Principal Global Investors

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Economic Insights: **About those future returns … where might you find them?**

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Intensified trade tensions and disappointment with interest rate cuts by the United States Federal Reserve (Fed) could provoke a summer relapse in equity markets. But if world growth picks up as we expect, investments in stocks and corporate bonds should be reasonably rewarding on a nine to 15-month basis.

Still, on a longer-term horizon, good financial returns might be very hard to find.

The backdrop for financial returns

Where to find good financial returns depends on the economic environment within which markets will function. The growth slowdown that began in China and migrated around the world continues today. It was exacerbated by uncertainties caused by the Trump administration's tariffs and trade tensions, which have intensified lately.

Two points on this topic:

- *There are signals of a pickup*. Last month, we noted that the world economy appeared at a crossroads. The global slump had lasted about 20 months, comparable to others since the financial crisis. It turned out to be longer and more severe than we earlier thought. Pessimism was rampant in June, and a further slide was surely possible. Our bias then was that growth would pick up late this quarter and into next year. But evidence of a clear turnaround was meager. Now, a few signs of improvement have arrived, suggesting that the end of the downturn might be ahead.

  Leading indicators compiled by the Organization of Economic Cooperation and Development (OECD) for China and a group of five other major non-OECD countries have both moved higher for four months. The OECD leading indicator for all member countries is nearly flat and likely to turn up shortly. Broad commodity price indices seem to be nearer consolidation than further collapse. The Baltic Dry Index of shipping costs surged this year. Recent economic data and business surveys were better than expected in Taiwan, as was June industrial production in South Korea. This suggests the end of the Asian downturn is at hand.

  Further, in both Europe and Japan, households and service sectors remain resilient with healthy labor markets and good wage gains. June retail sales in Germany jumped at the fastest pace in twelve years. The solid U.S. payroll report for July showed that the mighty American jobs machine is purring right along with improving wage gains. The huge upward revision to U.S. worker compensation in the National Income and Product Accounts (NIPA) showed that households are healthy, happy, and confident with great savings and surging real income. Eurozone composite business surveys likely reached a trough early in the second quarter; service sector surveys stay resilient. We don't think this downturn will become a recession and expect growth to return to near trend later this year.

- *It's a late cycle thing*. Some have wondered why U.S. business leaders lack confidence and convey pessimism, why capital spending has been so lifeless recently. Part of it was uncertainty about trade issues, but, the more likely reason became clear with the sizeable revisions to U.S. NIPA data. That big upsurge in worker income noted above came out of U.S. corporate profits, meaning total earnings have been broadly flat since 2016, rather than rising. A surge in interest costs, rising wage pressures, and a failure of revenue to match the pace of expenses caused a dearth of profit growth. Higher interest expense is the delayed effect of Fed rate hikes. The lack of revenue gains is due to drooping world growth. Wage pressure comes from a tightening labor market. It's no wonder CEOs are so glum: no profits, no spending, no way.

The bigger picture is that the lack of profit growth suggests the U.S. may be later in its business cycle than some have thought. Flat or contracting profits is one of three typical long-leading signs that a recession, however mild, may be out there somewhere in the future; now, likely still a ways ahead.

An inverted yield curve (i.e., yields on long-term treasury bonds below those on short-term bonds) is a nearly infallible recession omen and is already sending that message. Recent U.S. payroll reports that point to slowing job growth over the last several months is a third precursor. We don't think recession is a worry for this year, nor is it likely next, as these harbingers have a long lead time. But they do herald that the end-cycle is coming.

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A market return roadmap

The framework above suggests a market roadmap for investors over the next two or three years. But it's a sketch with no straight lines, no long-term trends, no passive index for investors to jump aboard and ride robotically into robust returns for years. Note a few interesting potential turns and twists in financial markets:

Stock market returns. Pushed up by central banks' dovish monetary accommodation and decent second quarter earnings, world stock markets had robust returns in June and mostly held together until late July. Frustration with Fed action at the July meeting, worries about President Trump's new tariffs, and delayed evidence of better world growth may provoke a summer relapse in world equity markets. If that occurs, the widespread pessimism would likely create a nine- to 15-month buying opportunity, assuming economic gains do eventually appear toward fall. Even without a correction, broad equity indices will likely offer a modest reward into late spring next year and perhaps somewhat beyond.

As worries about global growth intensified over the last few months, investors favored sectors that were thought to have secure earnings growth, like large cap tech stocks, or that were income proxies for bonds, like real estate investment trusts and utilities. Those defensive sectors have reached very high relative valuations. For this medium-term horizon, we'd advise a balanced portfolio with a typical weight of cyclical stocks that will benefit from a gradual return to world growth. U.S. stocks should outperform those in other developed countries. Emerging market equities might be a better bet, if the economic setting improves as we expect.

