Economic Insights: **The stirrings of expansion**

Update for the month of July 2020

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After a record-short recession, a new United States economic expansion may have begun.

Economic data suggests recovery may be under way in much of the world. Daily new cases of COVID-19 are rising in some areas, though sources (via Worldometers) aren't yet indicating signs of a second wave. Equities made progress in June with the best returns among emerging market and tech-heavy indices.

A modest stock market uptrend should persist through the summer but may encounter selling near the prior highs and more volatility before the U.S. election.

A record-short recession

The National Bureau of Economic Research (NBER), the arbiter of U.S. business cycle dates, concluded that February was the peak of the last expansion. That economic uptrend lasted 128 months from the recession low of June 2009, the longest in U.S. history.

The worst recession since the 1930s began in March, due to business closures and shelter-in-place policies to check the spread of the current pandemic. This recession has also been unique in its length, the shortest in history, ending in April or May, after only two or three months.

Whatever date the NBER puts on the recession's end, a new expansion may have begun.

That's mostly true around the world: A recovery from the worst global recession in decades is possibly underway. China was the first country to emerge from the COVID-19 lockdown and data from its government notes economic improvement in March from the collapse in January and February. Industrial output for those worst two months combined was down 13.5% below the prior year. Production surged in March and surpassed the prior year in April, up 3.9%; further progress was made in May. Purchasing manager indices (PMIs) from manufacturing business surveys improved from May and showed faster expansion. According to the Chinese government, industry is mostly back to normal and expecting output in June to exceed May's annual gain.

Chinese consumers have been more restrained, likely from lingering fear of infection and reports of a renewed outbreak in Beijing. Retail sales disintegrated in January and February, off a combined 23.7% from the same period in 2019. Sales recovered in May but were still down 2.8% from the prior year. Still, demand seems to be improving. June PMIs from services companies were robust and above expectations. The all-industry composite index from the National Bureau of Statistics reached the highest since mid-2018. China reports incredible progress in just a few months. If that's indeed the case, its sharp recovery would help lead the world out of recession.

The Eurozone economy is also showing signs of life after the devastating collapse in March and April. The PMI for manufacturing companies was 47.4 in June, still below 50 breakeven. But it's the second highest this year and up from a devastating April low of 33.4. The all-industry composite PMI jumped nearly 35 points in two months to 48.5, with further increases likely in July. Daily mobility statistics point to a healthy pickup in activity. German retail sales in May surged 13.9% over April to put them above the level in February as well as May 2019. May retail sales in France and Spain rose even more sharply. Confidence is still low but seems to be rising.

The Eurozone is benefitting from strong action by the European Central Bank (ECB) to increase its country bond purchases and expand its bank lending program. The ECB hiked its Pandemic Emergency Purchase Program (PEPP) to a massive €1.35 trillion of potential bond purchases. In addition, the latest auction of its Targeted Longer-Term Lending Operation swelled to €1.3 trillion, funds that are available to banks for specified lending activity at a cost that could be as low as 1.0%.

Further, after years of Eurozone austerity, fiscal stimulus is coming to the fore. The German government agreed to new fiscal spending well over €100 billion; other countries' deficits are surging. With PEPP, ECB bond purchases can be large enough cover the Eurozone's anticipated deficits. Widespread work subsidy programs have kept the Eurozone jobless rate from roaring higher, only ticking up to 7.7% in May. The Eurozone recovery will accelerate in the third quarter.

Japan's economy was faltering ahead of the COVID-19 crisis from the October hike in the value-added tax. Fourth quarter gross domestic product (GDP) in 2019 plunged 7.1%, annualized quarter-over-quarter, and another 2.2% in this year's first quarter. The economy in June was following two tracks: further weakness in industrial output, down another 8.8% in May after a bigger 9.8% plunge in April. The other track shows clear gains in consumer activity with May retail sales up 2.2%. The Apple Mobility Index for Japan keeps mending, now, nearly back to January's level. The composite PMI, at 40.8 in June, is still very low, but rising. Recovery appears to be underway, but it will likely be gradual and protracted.

The U.S. economy rushed higher in May after the collapse and closures of March and April. Regional manufacturing PMIs leapt to near breakeven or more in New York, Philadelphia, Richmond, Kansas City and Dallas, most well above expectations. May retail sales sky-rocketed 17.7% over April as consensus forecast only an 8.4% gain. According to data from the Bureau of Labor and Statistics, May payrolls climbed a monster 2.5 million jobs versus pre-report guesses of a 7.5 million job loss. June payrolls continued the gusher with a record gain of 4.8 million new jobs, 1.6 million above average projections. The May Chicago Fed National Activity Index rose to a record, implying U.S. GDP growth near 8%. The up-wave in data for May came from businesses reopening and people returning to work.

The revival from suspending business closures continued the first half of June. But gains seem to have stalled somewhat as daily new COVID-19 cases reached new records recently in several southern states. Restaurant seating data from Open Table, the online reservation system, fell off the last couple of weeks. J.P. Morgan's tracker of consumer spending data from its Chase credit and debit card system fell back noticeably in late June after increasing steadily since mid-April. The data doesn't seem to indicate this is a second wave of the pandemic, but lingering fear of further infection could prolong a return to normal.

