Principal Global Investors

Economic Insights: **An end in sight for the world slowdown?**

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By late summer, the global investment environment will change to one of better growth, a bit more inflation, and slowly rising long-term bond yields. Volatility surged since equity valuations peaked eighteen months ago, and that will continue.

Investment opportunities in financial assets may only work for six or nine months.
So what are the most promising options, based on what we've seen this June?

Long-term global government bond yields and inflation should trough this summer as global economic growth lifts. With that in mind, mixed income investors should stay cautious and stick to high quality, short to medium-maturity bonds. Better returns might be found in high-yield and emerging market credit in a six to nine-month window. Higher long-term interest rates may generate credit distress beyond that time.

In stocks, while summer may bring a setback, evidence of improving world growth should buoy global stock prices into early 2020, but with modest upside. A weaker United States dollar and accommodative central banks suggest non-U.S. stocks may be better performers.

There should be a rotation from bond proxies and defensive stocks, which have become expensive, to sectors that benefit from improving growth, especially financials. Rising long-term global interest rates will likely be a real headwind for stock and bond markets late next year and in 2021.

The investment cycle from March 2009 is ending. It was defined by slow growth, fear of recession, dread of deflation, and interest rates near zero or below—a perfect backdrop for the outperformance of U.S. financial assets. Markets are in a kind of transition, trying to find the leadership of the next cycle. Transitions are volatile and trendless, which is what we have today.

The next cycle may be characterized by a mildly higher inflation, slowly rising interest rates, and good returns from real assets.

But that may be a few years off.

Stock markets: upside limited, Fed stops the downside

A moderately favorable outlook for world economic growth, along with very accommodative central banks, should allow equity markets some modest upside into year-end. But if a pickup in growth is delayed into fall, investors may suffer another downdraft in stock prices as they did in May.

Stock prices surged across the board in June and the S&P 500 Index hit new record highs. Yet, yields on 10-year U.S. treasury bonds plunged to 32-month lows. What gives? Some say the dichotomy reflects a contrast in growth outlook: Equities observe a world economy on the edge of recovery, but bond investors see evidence the slowdown isn't over.

The real answer: It's all about central banks. Equity investors are giddy over prospects that the U.S. Federal Reserve (Fed) will cut the fed funds rate at the July meeting and again in September, bringing the rate range down to 1.75% to 2%. Other central banks have become much more dovish, too, as rate cuts are nearly universal. Ultra-low discount rates imply a higher present value of future earnings; ergo, stocks rally.

And bond markets? Central banks are about to cut official rates. Inflation is tame or falling almost everywhere. The consensus is certain that rates and inflation will stay low forever. So, bond investors don't believe long-term yields need a premium for future inflation. Long rates are just following short rates lower. Ultra-low bond yields are less a recession forecast, than simply the product of uber-dovish central banks.

Looking ahead
Central bank intention—rather than a poor growth outlook—explain the plunge in bond yields. The world economy should gradually improve into year-end. The odds of a U.S. recession over the next year are slim. We don't expect U.S.-China trade tensions to escalate again soon.

If this is all correct, world stock markets could still trend a bit higher, even after the surge in June.

A long and persistent bear market would require a sharp decline in business confidence that would inhibit hiring, raise joblessness, and curb wage growth and investment. These harbingers of recession would then overwhelm the impact of easier monetary policy and a lower fed funds rate. There's scant evidence of that scenario now, nor does it seem likely over the next year.

However, the combination of rising valuations and falling earnings estimates do suggest any upside is limited. An equity rally would also be constrained by interest rates, if they rise with better growth, as the entire upsurge since December was underpinned by the collapse in long-term bond yields. Further, if the expected pickup in world growth is delayed into fall, there could easily be another stock market downdraft ahead.

If so, that would surely be a medium-term buying opportunity.

The rally after such a slide may be the last hurrah for the long investment cycle from March 2009. Volatility surges at the end of a cycle and stocks have fluctuated wildly for months with little net gain. After vicious corrections and monster rallies, the S&P 500 Index is only about 4% above its January high of 18 months ago.

This cycle's ultimate demise will likely be from rising long-term bond yields, as described below.

