Principal Global Investors

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Economic Insights: **The rebound turns muted**

Update for the month of August 2020

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The United States economy surged ahead in May and June from the cavernous losses in March and April. But widespread concern about the rise in new COVID-19 cases dampened the rebound's vigor in July.

Economic data is improving in Europe and Japan. China's recovery is proceeding rapidly. Most stock, bond, and commodity price indices rose nicely in July. The economic rebound should keep the equity uptrend intact over the near-term.

But high valuations for both stocks and bonds suggest that long-term returns on diversified portfolios of financial assets will be less than impressive.

Recovery: Challenging and lengthy

U.S. economic data for May and June advanced in spectacular fashion after a record collapse in March and April. Retail sales for June surged almost back to their February level. National business surveys by the Institute for Supply Management show a solid expansion underway. The average of regional business surveys from the Dallas, Kansas City, Richmond, New York, and Philadelphia Federal Reserve (Fed) banks jumped from an April low of -66.4 to 12.4 in July, the best since late 2018. Housing activity is booming; July homebuilder confidence is back to its March level and above any point of 2019. The pending home sales index is the highest since mid-2006. Small business confidence from the National Federation of Independent Business is nearly back to its average of 2019.

We'd been expecting a V-shaped bounce that would last perhaps two to four months as U.S. businesses reopened and people started back to work. But widespread concern about the pickup in daily new U.S. COVID-19 cases since late June dampened the rebound's vigor, likely limiting the V to two months. Restaurant seatings compiled by OpenTable flattened out in July after rising in May and June. Daily traveler counts from the Transportation Security Administration had the same flat trend in July averaging about 665,000, but up from about 44,000 in April. The May-June rise in consumer spending evident in JP Morgan Chase credit/debit card data also leveled off in July.

The good news is that daily new U.S. COVID-19 cases may have peaked July 23 as the seven-day moving average has been falling since then, down to 61,964 on August 1 (here). If that does prove to be the peak, the U.S. recovery will likely stay on track but at a more muted pace than in May and June. Even with the July lull in the upturn, third quarter GDP should have quite a pop. Suppose June data is 5% or so above the second quarter average, a plausible estimate. Then, even if third quarter data stayed flat, the way the math works means GDP would show an annualized gain of 21%. So our earlier forecast of an 11.4% GDP gain this quarter could be too low.

Beyond the third quarter, though, full recovery from the pandemic recession may be challenging and lengthy. Millions of workers are still on furlough or permanent layoff. Many small businesses won't reopen, especially in leisure and hospitality, with even large chains facing huge losses. The COVID-19 virus is proving resilient and lasting and may require major changes as we learn to live with it. We're optimistic that the revival from the cavernous losses of March and April will last through 2021, but it will likely be at a more measured pace than the bounce since early May. As a result, the U.S. economy may not exceed its prior peaks in either GDP or employment until sometime in 2022.

Dynamic revival in China

Industry in China has come full circle. Industrial output was back above the prior year's level in June. With production activity mostly normalized, total June industrial profits showed a second month of growth at 11.5% over the prior year, following a 6.0% gain in May. Official purchasing manager indices (PMI) from the National Bureau of Statistics for manufacturing edged up to 51.1 in July up from a February plunge to 35.7, the worst on record. The non-manufacturing PMI slid 0.2 to a still-strong 54.2, which put the composite PMI at 54.1, the second best since mid-2018.

Real estate investment is still a driving force in China's economy. Construction PMI was a robust 60.5 and year-to-date property investment up 1.9% from the same period last year. The vigorous rebound has pushed investors into local stocks. Chinese stock indices were world leaders in July with the Shenzhen Composite Index up a healthy 14.2%.

Households in China stay more restrained, likely from a lingering fear of COVID-19 activity. China is experiencing a mild flareup of new cases in the last few days that may keep consumer spending from normalizing for a while. June retail sales were still 1.3% below June 2019. Vehicle sales, though, have been very strong. China was the first economy to exit the pandemic recession and its revival has been dynamic. We expect it to continue.

Word from Europe

Recovery in greater Europe is getting underway. United Kingdom retail sales soared 13.9% in June over May and the preliminary composite PMI jumped to a burly 57.1, the highest in years. The Eurozone composite PMI, at 54.8 in July was the best since mid-2018. Eurozone consumer sentiment is still low but rising. After a nearly incomprehensible 40.3% annualized plunge in second quarter Eurozone GDP, the upsurge in the third quarter should reach well into double digits.

Several things are helping in the Eurozone. New cases of COVID-19 are staying low and the end of the lockdown seems to have gone fairly smoothly. The robust rebound in China has given Eurozone businesses a lift in confidence given the area's healthy exports to China. Further, wage subsidization plans have kept unemployment from rising very much.

Perhaps most importantly, the political leadership of the European Union (EU) has created an economic recovery plan that encompasses what may be the first step toward a fiscal union. The Recovery and Resilience Fund is a €750 billion addition to the EU budget. The money will be borrowed in the name of the EU and the funds will be available for loans and grants to member countries. The purpose of the Fund is to finance investment projects that will raise a country's long-term growth potential. It's a real step toward coordinated fiscal policy. This Fund establishes the principle that the EU can borrow funds and repay the debt with taxes it collects from member countries. Euro-area recovery should continue.