The huge May pop from the April economic collapse was like taking the express elevator back to the ground floor from the sub-sub-basement, a V-shaped upwelling after a record contraction. From here, the U.S. recovery may become more a stair-step affair, with an activity breather followed by another rush higher. Now is likely one of those pauses. The rebound from the April economic plunge will likely resume with renewed vigor for another few weeks.

By September, though, the early reopening energy will have dissipated, and the recovery turn more gradual. We expect vigorous third-quarter GDP growth near 10% annualized but followed by a more prolonged recovery. Continuing claims for jobless compensation remain stubbornly high and reports of layoffs are still coming in. Some small businesses in the service industry won't reopen and it will likely take until 2022 for GDP and employment to reach their prior peaks.

Nevertheless, consumer incomes are being sustained; job growth is mushrooming. A healthy recovery should persist with growth in 2021 near 2.5% or more and some slowing into year end.

Looking ahead

Worldwide mending from the COVID-19 economic plunge appears to be underway. A few countries—India and Latin America in particular—are still struggling with a late arrival of the virus. But in the data covered in this piece, we see recovery in much of the rest of the world.

China was the first to grapple with the economic collapse and, according to Chinese government sources, is sharply rebounding. The rest of the world may follow that pattern. Prices and economic data are carrying the same message of upside surprise. Stock markets anticipated the revival with the best quarter in two decades. Some commodity prices are reacting to better demand. West Texas Intermediate crude oil hit $40/barrel. Copper is up 27% in price from its March low. The CRB Index of raw industrial prices has worked a bit higher since April. Bloomberg's broad index of commodity futures prices is up 10.3% since the trough in March. The Baltic Freight Index has nearly quintupled since mid-May.

The outlook for a summer pickup in growth looks good. The real uncertainty revolves around the odds for a second wave of virus activity in the fall and winter flu season. One disconcerting fact is that new cases haven't fallen to zero in any of the countries that we follow. Fortunately, fatality levels appear to have kept falling. Any economic dislocation from a second wave of virus activity will likely not be as severe as in 2020.

Focus on markets

June was a good month for most stock and bond markets. The S&P 500 index rose 1.8% in price but was outperformed by many foreign equity indices. The MSCI Emerging Market Index jumped 7.0% and the MSCI All Country World Index climbed 3%. While June returns were good, the second quarter was stellar; the S&P 500 Index soared 19.95%, the best gain since the fourth quarter of 1998. Of the 47 markets we follow, only the Mongolian Top 20 index lost ground for the quarter.

Bond investors were generally treated well, too, as markets were supported by massive central bank backstops. People holding funds with high yield and other diversified (but more risky) corporate bonds had robust returns as credit spreads narrowed markedly in the second quarter. Even owners of long-term safe-haven bonds had a positive return as yields on government bonds were flat to only slightly higher in June and the quarter.

Looking ahead

Holders of short- to intermediate-term bonds won't have to worry about the Federal Reserve (Fed) or other central banks hiking official rates anytime soon. The Fed will keep the fed funds rate in the 0% to 0.25% range surely through 2021 as inflation won't be a problem.

Large central bank bond purchases will keep yields on long-term U.S., German, and Japanese government bonds under modest down pressure through early next year. But, with yields already very low or negative, and unlikely to fall further in the next year or two, there's little scope to expect much return. In addition, as growth revives, there will be significant countervailing upward pressure on yields. So, we'd surely avoid investments in long-term, safe-haven government bonds.

Somewhat higher yields are available on diversified corporate, municipal, or emerging market bonds. Credit spreads have already come in significantly on investment grade bonds, so the potential return from further spread narrowing is limited. Credit spreads on high-yield or emerging market bonds could still narrow more so I prefer those to investment grade. However, we'd stick to higher quality bonds in those riskier sectors. We'd also prefer short- to intermediate-term maturities to avoid the risk of rising long-term interest rates next year.

Stock markets did broaden out during June. The Russell 2000 small cap index nearly kept up with the soaring Nasdaq Composite and did outperform the S&P 500 Index for the month and quarter. Wider participation is a real necessity if the rally is going to persist. With growth possibly reviving, we expect a modest equity uptrend to continue. The S&P 500 Index could challenge the February 2020 highs in the next couple of months, but we'd expect markets to encounter selling pressure then. Volatility may also return prior to the U.S. election.

We prefer stocks that do best as growth picks up, cyclical sectors like materials, industrials, financials, consumer discretionary. We'd also stick with small cap and emerging market stocks; both did well in June, and that should continue. The U.S. dollar is weakening; growth appears to be reviving; commodity prices are picking up; all are good reasons to prefer emerging market stocks. Fear around the persistent rise of new U.S. COVID-19 cases may have been behind the huge surge in tech and growth stocks last month. We still believe tech stock momentum will wilt before long, but we were early with that call last month. It has already faded versus the Russell 2000 and the MSCI Emerging Market Index.

All these suggestions remain tactical in nature, with a time horizon of nine months or so. The revival of world growth should keep the equity uptrend intact at least for a while. There's a lot of uncertainty around the strength of the rebound into next year and the potential for a second wave of virus activity.

Looking further ahead, stock valuations as well as bond prices are very high, signs that long-term financial returns may be far less than exciting. The best potential for robust long-term equity profits is a rotation into value and cyclical stocks, a reverse of the investment climate of the last decade.

For now, though, the recovery seems on track and we'd stay fully invested commensurate with one's tolerance for risk. Stay optimistic for now.

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