A major escalation of the U.S./China trade disputes beyond the newly announced 10% tariffs on the rest of U.S. imports from China would surely limit these positive prospects. However, President Trump can't unilaterally ratchet up trade tensions too far without hurting his reelection prospects. China will likely retaliate against the new tariffs, but monetary accommodation and a gradual pickup in world growth later this year will help mitigate the damage from trade.

Bond market returns. Bond investors have had a terrific year, especially those owning high-yield and long-dated U.S. treasury bonds. Barclay's index of global high-yield bonds had a 13.1% return this year through July. Barclay's index of long-term U.S. treasury bonds gained 11.1% over the same period. Government bond prices surged from the collapse in yields and corporate bonds gained from narrower yield spreads to U.S. treasuries. It's doubtful those gains in bond prices can continue. It all depends on long-term interest rates.

So, what's that outlook? Both the Fed and European Central Bank (ECB) will lower their official rates in September and keep them super-low for an extended period. Bond yields could fall further in the near term if equity markets relapse on distress over trade or monetary issues. Beyond that, it's likely that government bond yields are now tracing out a low through 2020.

Why? Inflation has trended broadly lower this year, but perhaps not by as much as the depth of the world slowdown might suggest. Several inflation measures tracked by regional Fed banks remain near the Fed's target and showed little weakness this year. High U.S. and Eurozone inventories pushed businesses to offer discounts, keeping inflation low this year. Inventories are being liquidated, so price weakness should vanish. Rising wages and tight labor markets will keep upward pressure on inflation. Besides a bit more inflation as the year progress, improved world growth should help mark the low for bond yields.

Bond investors should definitely avoid government bonds over the medium-term; they're too expensive and offer little return. We'd prefer corporate bonds offering higher yields, as mending world growth prospects imply manageable short-term risk in those riskier bonds.

A good long-term return may be hard to find

Beyond that nine- to 15-month timeframe, investors should stay cautious and liquid. The threat of recession over the next 12 to 18 months seems small, but the danger could mount in 2021. The hidden danger is more inflation and higher than expected long-term yields. Yes, the widespread consensus is that inflation and long-term interest rates will stay lower for longer, if not forever. The consensus believes that three decades of falling yields, followed by a near-decade of super-low rates and no inflation, is plenty of justification to extrapolate the same well into the future.

Is that reasoning valid? Not over the long-term. The disinflation of the last 25 years was most likely from globalization: outsourcing production to low-wage emerging countries which kept goods' costs and prices from rising. Those low costs also put downward pressure on developed country wages, which kept prices from rising more generally. But the cost advantage from far-flung supply chains is surely waning. Labor costs have risen dramatically in China, making U.S. manufacturing costs much more competitive when productivity is considered.

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Further, recent U.S., U.K., and European elections implied a recognition that outsourcing has negative local consequences. So trade barriers are rising. Both forces are pushing global supply chains to be revised and production to move closer to the sources of demand: higher costs, rising prices, and more inflation.

In addition, the severity of the financial crisis created an extreme amount of slack in labor markets and production facilities. It has taken years for those excesses to begin to be absorbed. Historically low jobless rates and rising wages in the U.S., greater Europe, and Japan suggest labor market slack is shrinking. The result will surely be more upward pressure on wages and prices. Central banks may ultimately find themselves behind the curve. The causes of the long disinflation are fading.

The real danger

The risk of a bit more inflation and higher long-term interest rates may create a challenging environment for investors after 2020. Higher interest rates could bring significant distress in the corporate bond market with prospects of rising defaults. The super-low cost of debt over the last decade has likely kept inefficient companies in business by allowing them to roll over their loans. Higher rates will put the hurt on whatever zombie companies are still operating. Higher mortgage rates will dent housing activity around the world.

If this milieu comes to pass, good financial returns will be very hard to find. Most financial assets, especially safe-haven government bonds, have very high valuations today, and they are unlikely to become much cheaper into mid-2020. Neither stocks nor corporate bonds will like the environment that could coalesce in 2021, if a bit of inflation returns with higher long-term interest rates. If the worst comes to pass in 2021, cash and safe-haven U.S. or Japanese government bonds would be the place to ride out the lurch. Eventually, this could bring a big rotation to value stocks and real assets (i.e., banks, financials, industrials, materials, real estate, commodities, emerging markets).

But, that's a story for later. After we learn whether this fairly glum roadmap comes to pass.

For now, keep a balanced portfolio of stocks and bonds, according to your risk tolerance.

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