here with valuations high,
And earnings guides may falter soon when next reports are nigh.
With yields so low and spreads so tight, could bonds still be a buy?
Short-term only, up in ratings, might be worth a try.

But, stocks and bonds tell different tales about what lies ahead.
Stocks say optimism reigns, but bonds cry growth will shred.
If bonds are right and growth is poor, then stocks will start to fall.
If bonds are wrong, then yields will rise, and stock returns stay small.

Inflation's not a problem now, consensus "low for long."
But, wages sure are surging and could turn that view all wrong.
Powell won this game; but, if inflation starts to rear,
We may need more than Powell's bat to finish out the year.

have another downdraft, those yields could shrink further into mid-year. Yields on ten-year U.S. treasury bonds are currently held down by negative yields on German and Japanese government bonds where growth had slowed the most. With our optimistic forecast for global growth, though, we'd expect long-bond yields to trough by mid-year and work higher into year-end. Besides the acceleration in wage growth, commodity prices are percolating; broad commodity indices are well off the lows of last year. So, inflation is surely not dead, only dormant.

Yield curve inversion

There have been many headlines about the recent inverted yield curve where the yield on 10-year U.S. treasury bonds fell below the yields three-month treasury bills. That has been an almost infallible harbinger of recession for decades. We're not too alarmed yet. In the past, the inversion had to continue for a while—weeks, not days, and it should be significant (i.e., more than just a few hundredths of a percentage point). It also needs to infect the whole curve, i.e., two-year yields over 10-year yields, and that hasn't happened yet. There's also some question about whether it even means anything today, given the Fed's suppression of long-term yields over the last decade.

Further, the yield curve becomes inverted when an aggressive Fed raises rates into restrictive territory and bond investors believe a recession is coming. Investors would buy long-term bonds as a safe haven, lowering long-term yields. With current yields so low, the Fed is not very restrictive now. In addition, an inverted yield curve is just one of many recession indicators, and few others are flashing warnings now.

Stock market outlook: Can the equity surge continue?

Probably not. World stock markets have had a terrific run in 2019. Of all the 47 world stock market indices we track, only two had a negative return during the first quarter. China indices lead the bandwagon with gains of 22.9% and 33.7% in Shanghai and Shenzhen, respectively, and 35.4% for China's small cap index. Interest rates collapsed during the quarter, so bond investors had a bonanza, too. Barclay's U.S. Corporate High Yields index returned a fantastic 7.3% in the quarter. Expectations for an eventual pickup in world growth and the sudden dovish fervor of central banks spurred the serendipity. Prices of real estate investment trusts soared on plunging interest rates and improved rental income prospects.

Looking ahead

The worst problem for equities would be a significant recession in a large part of the world economy. As we discuss below, that doesn't seem likely as world growth stabilizes and green shoots spring up. So the kind of devastating bear market that often accompanies a severe recession is surely not in the cards.

Another problem for equities would be a significant rise in long-term interest rates, whether from increased inflation or simply better growth. With current and expected inflation subdued, the prospects for new cycle highs in U.S. treasury bond yields in 2019 is likely pretty low. With investors clinging stalwartly to the "lower for longer" consensus, it will take evidence of inflation that will stay at or above central bank targets before interest rates would rise much above 3%.

Even with the massive post-holiday surge, stock markets haven't even recovered all the losses of 2018. So, it's hard to be enthusiastic about prospects for good stock market returns from current levels in 2019. Stock and bond markets have two different views of world growth. Super-low government bond yields suggest the outlook for growth is poor. Meanwhile, the post-holiday stock market surge portrays optimism about a solid recovery and healthy profit growth. If the bond market is correct, stock prices should fade as growth worries return. If the bond market is wrong, then interest rates would surely rise, causing stock prices to fall along with valuations. That's what brought the turmoil last year as valuations peaked in January 2018.

One positive scenario for stock markets: if interest rates would stay mellow even as the slowdown in world growth ended. Stock prices could then mildly advance along with rising earnings. But, it's hard to see 10-year U.S. treasury yields staying below 2.5% when nominal U.S. growth is 4% to 5%. We'd guess it's a time for stock investors to be cautious as returns from these valuation levels will likely be limited.

World economic outlook: green shoots

Stock markets plunged in December as evidence began to accumulate that a recession might be around the corner. Growth in China slowed significantly throughout 2018 and the fourth quarter rebounds in Europe and Japan were modest at best. The Fed added to the gloom by raising the fed funds rate and sticking to its prior hawkishness. US holiday sales were smashing records, but, sentiment plummeted with stocks.

Cooler heads prevailed in late December and stock markets rallied as investors anticipated the end of the slowdown. Front-running a recovery can only push stocks so far and the late-March stall may be investors waiting until some actual green shoots to validate the upsurge in stock prices. Those signs are starting to appear. After stabilizing in the second quarter, world growth should pick up mildly as 2019 progresses.

United States: chasing Australia

Even with a weak 2.2% annualized growth in the fourth quarter, the U.S. economy expanded at a robust 3% pace from the fourth quarter of 2017. However, the government shutdown that lasted into January will keep any rebound modest. That drag, along with seasonal adjustment problems that the Bureau of Economic Research can't seem to eliminate, may keep U.S. first quarter growth below 2%.

