Principal Global Investors

Economic Insights: **The third wave of revival**

Update for the month of January 2020

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World growth hit three air pockets since the Great Recession and financial crisis of 2008. The first slowdown followed the Euro-area debt debacle of 2011 and 2012. Then, in 2015, a soaring United States dollar and collapsing commodity prices created a severe manufacturing recession. After each slump, the global economy perked up rapidly in a synchronized rebound led by an accelerating surge in China. The latest downturn began in China in late 2017 as officials tightened credit to slow the growth rate of debt. World growth gradually wilted.

Now, a third wave of revival from this twenty-some month tumble has begun. Economic momentum is clearly improving in the U.S. and China. A modest upturn is starting in the Eurozone, and Japan's economy is nearing an economic trough.

China

Recent data validate this anticipation of better growth, particularly in China. Business surveys there have bounced in both manufacturing and service sectors. Credit growth has accelerated as the government made it easier for local governments to initiate bond issuance. China's leading economic indicator created by the Organization of Economic Cooperation and Development troughed in February, and our own activity guide has been picking up since spring. Broad gauges like retail sales, industrial production, and fixed asset investment all improved significantly in November. Narrower markers of railway traffic, electricity output and airway passengers have trended higher for several months. Robust real estate investment and rising house prices will help keep economic growth near target.

The partial détente in the U.S.-China trade conflict bodes well for better growth next year. Official statistics in China should show stable growth near the 6% range in 2020. Over the next decade, though, secular headwinds of poor demographics, rising debt burdens, and waning competitiveness will keep economic growth in a long, gradual decline.

United States

U.S. activity appears to be bouncing. The production cuts at Boeing may cut first quarter growth in gross domestic (GDP) by three or four tenths, but the strike at General Motors is no longer a drag on industrial output. Even beyond autos, though, manufacturing picked up in November. Small business optimism has perked up and remains near all-time highs. Job growth is extraordinarily strong for this late in an expansion. This boosted consumer confidence. Wage gains keep accelerating for production and non-supervisory workers, now at a smoothed 3.4% rise over the prior year. Household balance sheets are in excellent shape and the savings rate stays high at 8%. Housing activity is surging as consumers take advantage of low mortgage rates. Housebuilder confidence jumped to the highest in 20 years.

Though capital spending has been weak in 2019, we expect investment to rebound in 2020. After all, CEO confidence is rising off the lows, trade uncertainties have lessened, and growth is improving. Wage gains will remain stout, so consumers will support the overall economy. The robust savings rate and balance sheets make a sturdy foundation for vigorous consumer spending. We expect the expansion to persist through 2020 with growth at or above trend in a 2% to 2.5% range.

Eurozone

The Eurozone economy has lagged the U.S. and China recently, avoiding recession as the weak link this year, Germany, kept expanding in the third quarter. For the Eurozone as a whole, the trough was likely the fourth quarter of 2019. Service sector surveys have picked up from the bottom, but canvasses of manufacturing companies may not be there yet. Those latter surveys showed activity ticked down in December after weak October activity. But overall business sentiment shows signs of recovery. Robust household activity is keeping recession at bay, buoyed by a vigorous labor market.

The Eurozone is set for an upswing. With better vehicle sales and improving growth in China, German manufacturing will pull out of its funk. Wage growth is accelerating, and job gains stay hardy as the labor market tightens. Household spending will sustain economic growth and ward off recession. Capital spending will rise as confidence returns. We expect Eurozone growth to rebound modestly in 2020 to near 1.5%.

Japan

The hike in the value-added tax (VAT) in Japan on October 1 had the same negative impact as prior ones: heightened sales before the hike and a collapse afterwards. It may cause growth to contract in the fourth quarter and has surely delayed any rebound in Japan. Manufacturing remains weak from global headwinds. Although the job market is incredibly tight and job openings plentiful, the unemployment rate remains remarkably tiny at 2.2%. The labor force participation rate for prime-age workers, 25 to 54 years, keeps rising, now at 88%, a record by a huge margin.

Nevertheless, Japanese industry is in recession as machine tool orders and industrial production keep falling. We do look for growth to pick up modestly in 2020 as the tax impact fades. The government has proposed a large stimulus package to offset the VAT and the 2020 Olympics will provide a temporary lift. Industrial output in Taiwan and South Korea has trended somewhat higher, a harbinger of a broader pickup in Southeast Asia from which Japan will benefit.

Global overview

We believe the foundation is being set for a mild but sustained pickup in world growth for 2020. Central banks are very accommodative. Interest rates stay extremely low. The lagged impact of rate cuts will stay beneficial all next year. Stimulus in China, while timid, is supporting growth. Trade uncertainty has lessened. The U.S. dollar has weakened. Credit stress is negligible. Inflation stays moderate. Commodity prices are rising, sniffing the aroma of better growth. The third wave of revival has begun.

But there are some notes of caution. The January 3 killing of Iranian General Qassem Soleimani by U.S. forces brings the potential for a spike in oil prices. The initial bounce in prices was subdued, less than the immediate spike after the Iranian attack on Saudi oil facilities. A big spike in oil prices would be overall negative for the U.S. economy. Still, the vast increase in fracking oil production has muted negative fallout. Consumers will be hit from higher gas prices, but the fracking industry will be buoyed. The region is unstable, and uncertainty will continue. Significant escalation would curtail the upturn and could bring economic problems forward.

While upbeat activity is coming, the recovery will likely be shorter and less dynamic than the two since the financial crisis. This time, China's stimulus has been more timid than its credit-fueled binges of the past. The fiscal impetus has been through tax cuts, lower reserve requirements, increased infrastructure spending, lower interest rates, and select provincial bond issuance. Officials have tried to rein in excess debt growth and keep leverage under control. Bond defaults, unheard of in the past, have been rising, validating Beijing's need for caution on debt. Growth has stabilized in 2019 but won't be running away to the upside.

