Economic Insights: **Was the bond market right?**

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For the first time since early 2016, astute colleagues are asking about the odds of a U.S. recession this year. As the May stock market downdraft gathers steam, this worry spreads.

But there are **two markets** sending signals, each transmitting different messages.

On the stock side, the S&P 500 Index soared 25.3% from late December to its peak at April's end, which suggested the world economic slowdown was ending and growth would soon pick up. Similarly, in China, prices of local stocks blew higher as tax cuts, lower required reserves for banks, rising infrastructure spending, and more loans to small businesses were expected to boost China's flagging growth. The Shanghai Composite index shot up 32.7% on those hopes from early January to mid-April.

In contrast, yields on safe-haven government bonds in the United States, Germany, and Japan started sinking in late fall last year and were still making new lows at the end of May. Yields on 10-year U.S. treasury bonds plunged more than 1.0% from the November high of 3.24%. Yields on similar maturity German bunds and Japanese government bonds are below zero—those are near-record lows. The collapsing yields suggested bond investors feared the stock market optimism was unjustified, the economic setbacks weren't over, and the worst perhaps was yet to come.

Two markets, two messages.

Stock market optimism carried through early May. First quarter growth in Europe, Japan, China, and the U.S. was all better than expected. But with setbacks in recent U.S. and China economic data, and the breakdown of U.S./China trade talks, the bond market prophecies have proven psychic so far.

Bond investors were right about the length and severity of the global economic stumble that began last year. A sizeable buildup of U.S. wholesale inventories led to a months-long stagger in industrial output and brought the May plunge in business surveys to just above contraction levels. Those excess inventories will impede any U.S. recovery from this mid-cycle slowdown. Business surveys in China fell back a bit in April after a few months of gains. Tough U.S./China trade talk is adding to the gloom, casting a pall over future business investment.

We'd guess the current gloom is overdone. Excess inventories, absent other imbalances, aren't usually the cause of recessions.

Further, U.S. and German stockpiles are already declining. Too much inventory leads to price discounting, which may be the reason inflation has been so quiescent this year.

We expect trade negotiations of some sort will resume after mid-year. If that happens, growth will pick up and make this the third mid-cycle slowdown since the financial crisis.

We look for world growth to exit last year's slowdown as 2019 progresses.

Interest rates: Still waiting for better growth

Throughout May, major stock indices plunged as investors actively sold equities, opting for safe government bonds. Yields on long-term U.S. treasuries fell the whole month. Minutes from the last U.S. Federal Reserve (Fed) meeting signaled there was little reason to change the fed funds rate for some time into the future. The yield curve inverted at the short end.

What's ahead?

Since the holidays, the bond market fretted that global growth had downside risk. That fear turned to fact, as it's clear growth isn't yet recovering from last year's downward lurch. The new worry seems to be that deadlocked U.S./China trade talks, with little chance of resumption before fall, will create an even more meaningful slowdown.

In the short-term, all this suggests that long-maturity government bond yields have little upside risk and stock markets have more downside risk.

Fed funds
The Fed is now "patient," i.e., on hold, dependent on new data that may alter their plans. However, the Fed's sharp about-face from super-hawkish, and a hike in December to January's dovish turnaround, was surely motivated by the stock market collapse late last year. So, the Fed is clearly sensitive to market downdrafts.

If the current equity stumble extends and economic growth keeps stalling, we'd guess the Fed will cut rates in June or July—maybe both.

Long-term rates
There could be slightly more downside risk to government bond yields over the next month or so. But structural forces should eventually push yields higher late this year, in 2020, and possibly beyond. The disinflation brought about by two decades of globalization is fading. Central banks are trying to create inflation. Price discounting from excess inventories will end by late fall. Tight labor markets and accelerating wage gains will pressure companies to raise prices. The global savings glut—described by former Fed Chair Ben Bernanke to explain lower-than-expected long-dated yields—is over.

We think a mild inflation surprise will occur late this year or at least in 2020. Investors will demand a premium for potential inflation, so the eventual direction for long-maturity U.S. treasury bond yields is up.

Stock market: investment environment changing

Main Street still prospers while Wall Street struggles. Tight labor markets and robust wage gains are great for households and businesses even as financial markets flounder. Few world stock indices are higher than a year ago. Bond investors had good returns since the holidays but have been flat at best since late 2017.

But the long investment cycle from 2009 through early 2017 is waning as the accommodating economic backdrop changes. That near-decade of very slow growth, fear of relapse, and super-low interest rates and inflation meant excellent returns for investments in safe-haven government bonds and U.S. stocks, especially growth and tech.

As fundamentals shift, what propels the next investment cycle will change, too.

Reversals happen

We believe the driver of the next cycle will be a modest inflation surprise and the upward pressure it puts on long-term interest rates. Inflation that visibly approaches or surpasses central bank targets would reverse the trends that provided such great returns over that last cycle. It would bring a bear market in government bonds and distress in credit markets.

