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Economic Insights:
Will ghosts scare off the recovery?

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We don't think so, but ghosts of recessions past are haunting business leaders. The world economy is still at a "trick or treat" crossroads. One road to further slowdown, the other to recovery.

Slivers of good news suggest an upturn is coming, even though there haven't been clear-cut signs of it. Our conviction is growing for a pickup in world growth into mid-2020. That bump could provide a modest but erratic upside for stock markets.

A waiting game

Like Vladimir and Estragon waiting for Godot, we've been waiting for evidence to validate our optimism about U.S. and world growth. For months, signs have stayed mixed: good news was always balanced by proof of further deterioration.

Lately, though, geopolitical risks dogging business leaders have lessened, and lagged positive impacts of easy central bank policies have become more apparent. The U.S. economy remains resilient. There are grounds to believe Europe may be enjoying a tentative economic trough. Chinese activity is in a modest uptrend. Better industrial output reports in Korea and Japan hint that the manufacturing recession has started to fade.

The turn could be at hand.

The U.S. economy is doing just fine, thank you. The labor market is robust. The payroll report for October was way above expectations: a decent level of new jobs, plus a huge upward revision the prior two months. The GM strike took off about 40,000 and a quirk in census jobs dropped another 20,000. Excluding drags, payrolls would have advanced 270,000 jobs…fabulous. New entrants are swarming into the labor force; disability rolls are falling as labor force participation of disabled adults rises. Hourly wages are up over 3%. Wage gains haven't accelerated lately, but, gains should speed up shortly. Business surveys have improved even though CEO confidence remains at recession levels. Housing activity is accelerating as household formation swells. Consumer confidence stays high. Regional Fed manufacturing surveys have improved on average. Bank loans and the money supply are expanding nicely.

U.S. economic growth did decelerate a bit in the third quarter. Investment contracted for a second quarter with broad-based weakness likely from trade uncertainty. Consumers are keeping things humming with strong spending on durable goods. Solid income growth means that purchases don't erode household savings.

The dichotomy between business and consumers may carry through the next few months. Flagging profit growth could keep capital spending and business confidence on the weak side. If layoffs stay low and the labor market healthy, consumers will keep the economy percolating. We look for U.S. growth at 2% -2.5% through mid-2020 with mild deceleration in the second half. Falling profit margins pose a risk into 2021. The surge in corporate debt may bring stress to credit markets. The coming economic upturn may not be strong nor long.

Economic momentum may be on the uptick in China, too. Retail sales, industrial production and fixed investment all improved in September. The official survey of Chinese manufacturers was very weak, staying below the 50 breakeven level at 49.3, the lowest since February. But, a private barometer from Caixin Global was vastly better at 51.7, the best since early 2017. Output, plus new and export orders, were all the strongest since 2018 or before. Vehicle sales have improved markedly since spring. Several monthly series, like exports, electricity production, and cement output have been trending higher sequentially.

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Loan and credit growth are better. Bloomberg's measure of China's credit impulse, which monitors incremental gains in lending versus gross domestic product (GDP), has rebounded this year. The issuance of special local government bonds has accelerated since June. The boost in credit and fiscal stimulus from the central government should keep economic growth around the 6% target. Secular forces—demographics, declining competitiveness, and high debt levels—are big long-term headwinds for growth.

The Eurozone has been muddling through the world slowdown. It still is, but we hear whispers of better things. Third quarter growth in real GDP wasn't as bad as expected, up 0.75%, seasonally adjusted annual rate. Household demand was decent as auto sales rebounded; capital spending was unexpectedly good. The composite business survey for October showed a marginal uptick. Bank loans and the money supply are growing, which bodes well for modest growth. The labor market is in good shape with the jobless rate at 7.5%, the lowest in over a decade. Overall employment growth is steady.

The main weakness in Euro area growth has been exports outside the region. With business surveys and industrial production improving in emerging Asia, those export troubles may have bottomed. It's likely the Eurozone downturn was at its worst in October. Stabilization is more likely than recession, but, progress out of the trough may be tough. Even with super-slow growth, though, inflation is edging higher; the consumer price index ex food and energy is up 1.1% over the prior year. Central bankers should feel better.

We don't see Europe falling into recession but, it's hard to see much upside near term. Business sentiment is abysmal. The weakness in manufacturing looks to be spreading to services. A Brexit extension may provide mild relief. Any turnaround in world growth may lift manufacturing. Region-wide, growth should be 1% the first part of 2020.

Japan is a different story. The two-percentage point rise in the value-added tax on October 1 pulled consumer spending forward, so retail sales will be weak for a while and GDP may contract. There are some bright spots. Industrial production was robust in September. Machine tool orders and business surveys seem to be stabilizing. The jobless rate rose two tenths in September, but, at 2.4%, it's incredibly low. The labor market is great; the ratio of job openings to applicants is 1.59, near record highs. Total employment is growing around 1% even as the population is falling. We expect economic activity to trough the fourth quarter. A mild pickup in world growth would be a nice tailwind for Japan.

Looking ahead

The global downturn of the last 20 months has been the third since the financial crisis. The biggest risk to this third upturn is flat profits and falling margins, which suggest it may be neither lengthy nor dynamic. High corporate debt levels combined with falling profits could bring credit market stress and a potential downturn in 2021.

