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Economic Insights: **Headlines still worried, momentum a little better**

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The world economic slowdown refuses to fade. The frenzy of gloom about imminent recession seemed to peak in August, but there are still few clear signs of recovery.

On the edges, though, economic momentum feels better. We look for a mild rebound in global growth into mid-2020. If it occurs, that should offer a modest upside to the stock market.

Tug-of-war

For some months, the world economy has seemed at a crossroads. With industrial activity stagnating, confidence downcast, trade tension lofty, profits flat, and stock markets under pressure, the gloomy stage feels set for recession.

And yet. Pulling the economy back from the brink were robust household spending, solid labor markets, healthy wage growth, super-low long-term interest rates, and easier central bank policy.

The global economy struggles to find a bottom to this long-running slowdown.

That tug-of-war continues, and the geopolitical backdrop remains ugly. But look closely. The data is more mixed than headlines may indicate. There's even evidence of green shoots out there.

Look at China, for example. Headlines described the recent August data as disappointing, with key sectors experiencing slower year-over-year growth than in July:

- Retail sales: 7.5% versus 8.0%
- Industrial production: 4.4% versus 5.1%
- Fixed investment 5.5% versus 5.8%

These results belie the fact that there's been monthly sequential progress since the low earlier in the year.

The trough for China's growth seemed to be the period of February through May, with monthly data improving in June and August. Industrial production had a nice 0.4% or so bounce in August from July, even though year-over-year growth fell. Fixed investment was also up sequentially the last few months. Exports and imports are both above a recent trough. Auto sales are down sharply over last year but have advanced nicely the last several months (incentives had boosted prior sales). Railway traffic and electricity output are above their lows from earlier in the year. Business surveys have ticked higher with manufacturing now showing expansion.

Further, Chinese data on industrial profits, exports, nominal gross domestic product (GDP), producer prices, crude steel, and cement output, among other series, haven't declined as severely as those of the industrial recession of 2015. That's also true of private surveys of United States company sales to China.

We look for official growth data in China to stabilize close to the 6% range this year.

The Eurozone is a slightly different story. Preliminary results of September business surveys were well below expectations. Manufacturing business gauges hit the lowest since the Euro-area debt crisis of 2012—weighed down heavily by the German result, which was lower than during the global financial crisis. The tally of service businesses also fell but remained solid and above January's low.

The Eurozone Commission survey on economic confidence fell again, but showed the dispersion between industry and households, as consumer confidence stayed at mostly healthy levels. Though down sharply over the prior year, Eurozone auto sales are recovering nicely from last year's big change in emission standards.

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Germany is the downside outlier, likely already in a mild recession. German manufacturing exports were hit hard by the slowdown in China and rising labor costs are squeezing profits. France is expanding, buoyed by rising business and consumer confidence, the prospect of new tax cuts, and some structural reforms, which improved competitiveness.

Overall, Euro-area bank loans and the money supply are rising, job growth is still okay, and households appear resilient. Falling business surveys suggest growth may stay near 0.5% or so, with some downside risk.

The Japanese economy surprised positively in the first half, but, like the Eurozone, is being worn down by the global slump. The two-percentage point hike in the Value-Added Tax, set to take effect next week, will further drag an already weak story. The Markit News survey of manufacturing businesses fell back to its January low, but the tally of companies in service businesses was the second highest since 2017. Like other developed countries, tough and hardy households are carrying Japan's economy.

There are still plenty of local recessionistas, but the U.S. may be the closest to a clear recovery from the world economic stumble of the last 20 months. Housing activity is visibly accelerating with sales, starts, pending sales, and homebuilder confidence all in distinct uptrends. That doesn't happen with a recession lurking.

Industrial production is getting a nice bounce after languishing most of the year. The Markit News canvasses of manufacturing and service businesses both ticked higher. Household confidence is off the peak but very strong. Job openings are a bit below last year's November high. There are no signs of layoffs, and consumers still see a welcoming job market with many employment opportunities.

We look for the U.S. economy to track 2% to 2.5% growth well through most of 2020.

Downside risks

They're weighty. Geopolitical risks are large and well-known. But the biggest recession risk we see is a deterioration in corporate profits. Business sentiment has been lousy all year. The portion of chief executives or financial officers who expect a recession in the next year has stayed above 60% since January. Capital spending has been weak. Hiring has slowed.

For some time, we chalked all that up to trade tensions, tariffs, and related uncertainties. However, recent downward revisions to U.S. corporate profits suggest that margins have been shrinking. Business sentiment is closely tied to profit growth. Overall profits have been mostly flat for several quarters and are below their 2018 peak. Rising labor costs and higher interest expense from greater debt burdens have pulled earnings lower.

Improving productivity can arrest some of the margin pressure and has been helping for a couple years. However, accelerating wage growth in this late stage of the business cycle will be a persistent problem.

Besides slowing job growth and an inverted yield curve, dwindling profit margins are a third clear sign of a U.S. recession somewhere out in the future.