Even mildly higher interest rates suggest that value stocks could outperform growth, and that financials might offer better returns than the tech darlings of the last decade. Once last year's sluggish growth phase ends, better global growth and less fear of relapse could lead to a peak in the U.S. dollar and the underperformance of U.S. stocks versus those in Europe or the United Kingdom, as well as currencies like sterling, the euro, and the yen.

Transition

We're likely in a transition period from the end of one cycle until the new one gathers intensity. This suggests markets could remain trendless with poor overall returns a while longer.

Such a dramatic change in market leadership or investment cycle doesn't occur overnight. Inertia and reluctance to sell past winners mean investors need time to recognize that the backdrop has changed. That's what happens in a transition. Past leaders fail. New ones gain momentum.

For example, in equity markets, central banks are likely protecting against massive downdrafts, but April's high valuations mean the upside is limited.

Trendless markets, indeed.

Investment implications—and a word of caution

We've been singing the same cautious tune for some time and it's still the right song.

We like short- to medium-term, high-quality bonds, whether credit or government. In equities, we'd stick to defensive sectors for now, but, shorter-term investors might look for a moderate buying opportunity this summer as last year's slowdown fades. We like commercial real estate, as rents can still rise with mild inflation even if property prices are capped by higher long-term yields. Real assets in general, like farmland, commodities, or gold, may become more trendy than financial assets if the next cycle materializes.

The risks, however, are real and significant. We'll cover this more deeply in the next section, but the world economic slowdown isn't over yet and renewed tough trade talk creates new uncertainties for business. Potentially extending new tariffs to Mexico was a real surprise. Even if it was merely a negotiating tactic, it creates doubt about the permanence of other trade deals. In addition, the existing tariffs, as well as ambiguity about future deals, could easily curtail profits and delay business investment decisions and hiring, extending anew the current economic lethargy.

World economy: a rerun of 2015?

As the old saying goes, history doesn't repeat itself, but it rhymes.

Today's economic backdrop looks a lot like 2015. At that time, a decelerating China pulled down global growth. Excess capacity sent commodity prices tumbling and the dollar soared. The U.S. industrial sector fell into recession as the oil industry reeled from decade-low prices and weak global trade weighed on manufacturing.

Fast forward to now, with global trade suffering aftershocks from China's slowdown. U.S. industrial production is waning and business surveys have plunged. This time around, global growth is slowing, inventories are too high, and trade uncertainties are hurting business confidence.

As in 2015, this latest pullback will end. Yes, Chinese activity has weakened anew, and elevated trade tensions may further derail whatever green shoots were visible. So a world growth pickup may be delayed a few months.

Still, the first quarter rebound in Chinese data, decent Eurozone economic growth, and improving consumer confidence are tentative signs that a rebound is ahead. A growth pickup in the U.S., China, and Europe will help propel the rest of the world economy.

Here's a deeper look at each of those sectors:

United States

The weakness in manufacturing activity hasn't yet fed through to consumers. The labor market is fantastic. Consumer sentiment is at or near cycle highs reflecting that strength. Real consumer spending is up 2.1% (3-month annualized growth) in April, up from near 1.3% in the first quarter. Home builder sentiment has jumped; home mortgage applications are trending higher even though April home sales were a bit weak. Inflation is non-existent, perhaps an impact of price discounting in inventories. First quarter's measure of core consumer expenditure inflation (ex food and energy) was revised down to 1%.

Looking ahead
A pickup in U.S. growth may be delayed. Second quarter growth is nearly stagnant as inventory accumulation falls. The weakness in capital goods orders suggest investment will stay tepid. Consumer spending should bounce back from a first quarter hiccup. Manufacturing will likely pick up later in the year as companies should've worked through inventory overhangs. A rebound in global growth may provide an additional tailwind. We still expect 2.0% to 2.5% real economic growth this year.

Europe

Activity bounced in the first quarter. Even as manufacturing surveys signaled decline, our own Euro area business indicator picked up from its December low. Germany grew nicely after its economy stagnated late last year. Euro area wage growth accelerated to a new cycle high, a strong positive sign for consumer spending. The German jobless rate did tick up a tenth, but a large share of that jump may be due to a reclassification of workers.

Looking ahead
Europe should grow in the 1.0% to 1.5% range this year, at trend or slightly below. The services sector has held up well, supported by the robust labor market and that should persist. The risk is that worsening sentiment from new trade tensions could start to affect hiring decisions. On the upside, if global growth does pick up, exports and manufacturing will rebound.

China

Growth weakened after the healthy rebound at the start of the year. The employment index in a key manufacturing survey dropped to the lowest level since 2009. Some of the strength in the first quarter—particularly in industrial production—may have been overstated, a typical feature of Chinese data. Better-than-expected growth in the first quarter suggested China would slow its impressive fiscal stimulus. But lackluster April and May data, plus more tariff tension, means broad-based stimulus will make a comeback.

Looking ahead
Growth in China has likely stabilized and will likely strengthen somewhat as the year progresses. Renewed stimulus in the face of heightened U.S. tariffs will prevent a further weakening in activity. The Chinese service sector is expanding and fairly robust, which will keep overall growth near the official target.

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