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Economic Insights: **A stalling rebound?**

Update for the month of November 2020

Commentary by **Robert F. Baur, Ph.D.**, executive director, chief global economist

The surge in daily new Covid-19 cases in Europe is stunting the recovery, but manufacturing there is strong. Even as virus cases in the United States rise, the rebound is extending, and the energy continues.

The U.S. and Chinese economies are driving the world revival. October equity market corrections aren't new to investors, but this one felt vicious. The potential for a contested U.S. election could keep volatility high through year-end, but we expect a modest uptrend to materialize in the New Year.

Long-term interest rates could have a mild upside if economic renewal endures.

Arrive, revive, take five

The mindboggling rebound from the wreckage of the COVID-19 lockdown arrived in the third quarter. In the Eurozone, real gross domestic product (GDP) grew at a skyrocketing 61.1% annualized pace from the second quarter. U.S. GDP leapt by a nearly as astonishing 33.1% annualized, even with no inventory gain and a three-percentage-point deduct from net exports. The U.S. economic revival continues apace with healthy momentum into November. China's resurgence remains vigorous as the first country to show an annual gain in GDP.

After the supercharged economic blastoff of the last quarter, recovery in the Eurozone could "take five" this quarter, as a mild contraction may occur given the surge in COVID-19 cases and renewed restrictions on economic activity. The seven-day moving average of daily new virus cases is more than 20,000 in Italy and Spain, more than 40,000 in France, and at new records in most Euro-area countries and the United Kingdom (here). Fortunately, fatality numbers are staying well below the high levels of March and April. Renewed restrictions on many service-sector businesses will take their toll on growth, but there are big differences between sectors. October surveys of manufacturing companies rose nearly a point to 54.4, the highest since August 2018, while those from service businesses still indicate contraction.

Rising risks induced the European Central Bank to signal more easing action in December to keep financial conditions favorable. This would likely be increased bond purchases and larger targeted lending operations to keep plenty of financing available to business. We also expect Euro authorities to turn a blind eye to mushrooming fiscal deficits across many countries. In similar action, the U.K. support programs have already been extended. We look for a mild contraction in fourth quarter GDP, but a renewed recovery in 2021. Households still have the wherewithal to spend as U.K. and Eurozone retail sales are already well above pre-pandemic levels. As Asia gets back to normal, Europe will benefit from robust foreign demand.

The outlook may have brightened somewhat for Japan. New infections haven't risen recently as they have in the U.S. and Europe (here) and daily fatalities stay in single digits. Most of the remaining restrictions on activity were eased in September. Retail sales have recovered almost all the ground lost during April and May. Industrial production jumped 4.0% in September, the fourth consecutive gain, and manufacturers expect a sustained recovery. Exports are gaining momentum given the strong rebound in China and other parts of Asia. Surveys of purchasing managers improved a bit in October but show only limited healing. The government plans to extend its subsidy program for travel expenses and restaurant payments. We expect Japan's gradual recovery to continue.

China's amazing resurgence continues as the economy returns to normal. Retail sales had been the slowest sector to come back but September sales were 3.3% above the prior year. Households had restrained their activity for some months over possible new outbreaks, but the strong showing in retail reflects a broader consumer recovery. Exports have been vigorous for months, but solid imports in September pointed to strengthening domestic demand. Credit expansion was sizeable in the latest data with total social financing rising 13.5% over the prior year. The healthy recovery will persist with strong growth in the fourth quarter and sustained progress in 2021.

Daily new U.S. COVID-19 infections keep making new all-time highs. Single-day new cases exceeded 90,000 on October 31 for the second day (here) and pushed the seven-day moving average to a new record above 79,000. New daily fatalities have been flat—around 800 the last 10 days—and are well below the highs of both spring and summer.

Renewed restrictions on U.S. economic activity from rising daily cases have been limited so far. Absent a stronger second wave of infections, the U.S. economic rebound appears to have compelling momentum to carry into 2021. Capital spending is brisk; shipments of nondefense capital goods ex aircraft are nicely above year-ago levels. Record new orders for similar capital goods are a great omen for further healthy investment. Housing activity is booming, with homebuilder confidence at record levels the last two months. Household formation is increasing rapidly and suggests that housing starts and home sales will stay spirited.

Surveys of manufacturing businesses by regional Federal Reserve (Fed) banks are uniformly robust. The national business surveys by MNI Markit News International are also healthy; the October composite index tied the best level since July 2018. The service sector was hit the hardest by the pandemic, yet even the index level for services companies is the highest since June 2018. Job gains should stay healthy: the American Staffing Association index of temp-help jobs keeps improving. The Conference Board's index of job availability is the same as November 2016 when the jobless rate was less than 5%. Good job growth and a high savings rate should fuel solid consumer spending gains well into 2021.

Besides validating the astonishingly fast resurgence in the third quarter, the U.S. GDP report had some clear signs that the recovery will continue. Total inventories actually fell slightly (i.e., accumulation didn't add to growth). With inventories extremely lean after pandemic-induced production lapses, restocking will keep industrial production expanding. Further, net exports (exports less imports) subtracted three percentage points from growth, a much larger-than-typical loss, as imports roared back much faster than exports. As other countries recover from the pandemic recession, U.S. exports should pick up dramatically and add significantly to growth.