Extended difficulties in Japan

The pandemic extended the difficulties the Japanese economy was having trying to recover from an October hike in the value-added tax. Now, however, just as data began to improve a bit, the number of daily new COVID-19 cases is spiking, reaching a new high of 1464 on August 1 by one source (here).

Industrial production did rise 2.7% in June over the prior month, the first increase since January. Retail sales bounced sharply in June, jumping 13.1% over May and bringing sales back near the level of early 2020. Consumer sentiment has picked up somewhat from an historic April low but is staying depressed. Business surveys still show contracting activity. Third quarter data should show a substantial leap higher, but the recovery will surely be sluggish and prolonged.

Looking ahead

Recovery from the pandemic recession is in progress around the world. It's well underway in China and parts of Southeast Asia and getting a good start in the Eurozone and the United States. Global stock prices have anticipated the revival with the strongest four-month rally in years. Commodity prices are mostly carrying the same upside message. The CRB Index of raw industrial prices reclaimed nearly half the ground it lost from the January high. European Brent crude oil prices more than doubled from the April trough. Copper prices, an excellent indicator of economic activity, have been surging, up 35% since mid-March.

The fast, sharp economic recoil from the demoralizing pandemic plunge is likely over, although lagging data reports will continue to look great for another month or so. Several countries are still experiencing high or fast rising daily cases of COVID-19, especially India, much of Latin America, Iran, Indonesia, and the Philippines.

Recovery in emerging markets will lag the rest of the world, but is being boosted by robust growth in China, super-low interest rates, and a weaker U.S. dollar. We expect the global recovery to proceed quickly during the rest of 2020. We're also optimistic about 2021. But, until a robust vaccine is developed or we learn to coexist with COVID-19, the economic outlook will remain somewhat fluid.

Focus on markets

July was another strong month for stock and bond returns and for broad commodity price indices. The S&P 500 Index rose 5.5% in price. The MSCI Emerging Market Index outpaced U.S. equities rising 8.4% in the month, boosted by the factors noted above. Performing just below the top returns of several Chinese equity indices, the Dow Jones Transports racked up an unusually hefty 9.0% price gain for the month.

Two factors contributed to healthy bond returns across the risk and long-duration spectrum. Yields on long-term U.S. treasury bonds plunged to new multi-century lows and the Fed soothed bond investors' fears of an insolvency-driven credit crisis with super-easy policy. Barclay's U.S. Corporate High Yield Index and U.S. Long Treasury index gave investors a 4.7% and 4.2% return, respectively. Euro area and emerging market bond indices had generally good returns, too.

Outlook

With short and long-term interest rates near record lows or below zero, and little reason to expect much change this year, bond investors will have difficulty finding robust returns. The Fed will keep the fed funds rate near zero likely through 2022.

The results of the Fed's long study of changing it's 2% inflation target may be unveiled at the September meeting. We expect the change to be a target of 2% inflation averaged over a period of time. So, a decade of inflation under 2% could be offset by a period over 2%. This could extend the near zero fed funds rate indefinitely.

Yields on long-term government bonds should begin to have some upward pressure late this year or next, absent lasting pandemic issues. Bond investors could position for that eventuality by owning short-to intermediate-term corporate bonds, expecting a little more compression in the yield spread between corporate and government yields. But there isn't much juice left in that tank as spreads have already narrowed dramatically.

For long-term equity investors, we've suggested there would be good odds of an internal rotation in stock markets from secure growth stocks to cyclical companies at some point. The latter stocks benefit from strong growth. Stocks of the former type thrive in an environment of slow growth, super-low interest rates, and little inflation, just like the decade since the financial crisis. Growth and tech stocks outperformed mightily over that period.

We have long felt the decade of the 2020s would be a much different environment from the 2010s. It would be characterized by a bit of inflation surprise driven by fading globalization, massive fiscal spending in response to the pandemic lockdown, and central bank support of that policy with large purchases of government bonds. The rotation we suggested would outperform in that environment and we expected it to begin over the next year.

There are tentative signs of it already. The price momentum of very large tech stocks and even the Nasdaq Composite could be starting to fade. The July returns of the Dow Transports and Emerging Markets are examples of cyclical company success. Further, the market has been broadening: The Russell 2000 small cap index nearly kept pace with the Nasdaq 100 Index since the March equity trough. The S&P 500 Index outperformed the Nasdaq Composite after July 9. The materials sector did better than the S&P 500 Index since March and the Industrials sector is no longer underperforming.

Whatever rotation is underway, if indeed it is, will be sporadic and irregular. This analyst still thinks positioning one's portfolio for that rotation is the best way to acceptable long-term returns if we are through the worst of the pandemic. The long-term upside for broad indices may be limited by very high existing valuations, whether using the ratio of price to sale or to earnings. There is a very large valuation difference between value and growth stocks. At some point, rotating into long underperforming sectors may provide decent returns even if major indices make little progress.

We'd no longer overweight growth and tech stocks but prefer cyclical sectors, such as materials, and industrials, consumer discretionary. Financial stocks will do well when long-term bond yields see some upward pressure. That should happen at some point, more a question of when, not if. With the U.S. dollar weakening and interest rates still super-low, stocks in emerging countries will likely continue to outperform, so don't discount them.

For the short-term, recovery from the recession should offer further modest upside to world stock markets. The S&P 500 Index could reach new highs in the 3400 to 3500 area. We expect more volatility leading up to the U.S. presidential election and perhaps after, given possible problems around voting during a pandemic.

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