China's uninspiring recovery can't be the engine of a dramatic global synchronized rebound as in 2017. With China's import machine failing to gear up as before, its boost to the world economy will stay subdued. Any growth revival in the Eurozone, Japan, and emerging markets will likely be restrained as well. Further, with a Phase 1 agreement between the U.S. and China, it's possible the Trump Administration could make the Eurozone its next tariff target.

Can the U.S. alone be the driver of a dynamic world revival? Likely not. There are several typical signs of the end-cycle that are apparent, which suggest that the current U.S. rebound will be not as strong nor as long as past bounces.

The world uptrend currently unfolding will likely have enough momentum to carry at least into early 2021. However, the potential dullness of this upturn could create the setting for another slump of sorts in mid-to-late 2021. Accelerating U.S. wage gains could set the stage for the recently dreary profit growth to become losses. This would shut down job growth and capital spending and potentially usher in a mild U.S. recession. If that were to happen, other signs would arise before the recession's onset that could give more clarity about its timing and severity.

For now, though, let the growth pickup to run its course and enjoy the ride while it lasts.

Investment Implications

The economic backdrop always sets the stage for what investors will experience in stock and bond markets, because it's those underlying fundamentals that drive future financial trends. A stronger world economy in 2020, followed by potential problems in 2021, suggest there will be no multi-year trends that investors can simply ride to easy profits. The New Year will be a time for shorter-term, tactical decisions.

Whether thinking short- or long-term, most diversified equity investors had a fabulous 2019. The S&P 500 Index soared 28.9% in price during the year, while the broad MSCI All-Country World Index surged 20.8%, not including dividends. Long-term, buy-and-hold investors didn't fare quite as well after adjusting for the 20% or more plunge in stocks from early October 2018 through late December 2018. Still, multi-year holders of the S&P 500 Index gained 10.4% from that 2018 peak through yearend 2019. That's a nice return.

Bond investors also had a great year. All the 22 bond aggregates we follow had positive returns. The best reward came from owning long-dated U.S. treasury bonds as interest rates fell to low levels raising the price of those bonds. Barclay's index of long U.S. treasury bonds returned a terrific 18.1% during the year. As August worries about an imminent recession faded, owners of investment grade, high-yield, and emerging market debt enjoyed returns of 11% to near 15%.

What's ahead for interest rates? The Federal Reserve (Fed) has made it clear that the bar for raising the fed funds rate is high. That means the Fed won't hike rates until there are definite signs that inflation is picking up in a sustained fashion. In addition, the Fed will likely change its inflation-fighting framework away from a simple fixed 2% target. The new target may be 2% "average inflation" over time. So, if inflation stayed below 2% for several years, the Fed would allow inflation to exceed 2% for a while to "make up for" the undershoot. All this implies the Fed will stay on hold throughout 2020 and perhaps much longer.

Improving world growth would suggest that long-term interest rates will see mild upward pressure in 2020. We wouldn't be surprised to see yields on 10-year U.S. treasury bonds hit 2.25% or more at some point. Similarly, yields on 10-year German bunds will turn positive, up from -0.4% or so in early December. With yields at the short end fixed by the Fed, modestly rising long-term yields imply the yield curve will steepen. That would please members of the Fed Board.

Today, short-term bond yields aren't much lower than those on longer maturities. Bond investors with a six- to nine-month (or perhaps 12-month) perspective should stick to corporate or municipal bonds with two- to four-year maturities. Given that the potential cyclical upturn could weaken into 2021, we'd buy only highly rated securities. That would apply to any risk class: investment grade, high-yield, or emerging market sovereign or corporate debt. Just stay with the highest quality. If the upturn is more dynamic than expected, long-term yields will likely rise further, so that short-maturity stance would still be appropriate.

Can stocks keep moving higher? With better global growth and absent a significant escalation of Middle East conflicts, there should be some modest upside for world stock markets in 2020. Rising yields would imply it's better to overweight stocks versus bonds in 2020 at least for a while. For U.S. equities, valuations are high and profit expectations are likely too robust, so, it may be a grudging uptrend. The price-earnings ratio of the S&P 500 Index using trailing 12-month operating earnings is 20.4, not far from the peak P/E of 21.5 at yearend 2017. Standard and Poor's average analyst estimates of 2020 earnings growth were 11.1% at yearend 2019. That estimate has been gradually falling and will likely continue to fade.

An equity portfolio that's balanced between U.S. and international, as well as between sectors, may have the best opportunity for decent returns. Faster world growth is often a drag on the U.S. dollar. Foreign equities are generally starting the year with lower valuations. Big U.S. tech companies have been leading the long uptrend from March 2009, but that leadership is waning. We wouldn't underweight value stocks or the financial sector as growth picks up.

However long this upturn in stocks persists, it will likely be the last rally before the end of the historic U.S. expansion. It's now midway in its eleventh year, the longest ever. It's also the first time the U.S. economy has traversed an entire decade without a recession.

Beyond whatever economic problems may develop in 2021, good financial returns over the next decade may be very hard to find. Several broad measures of sentiment point to low decade-long average U.S. stock returns:

- the price-earnings ratio;
- Tobin's Q, or the ratio of market capitalization to replacement value;
- Warren Buffet's favorite indicator, the ratio of total U.S. market capitalization to the size of the U.S. economy;
- and the portion of equities in total household financial assets.

Each is a sign of widespread public enthusiasm for stocks, which has historically been a broad contrary indication for future returns. While we expect the six to 12-month outlook to be rewarding, investors may want to be cautious about the long-term.

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