Interest rates: near a low in long-bond yields

The eight-month plunge in 10-year U.S. treasury bond yields is likely over. Yields will slowly work higher into year-end. At some point, rising interest rates will become a problem for stock and credit markets, likely late next year or in 2021.

For 35 years, yields on 10-year U.S. treasury bonds kept falling, from 15.8% in 1981 to 1.3% in 2016. After that long drop, plus a decade of deflation dread and near-zero interest rates after the financial crisis, it's no wonder investors are certain inflation and interest rates will stay lower for longer.

But, is it true? We doubt it. No trend lasts forever, even one that lasts for 35 years. It just becomes easier to extrapolate. The world growth slump and tepid inflation are what's keeping safe-haven, government bond yields at mind-bogglingly low levels.

Both may be about to change, for a few reasons.

First, long-term bond yields will begin to reverse their decline once the expected rebound in world growth becomes evident later this year. The June surge in U.S. payrolls and production worker earnings, plus better-than-expected business surveys, may be the first signs of a turnaround. U.S. treasury yields of 2% are incompatible with current nominal 4% growth in U.S. gross domestic product (GDP).

And second, inflation has been weak the last several months as a lagged effect of the world growth slowdown from mid-2018. The most recent data suggests this year's down pressure on inflation is fading. Tight labor markets and rising wages have been a consistent theme in major developed countries. While fast U.S. productivity growth has kept unit labor costs under control recently, wage gains will eventually push inflation at least to central bank targets. Further, trade uncertainties and rising production costs in China are beginning to limit the price advantages of outsourcing.

That 25 years of disinflation fostered by global companies moving production to lower-wage workers in emerging markets is about to fade, too.

Looking ahead
Even with the June rebound in U.S. payrolls, the Fed should still follow through on their implicit pledge to lower the fed funds rate by 0.25% in July and perhaps again in September. That will reverse the yield curve inversion, extend the expansion as Fed Chair Jerome Powell described, and keep the labor market pulling workers off the sidelines.

Following these cuts, the Fed will surely have a high bar to raising rates again. The next rate hike may not be until inflation has been at or above the Fed's target for at least a few months, likely well into 2020.

Yields on long-term government bonds may take yet another dive in sympathy if a summer stock market downdraft occurs. However, if world growth picks up as we expect, long-bond yields will rise alongside a rebound rally. Ten-year U.S. treasury yields of 2.5% might be possible by yearend. Stock prices and yields can rise together for a while.

But, eventually, higher bond yields will cause trouble for credit and stock markets, as happened when 10-year U.S. yields rose above 3% last summer.

World economic outlook: slowdown to fade

The global economic slowdown that began in mid-2018 was exacerbated and extended by renewed trade tensions. They should trough in the third quarter. Absent a worsening drag from trade, a pickup in world growth will be evident by the fourth quarter.

The world economy seems to be at a crossroads. The global downturn of late last year has lasted longer and been more severe than many expected. The widespread drop in sentiment among leaders of global companies worsened in May from renewed trade uncertainties. Risks have clearly risen. The biggest hazard is that businesses lose faith in the expansion, decide a recession is coming, and curtail investment, hiring, and wage gains. That hasn't happened yet, and households remain the driver of growth in developed economies.

Still, economies seem fragile and there's not much evidence yet of a turnaround.

However, the speedbumps that brought the world economic downturn last year seem to be dissipating. China loosened restrictions on lending and is trying to boost growth with tax cuts and new infrastructure spending. The short-term Euro area drags from French protests and German auto emission problems are over. Central banks have turned accommodative and interest rates have plunged. A pickup in Chinese growth would mean more exports for the Eurozone and developing countries. U.S. inventories, which rose to excess around yearend, are slowly declining. Trade tensions are ebbing as U.S.-China talks restart.

Better growth should be forthcoming as these drags disappear.

If that happens, this would be the third mid-cycle slowdown since the financial crisis of 2008 and a rerun of the industrial recession of 2015. That decline was severe, but didn't ultimately impact consumers.

Healthy household spending prevented a U.S. recession then, and we expect the same outcome this time.