We expect fourth-quarter U.S. real GDP growth to be in the 4% to 6% range. A safe, effective and available vaccine(s) early next year could keep the recovery moving at a 3% pace or more for several quarters. Absent that, the leisure and hospitality sector will be slow to rebound and keep 2021 U.S. growth near trend, around 2.5%.

Looking ahead

After an incredible third quarter bounce in world economic activity, the intensity of the rebound is stepping down. The recovery clearly hit an air pocket in Europe with new restrictions following a significant second wave of infections. So far, the rise in U.S. new virus cases hasn't impeded growth; Transportation Security Administration traveler counts, weekly store foot traffic data from Cornerstone Macro research, and consumer spending from tracktherecovery.org stay in a modest uptrend. Good demand from China, super-low interest rates, and a weaker U.S. dollar are good fundamentals for developing countries. Central banks stay supportive and more fiscal spending is on the way.

The rebound is moderating but not stalling. The world recovery should persist through 2021.

Focus on markets and the election

September and October have an unhappy history for stock investors. There was the market crash in 1929. A record loss on Black Monday 1987. The Russian debt default in 1998. The financial crisis collapse in 2008. This year, investors endured two wrenching S&P 500 Index declines of 10.6% from a new high in September and 8.9% from a near-new high through October 30. The first was fueled by concern about too little fiscal largesse, the second by the rising storm of pandemic infections. Now, that Index is off 6.6% in the last two months but is still up 1.2% for the year. In this election season, the volatility may continue through year-end.

The differences between the Presidential candidates and their platforms are vast. But, the divergence in financial market performance with various election outcomes may be less than some expect, at least on a nine to twelve-month outlook. There are three main election results: status quo; a Biden presidency with a divided Congress; and a Democrat sweep of both ends of Pennsylvania Avenue. More regulation of business in the latter two outcomes and higher taxes and tax rates in the third may not be conducive to healthy stock market returns in the long run. However, there will surely be significantly more fiscal spending via a fourth pandemic stimulus, plus a likely infrastructure package of varying but substantial size, in all three scenarios.

The combination of continuing economic and profit recovery, an aggressively easy Fed, and the considerable fiscal largesse to come should be positive for the stock market at least for a while. From the markets' current highly valued perch, any intermediate-term uptrend will surely be modest. Growth may slow a bit under a Biden presidency, as the economy realigns to his priorities. That could keep long-term interest rates lower for a little longer.

How could such different election scenarios result in mostly similar financial market outcomes? In part because they're global trends that will continue regardless of who's in the White House. Think fiscal policy and fading globalization. Since the 1980s, monetary policy had been the main tool to combat recessions. The Fed would lower interest rates to stimulate consumption and investment. Fiscal policy had gotten a bad rap in the 1970s with high inflation and stagnant growth. Now, massive fiscal spending is combined with aggressive Fed bond purchases to reinvigorate the economy; it's the same in all major developed countries.

Globalization has been slowly fading for some time. Two decades of fast wage growth in China made that country much less competitive than in the 1990s. In addition, populist policies voted in by those left behind by globalization or whose jobs left for China slowed the outsourcing trend. Now, the pandemic has provided another reason for countries to reassess their economic dependence on, and supply chains in, China. Reshoring of U.S. jobs will likely continue regardless of the election.

Financial market outlook

The above combination of considerable fiscal spending, financed in part by central banks, plus the fading of disinflation, fostered by globalization, suggests this decade will be characterized by more inflation than expected by the consensus. That's also the goal of central banks. Sustained inflation at or somewhat above the target of 2% implies measurably higher yields on long-term government bonds. Moderately higher inflation would also imply faster nominal growth. Such a change in the investment environment should spark a rotation away from growth and tech stocks into those sectors that do well when growth picks up, such as materials, industrials, financials, and small caps—all underperformers for years.

Since summer, there have been several attempts by markets to start such a rotation. All have failed to generate a lasting change in trend. The persistence of the virus and its complications is impeding the brisk rebound that would promote a sustainable rotation and renewed market uptrend. The height of the winter flu season is likely December and January. Besides election uncertainty, the unknown size of this virus wave means caution is warranted into the early New Year.

We remain mostly optimistic after that. A vaccine for the virus is surely possible and therapeutics are improving. The world economic and profit recovery should continue. Faster nominal growth will be positive for the stock market. We'd stick to a balanced U.S. portfolio, but believe the coming market rotation will be good for emerging market stocks, too. Signs that this rotation is underway are a steeper yield curve, a renewed U.S. dollar downtrend, and persistent gains in commodity prices.

Bond investors will have a hard time finding good returns. We'd avoid long-term government bonds, as most have negative inflation-adjusted returns. We still favor non-traditional fixed income alternatives--high-yield, preferred stocks, municipals, emerging market bonds. However, we'd definitely stick to high-quality and short- to intermediate- maturities of two to four years, as credit spreads offer little potential gain and long-term interest rates will gradually work higher.

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プリンシパル・グローバル・インベスターズ株式会社
〒100 0011 東京都千代田区内幸町 1 1 1 帝国ホテルタワー
電話：03 3519 7880（代表） ファックス：03 3519 6410
代表者：代表取締役社長 板垣 均
ホームページ：http://www.principalglobal.jp
金融商品取引業者登録番号：関東財務局長（金商）第 462 号
加入協会：一般社団法人 日本投資顧問業協会
一般社団法人 投資信託協会