Connecting profits, trade

There's another reason to be uneasy about profits. Today's trade conflicts are a symptom of an upheaval in the underlying world economic framework. U.S. profit margins have been surging since the 1990s, partly from globalization. When China joined the World Trade Organization in 2001, the country added hundreds of millions of low-cost workers to the world labor supply. U.S. companies moved production facilities to utilize those workers and export their lower-cost goods to the West. Those competitive wages in China led to weaker demand for labor and slower wage gains in developed countries. In the U.S., labor's share of the total output value of all goods and services produced plunged. The remaining portion of output value accrued to capital or business profits, which surged.

Every cycle produces within it the seeds of its own destruction. This one is reversing for two reasons. Chinese wages grew very fast as more global companies set up shop there. Chinese workers gradually became less competitive. Then slow wage growth and the popular narrative of stagnant income created a political backlash that's still playing out in the U.S. and greater Europe. Today's trade tensions are a consequence of that backlash.

For both reasons, businesses are reworking their supply chains. These changes will likely result in higher labor costs as developed-country workers regain a measure of bargaining power. That will dent those lofty profit margins.

In fact, the workers' share of output value has already reversed some of the fall of recent decades. And the mirror image is narrowing margins and shrinking profits.

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Looking ahead

While growth is struggling in the Eurozone and Japan, we expect the developing momentum in China and the U.S. to broaden into a modest world upturn into 2020. With companies under profit pressure and uncertainty still high, any revival that gets underway could run out of steam late next year or early in 2021. That might set the stage for a mild recession.

The long rise in corporate debt, propelled by super-low interest rates, could bring credit strains and worsen a nascent downturn. For now, though, let's enjoy the recovery and see what happens.

Investment ideas

What does this framework mean for interest rates? It suggests that the plunge in government bond yields this year overestimated the risk of imminent recession in developed countries, especially in the U.S. So yields on 10-year U.S. treasury bonds surely found a trough at 1.4%. Better growth should put upward pressure on yields.

However, the Eurozone economy is lethargic, and the European Central Bank will keep monetary policy extra-accommodative for the foreseeable future. Accordingly, yields on 10-year German bunds will stay well below zero. That crazy-low level will likely keep U.S. treasury bond yields from rising above 2%. If yields did hit 2% or more, U.S. treasury bonds would be worth a buy for a short-term trade.

Since clear evidence of a U.S. growth renewal may come only grudgingly, the Fed will likely cut the fed funds rate another 0.25% in October. If that occurs, we'd expect no further Fed action for a long time.

Another reason for a lengthy hold is the current Fed debate on instituting a strategy to "make up" for deviations of inflation below 2%. The target would be 2% average inflation (allow inflation above target to offset time below target). Either way, the Fed will likely remain on hold until the next recession.

With this backdrop, we'd suggest bond investors stick to high-quality corporate bonds. Corporate leverage has increased dramatically, and credit stress will rise sharply ahead of the next recession, so good quality and robust interest coverage are essential. One could mingle in some of the most liquid, best quality bonds in the high-yield or emerging market universe to reach for a little better yield. Except for a trade as noted, we'd avoid government bonds until well into 2020. Euro-area corporate bonds, too. We doubt their current high values are indicative of any fundamental worth; in short, they're overpriced.

What about equities? Even though U.S. stocks are near record highs, they've been in a slow-motion bear market since January 2018. Even today, the S&P 500 Index is only 3% or so above that level. That was also the month of peak valuations; today's price-earnings ratios are well below those of early last year. Big tech stocks, epitomized by the FAANGs, have been the leaders of the long rally from March 2009. But their outperformance ended in June of last year. Passive investors cannot be happy.

Outside the U.S., broad indices are not near prior highs. The STOXX Europe 600 Index is still more than 5% below its high of April 2015. The Nikkei 225 in Japan would have to rise over 10% to reach its October high of last year. The broad MSCI index of emerging market stocks remains more than 20% beneath the top of January 2018.

What's happening is that low interest rates have reached the limits of their ability to drive stock markets higher, absent surging economic growth. Similarly, easier monetary policy can no longer be counted on to lift stock prices much more. After all, how could central banks be any more dovish than they are right now? Yet stocks are going nowhere.

Consider that the huge fourfold rally in U.S. stocks in the decade after March 2009 coincided with the slowest recovery from a recession in U.S. history, thanks to interest rates. Today's stock price is thought to reflect the present value of future earnings or dividends. As interest rates fall, the present value rises even if future earnings don't change. To rally further, stock prices need better economic growth. Hopefully, that's coming.

October could be an erratic month; it has been historically. If world growth does pick up mildly into next year as we expect, stock prices should have at least some modest upside. There could be new highs for the S&P 500 Index and a return to (or near) past highs for other broad indices. With recession prowling somewhere out in the future, one should stay cautious as stocks still sport elevated valuations.

That said, we'd prefer U.S. large-cap stocks to other indices, even as international stocks are more cheaply valued. Small-cap stocks usually underperform in the later stages of the business cycle.

We'd also maintain a portfolio balanced between defensive and cyclical sectors. Dividend-paying stocks and bond proxies have gotten very expensive and tech stocks are well past their performance peak. There was a short rotation into value stocks in early September, but it didn't last. Longer-term, that rotation will persist, but not in the next several months.

Stay balanced. Stay cautious.

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