United States

Happy birthday to the expansion that begins its eleventh year this July, making it the longest in U.S. history. Trade uncertainties aren't impacting small businesses yet, where expansion plans and optimism are near-record. A tightening labor market and robust wage gains are pulling people back into the workforce, raising total household income. Workers in the lowest wage decile are seeing the best job growth and fastest wage gains. Consumer confidence stays high. Vigorous capital spending brought a healthy bounce in productivity growth, now well above 2%, the best in years.

Looking ahead
Tame inflation and 3%-plus wage growth mean rising standards of living, keeping household spending sturdy and resilient. Second-quarter growth could be weak as inventories contract, but that's beneficial for future gains. Housing activity should add to growth this year with lower mortgage rates and decelerating house prices. Wage growth has plateaued at a robust level, but should pick up and induce more investment to keep unit labor costs under control. We expect 2% to 2.5% growth this year and next.

The longest expansion in U.S. history should see at least one more birthday.

Better growth should become evident as 2019 progresses.

Europe

Growth in the Eurozone wilted with summer heat last year from the "yellow vest" protests in France and automakers' problems with new emission standards. Years of political risks have taken their toll on business sentiment, and slower growth in China hurt Euro-area exports. Consumer spending, benefitting from a tight labor market and rising wage gains, kept the broader economy well out of recession. The European Central Bank's clear intent to provide more stimulus if needed should help support confidence and investment.

Looking ahead
Geopolitical uncertainties abound with ongoing United Kingdom exit negotiations and new people in European Union leadership positions. Still, the outlook is slightly brighter and cause for modest optimism. China's economy has stabilized and should positively impact Euro-area exports. The domestic economy remains robust in much of Europe with good wage gains and a shrinking jobless rate, now down to 7.5%, the lowest in a decade. The French protests have ended, and auto sales have rebounded. Eurozone growth may stay in the 1% range this year, but with potential to strengthen modestly by yearend into 2020.

Japan

To VAT or not to VAT: That is the question. Another hike in the value-added tax (VAT) from 8% to 10% is scheduled for October. First quarter GDP growth of 2.2% annualized was an upside surprise and private consumption appeared strong in the second quarter. Exports stay weak from the global slowdown, but May industrial production did rise 2.3% over April. Business sentiment among manufacturers continues to fall, but has stayed above the lows of 2016. Confidence among service businesses remains strong. The labor market stays tight, with the jobless rate at an incredibly low 2.4%.

Looking ahead
Japan's robust job market had been putting upward pressure on wages, helping support household spending. Private surveys suggest capital spending will stay resilient and the 2020 Tokyo Olympics will promote vigorous public spending on infrastructure. Financial institutions are still quite willing to lend to small- and medium-sized businesses. A VAT hike, if implemented, would suggest a strong third quarter, but be very negative for the fourth quarter. With no VAT hike, growth in Japan would likely be in the 1% range this year.

China

Does weaker data mean more stimulus? It probably does. The restrictions on debt growth that brought the slowdown to China have been removed and funds are flowing. Interest rates and tax rates are lower, required reserves for banks have dropped, and public infrastructure spending has ramped up. Still, June manufacturing business surveys were weak. May industrial output and investment stayed soft. Overall growth likely stabilized in the second quarter, evidenced by a nice uptick in May retail sales.

Looking ahead
Our economic momentum gauge of various production data series turned up and suggest improved growth. Using official data, growth in China will likely hit the government's 6.0% to 6.5% target range for 2019. Growth may fade in 2020 and beyond as the stimulus wane, the labor force starts to contract, and increasing debt fails to provide much of a further boost to growth.

Emerging markets

Feeling a modest tailwind here, with commodity prices under pressure and trade under assault. Growth in emerging countries that depend on exports has been languishing. Business surveys continued to fall in June, with the average suggesting a broad contraction in manufacturing.

Looking ahead
Persistent capital inflows and banks' relative willingness to lend suggest credit problems are not severe, especially with a weaker U.S. dollar and the plunge in interest rates. If the major economies do take a turn for the better, it would provide developing countries with a solid underpinning for improved growth.

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