Principal Global Investors

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Economic Insights: **Is recession already baked in?**

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The summer market relapse is well underway. The plunge in bond yields is bringing increasingly agitated warnings about worsening growth and recession. But this frenzied agonizing may simply mean we're in the worst of the slowdown. In other words, it's always darkest before dawn.

The odds, we think, we hope, favor the latter.

A storm before the calm

Attitudes can change as fast as the weather, can't they? Major indices on United States stock markets hit all-time highs in July and 10-year U.S. treasury bond yields stabilized near 2%. All was right with the world.

Then sentiment collapsed with bond yields throughout August as 30-year U.S. treasury yields fell below 2%—a new record low—and 10-year yields breached 1.5%. Traders said this was the consummate economic harbinger and the August plunge meant distress at best, recession likely. Trade tensions escalated with mutual retaliations between the U.S. and China. U.S. stock indices whipsawed as prices moved more than 1% for 10 days in August, the most since gloomy February 2018.

Central banks are in a tizzy, too. More than 30 have sliced interest rates this year, from Botswana to New Zealand to China, with more cuts coming. At Jackson Hole, Federal Reserve (Fed) Chair Jerome Powell ditched language about a "mid-cycle adjustment" in fed funds, indicating that policy would adapt to incoming data, while noting that prior weeks had been "eventful." Under pressure from negative interest rates, bank stock indices in Europe and Japan are plumbing 20-year lows. A robust U.S. dollar is putting pressure on Argentina and other emerging markets. Still, an encouraging Presidential tweet or lack of Chinese retaliation can turn a vicious down day into a surging rally.

But even with the plunge in long-term yields and agonizing about recession, have the underpinnings of world growth worsened drastically? We don't think so.

The world slowdown began in China in 2017 when officials put restrictions in place to ease pollution and slow the rise in debt. The resulting slump gradually migrated around the world. As growth in China slid, countries that exported to China saw reduced sales, curbing growth in emerging countries and Europe, especially Germany. U.S. growth was the last to slow, as the boost from tax cuts waned and trade uncertainties curtailed capital spending.

World growth has been slowing since mid-2018—slow growth is nothing new.

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Stabilization comes before calm

Last month, we noted signs of progress. A few more are popping up. Yes, the broad Markit News surveys of U.S. businesses were weak with manufacturing edging below 50 (a small contraction). That's still well above recession levels. Further, the six regional U.S. manufacturing company surveys upgraded in August with five showing expansion versus only two in July. Bank loans are rising. Initial claims for jobless benefits show no negative trade impact. Layoff announcements are minimal. Wage gains are still accelerating, with the latest Atlanta Fed Wage Tracker up 3.9%. Second quarter corporate profits jumped 5.1% and are now up 2.2% over the prior year, no longer a recession indicator. Consumer spending is robust, up 2.7% over last year and appears on track for a strong gain this quarter. Gas prices are falling, helping budgets. The household saving rate is 7.7%; balance sheets are in fine shape.

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Even in beleaguered Europe, where the business confidence shock was the worst, data is trending modestly positive. The European Economic Sentiment Indicator rose a few ticks, contrary to expectations. The composite Eurozone business survey rose in August to a decent 51.8, still above a January low. The drop in the jobless rate to a decade low 7.5% has been broad-based. German manufacturing was badly thumped by falling exports to China, but the unemployment rate is only 3%, and companies report labor shortages.

Asian Emerging Markets may also be on the mend with better export and production data, especially in Singapore, South Korea, and Taiwan. Mainland China business surveys for August improved for both services and manufacturing and are trending modestly higher. Industrial profits in China showed recovery in July. Borrowing rates were lowered for small businesses and more fiscal stimulus is likely coming. Global companies most exposed to China are outperforming. Local Chinese equity indices had better returns in August than major U.S. indices.

In Japan, the economy has been struggling ahead of the scheduled October rise in the Value-Added-Tax. The U.S. and Japan will formally sign a trade agreement at the end of September, which should be positive for both signatories.

Looking ahead

The escalation of trade conflicts and tariffs in August did worsen sentiment and likely delayed further recovery. With uncertainty high, it's natural for business leaders to shelve long-term capital spending decisions until the trade dustup clears. Investment has shrunk around the world, but uncertainty has so far not shriveled hiring plans.