We expect U.S. growth to return to trend, about 2.5%, the rest of the year. Regional Fed business surveys have already recouped some of their losses. Consumer confidence measures have risen off earlier lows. Small business optimism ticked up in March. And why wouldn't household confidence stay robust? Job openings keep hitting new records, wage growth is accelerating, and joblessness among the hardest hit workers has plumbed all-time lows. A proxy for total U.S. household income rose 5.4% in March over the prior year, the best jump in more than a decade.

Looking ahead

If this U.S. expansion lasts through July, it will become the longest in U.S. history. While we doubt the next U.S. recession will be 27 years away like Australia's current record run, whatever downturn comes will likely be mild and several quarters away. The key is further wage gains and job growth—and both have been smokin'. The Household Survey by the Census Bureau showed 2.88 million new jobs in 2018, the third best in more than three decades. The labor force participation rate for prime-age workers (aged 25-54) is rising nicely, indicating businesses are pulling in new workers from the sidelines.

The old age of U.S. capital stock plus the incentives in the Tax Cut and Jobs Act of late 2017 should keep investment growth healthy, albeit not as fast as the spectacular 7% pace of 2018. Solid capital spending suggests that the recent pickup in productivity gains will continue. It's those increases that raise standards of living, boost confidence, and keep household spending vigorous. We expect U.S. gross domestic product (GDP) to grow around 2.5%, driven by sturdy investment and strong consumer spending gains.

Some forecasters see harbingers of recession lurking in the background. An early-first quarter poll of U.S. chief financial officers by Duke University noted a near-majority believed a U.S. recession would develop yet in 2019. That doesn't seem likely. The Fed isn't aggressive. Inflation is tame. Household debt isn't a problem currently. Inventories aren't too big. Payrolls are trim. Corporate profits are still growing. The imbalances that typically presage a recession just aren't evident.

Europe: tighter labor markets, rising wages

Eurozone data has been thoroughly disappointing. Slowing manufacturing activity, softening Chinese import demand, and political tensions have kept a lid on Euro area growth into 2019. Italy fell into a technical recession and China's slowdown almost pushed Germany into one. The latest business surveys for March are still edging lower. But job growth has been stout, with the jobless rate the lowest in a decade. That puts upward pressure on wage growth, which in turn boosts household consumption.

Looking ahead

Europe's immediate growth prospects, while negative, will likely pick up in the second half. Many of last year's negative growth pressures have moved into reverse and a stabilization in China's import demand should provide a meaningful boost to European exports. Business and household confidence didn't fall nearly as much as the business surveys indicated. Business confidence has already ticked higher in Germany and France. The European Central Bank (ECB) responded to the downshift in growth by extending its no-hike guidance through the full year and announcing new liquidity provisions, a strong banking system support. It also appears that fiscal policy will become more expansionary after Euro area elections. We expect growth to be positive but uninspiring in the 1% to 1.5% range this year and into next.

Japan: robust job market

After GDP contracted in last year's third quarter, the rebound was barely modest. Manufacturing activity is weak, given the slowdown in global growth and international trade. Profits are falling after several years of robust growth, but businesses don't seem to be retrenching. Office vacancy rates in Japan's major cities are the lowest since the mid-1990s and rent growth is rising.

Household consumption will continue to be the economic driver supported by good income gains from the job market. Japan's job market is incredibly tight, with an ultra-low jobless rate on only 2.5%, the second lowest since 1993. There are 1.63 job openings for every job applicant, the most since a short spike in 1973, so anyone who wants a job should find one. Total employment is rising even as the population declines. We expect growth to be 1% or so this year with some downside risk if the hike in the value-added tax if enacted.

China: a billion here, a billion there …

Pretty soon you're talking about real stimulus. Last year's slowdown in China's growth was somewhat self-imposed from an official attempt to slow the growth of debt. The idea likely was to prevent excess debt from creating a financial crisis in the future. That drag coincided with another obstacle to growth, reducing the pollution in China's major cities. Add the trade dispute with the U.S. and the global growth downshift and China's slump became worrisome.

Starting last year, officials began to energize the economy with several rounds of stimulus:

- cuts in income taxes and the value-added tax,
- lower bank reserve requirements to improve liquidity,
- less enforcement of pollution regulations, and
- easier lending standards.

The improvement in the latest business surveys suggest that growth has stabilized already. Fixed investment has ticked up and retail sales growth has quit falling. Private reports indicate a surge in lending. Using official figures, growth will likely remain around 6% for 2019, although we would expect any uptick to fade into 2020 as the stimulus wanes.

Emerging markets: a favorable tailwind

For several quarters, India has been the fastest growing major country in the world. Since taking office, the Modi government enacted several changes that were initially economic drags but with long-term positive effects. Those changes have shown up in India's recent 7% pace of growth. Growth did tick down in late 2018, but we think a rebound of sorts is occurring. Business surveys are edging higher and new manufacturing orders are strong. The SENSEX Index is pressing up against new highs and inflation seems under control, at least for the moment. The central bank will likely cut rates another 0.25%. GDP growth could remain in the 6.5% to 7% range.

A China growth pick-up later this year would help lots of developing countries, especially in Asia. In addition, U.S. interest rates have fallen substantially. The U.S. dollar isn't making new highs. These events, plus a gradual pickup in world growth, will provide a decent tailwind for emerging markets as 2019 progresses.

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