More evidence is needed to say the slowdown is ending. We think the proof is coming. Commodity prices seem to be trying to form a bottom, a positive signal. There is better momentum in the U.S. and China. Japan and the Eurozone are struggling, but not desperate. Improving business surveys in China, South Korea and Taiwan are signals that an upturn is likely.

Central banks ask how low is low?

How 'bout them negative rates? Official interest rates keep falling and falling and falling. At the September meeting of the European Central Bank (ECB), the Governing Council lowered its official rate to -0.5% and announced new bond purchases of €20 billion per month. The forward guidance was essentially that rates would stay at the current level or lower for light years. New ECB President Christine Lagarde will maintain former President Drahgi's "do whatever it takes to preserve the euro" attitude.

The U.S. Federal Reserve (Fed) reduced the fed funds rate 0.25% for a third time this year, to a range of 1.5% - 1.75%. Fed Chair Powell was emphatic: we're "not thinking about raising rates right now," a "Read my lips; no new rate hikes" throwback. We expect fed funds to stay on hold through 2020 and certainly no rate hikes until pigs fly or after the next recession, whichever comes first.

The recently weaker U.S. dollar helps emerging country central banks drop their rates without fear of currency weakness. At the Bank of Japan's October meeting, officials refrained from pushing rates more negative, but noted that if further action was needed, it would come.

Is anyone thinking about bringing interest rates back above ground? The Riksbank of Sweden was the first central bank to move into subterranean territory and likely the first to slither out. Riksbank Governor Ingves said it would be a "bonus" to return to zero, warning that interest rates need sunlight eventually.

What's going on? Today, some $16 trillion of bonds currently yield less than zero. It's bizarre. Owners of those bonds are paying borrowers for the privilege of getting "most" of their money back. To understand it, think of a casino: A gambler patronizes a casino and bets $100 on a regular basis. Over enough time, that bettor will go home with an average of maybe $95 for every $100 wagered. That's just the way casinos work; the House wins. Oh,

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the player will have had fun, seen lots of blinking lights, heard bells and whistles, gotten some free drinks and encouraging pats on the back. That's surely worth $5?

As an alternative, one could put $100 into a ten-year Swiss government bond with a current yield of -0.56%. After ten years, the Swiss government would give the investor $94.54. There would be no bells, flashing lights or whistles and certainly no free drinks. Are we simpatico here?

Why would anybody buy a bond with a negative yield? There actually are a few reasons.

Regulation Financial institutions or pension funds may be required to keep a portion of assets in riskless government bonds regardless of yield.

Currency hedging Euro area investors may find that U.S. treasury bonds offer worse returns than negative yielding German bunds when hedging costs are included.

Deflation If prices fall, investors might gain from such bonds if the negative yield is above the rate of deflation.

Fear Investors may believe other assets will have worse outcomes.

Expect even lower yields Prices of negative yielding bonds will rise if yields become more negative, giving investors a robust return.

What's the impact? Initially, there may be some positives. Negative rates may support the local economy, pushing down borrowing costs to induce investment and spending. Governments benefit through lower debt service costs. Negative rates weaken a country's currency and boost exports. But, the longer rates are suppressed, the more problems that may develop.

- Low returns on safe assets threaten pensions. Insurance companies and pension funds won't get enough return to pay liabilities. Workers must put more into the fund. Companies would raise fund payments, hurting profits.
- Individuals saving for their own retirement would save more. Greater savings mean less money to spend, slower economic growth.
- Negative rates create uncertainty by suggesting the economy is in terrible shape, if such an unusual policy is necessary.
- Banks would raise borrowing rates and/or reduce lending.
- Capital would be misallocated by funding low-return ideas and keeping inefficient companies in business. Productivity gains would fall.
- Banks would likely not charge customers for holding cash. So, bank costs would rise. Banks would raise other charges to compensate.
- Low safe returns induce investors to take on more risk leading to potential asset bubbles and then financial crises.
- Super-low interest rates raise asset prices, creating more income inequality by favoring people most likely to own those assets.

Where does it end? We don't know. But, a long period of negative interest rates will likely create plenty of unanticipated consequences. Below-zero yields are surely unsustainable.

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Investment ideas

The long stock market rally from March 2009 to January 2018 may be over. A new and different investment cycle is likely coming, but it's not here yet. As a result, we don't see any enduring trends on which investors can jump and stick for long-term profit. It's a short-term, tactical environment over the next 18 months to two years.

In that period, our economic framework suggests mild upward pressure on long-term safe-haven government bond yields. Ten-year U.S. Treasury bonds yielded 1.69% at the end of October. Those yields could hit 2% or more if global growth picks up. If the upturn is indeed shorter and weaker than the last two, U.S. treasuries yielding 2% to 2.25% would be a good buy for 18 months ahead of a possible 2021 economic downturn.

For a one-year window at least, bond investors should stick to high quality corporate or municipal bonds at two to four-year maturities. Investment grade, high-yield or emerging market debt would work, just stick to the highest-rated securities.

Equity markets should still have some modest upside if growth improves as we expect. But, at these tall valuations, the future may be limited. If recessions' ghosts are worrisome, investors might consider taking a few profits on a semi regular basis, if or as the uptrend progresses. We'd maintain a portfolio balance, both by sectors and by major country. International may outperform U.S. equities. Value indices are too cheap versus growth. Caution and balance rule. Trick or treat?

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