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Could we talk ourselves into a recession? Sure. A further downward spiral in sentiment would be trouble. It could start a self-fulfilling cycle of layoffs, puny wage growth, anemic consumer spending, and lousy profits. Has that ever happened? It's not evident. Past U.S. recessions have mostly begun after a shock or imbalance, which then impacts sentiment. Few imbalances are apparent.

We think it's too early to plan for recession within the next year. That's more likely a 2021 story. The record-long U.S. expansion still has legs (see: a healthy labor market and vigorous wage gains supporting consumers). A slump remains at bay. The plunge in U.S. treasury bond yields likely has more to do with expected central bank easing and yield-seeking inflows from Europe and Japan than actual recession fears. China is adding to its fiscal and monetary stimulus. Central banks stay very accommodating. Financial conditions have eased. There is little stress in credit markets.

We expect a mild pickup in world growth in the fourth quarter.

The market message

The most disturbing feature of the year to date has been the relentless nose-dive in long-term safe-haven bond yields. From a peak of 2.8% last January, yields on 10-year U.S. treasury bonds ended August at 1.5%. Similar maturity German bund yields plummeted from 0.3% to 0.7%. How can yields be negative? Central bank action. And a negative yield means a sure loss for bond buyers. Why would anyone do that? Expected profits from even lower rates; fear of worse losses elsewhere; regulations for financial institutions; no safe alternatives.

But it's still surreal.

The fear generated by the plunge won't vanish easily. Central banks will lower rates further. The Fed will cut the funds rate by at least 0.25% in September, with some odds of a 0.5% drop. If markets stay roiled, there may be further cuts. The European Central Bank will drop its official rate more deeply into negative territory and probably restart bond purchases in September. Even if inflation does inch higher, which we expect as the slowdown fades, central banks will stay accommodative for a long time. We doubt the Fed will raise rates again until after the next recession.

Long-bond yields are too low even for the current environment, but they will likely not advance without clear evidence of a pickup in growth. August was an ugly month for investors who were not overweight defensive stocks or mostly in bonds. With any trade resolution unlikely soon, the erratic markets of August may persist into October, an historically tough month for investors. If that's the case, U.S. treasury yields could retest the lows of 2012 and 2016.

Beyond that, government bond yields are surely tracing out a trough that will hold into 2021. This would be a great time to secure a fixed-rate loan or mortgage for a couple of years. Inflation is at a low ebb now, but upward pressure is likely coming. That's because inflation has been weak this year as world growth slowed the last 18 months. Any recovery would push inflation higher. Inflation has also been ultra-low since the financial crisis as slack exploded in labor markets and production facilities. The decades-low jobless rates in developed countries and rising capacity utilization suggest that slack is fading. Low inflation that came with it will reverse. The down pressure on inflation from 25 years of outsourcing should diminish, too. Wage costs in China have surged and supply chains are shifting due to political forces.

Regarding equities, most world stock indices are ahead for the year, thanks to the turnaround in central bank intentions and the collapse in interest rates. The rest of the year may not be so pleasant. The volatility of May and August will likely continue until a definite recovery of world growth becomes evident sometime in the fourth quarter. That pickup in growth should spark a modest equity rally into 2020, back to recent highs or beyond. It might start from a lower level, however.

The wonderfully profitable investment cycle from March 2009 through last year is likely over. Valuations peaked in January 2018 and are lower today. The long leadership of technology companies appears to have peaked in June of last year. Investors are searching a new, long-enduring theme or trend, but they're not finding who or where it might come from. As trade tension and growth worries have intensified, investors rotated into defensive sectors taking them to valuation extremes relative to the rest of the market. That explains the strong recent outperformance of real estate investment trusts, utilities, and consumer staples sectors. That's also typical equity market performance late in a business cycle.

We've advised caution for many months and still believe it's the right touch. Without a recession, it's hard to imagine U.S. treasury yields going much lower from here. We'd prefer high quality investment grade or high-yield corporate bonds over governments as they offer higher yields. Their yield spreads to U.S. treasuries could even narrow, raising returns if growth improves and fear recedes.

For investors with cash to put to work, short-term U.S. treasury bonds offer some yield, tax advantages, and safety. While the end of the business cycle is somewhere in the future, we don't think it's imminent, so cashing out of equities is likely too drastic a step just yet.

We think there's still a little upside in large-cap U.S. stocks, balanced between sectors. Beyond a further major escalation in trade conflicts, the biggest risk is a rise in long-term government bond yields. That's likely coming, but certainly not in the immediate future.

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