Russell Investments

2020 GLOBAL MARKET OUTLOOK

Cycle, interrupted

Central bank easing and the cooling in the China-U.S. trade war have set the scene for a global economic rebound in 2020. Our forecast pushes the risk of recession into late 2021, giving equity markets modest upside potential for 2020.

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INTRODUCTION

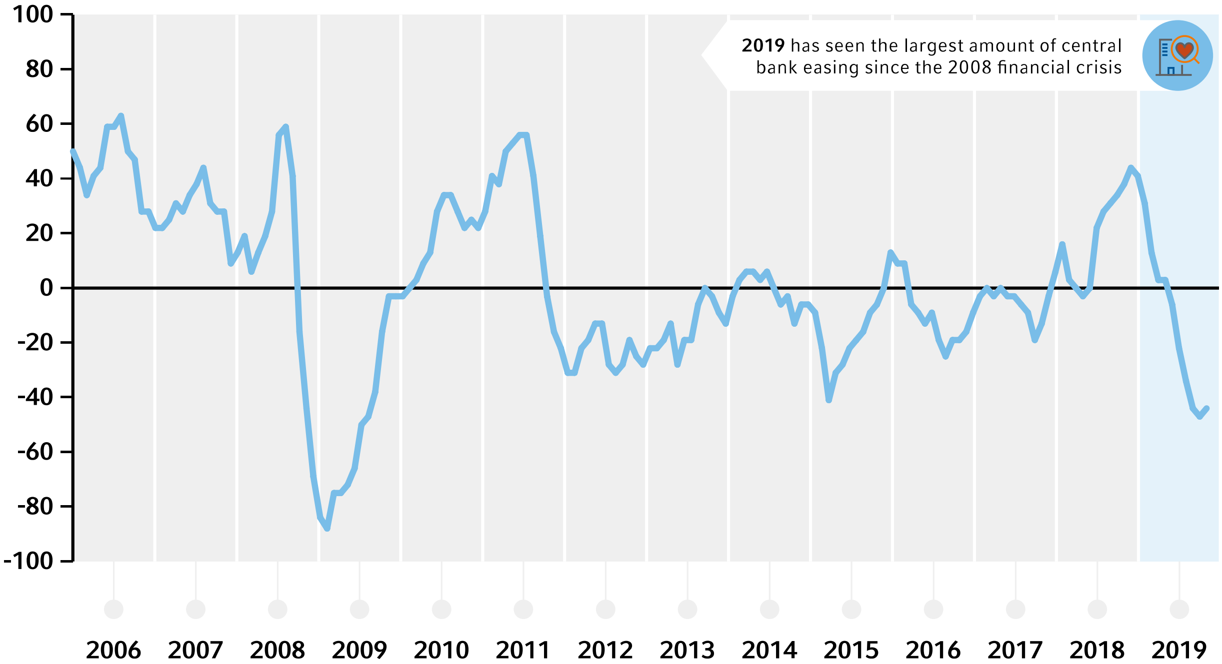
Global Market Outlook 2020: Cycle, interrupted

Signs point to a mini-cycle recovery in 2020, with central bank easing in particular helping to stave off short-term recession fears.

Hold the epitaphs: this aging cycle seems likely to last beyond 2020. This time last year, it appeared that U.S. Federal Reserve (Fed) tightening, the China-U.S. trade war and diminishing economic slack[1] could push the U.S. dangerously close to recession by the end of 2019. At times during the year, recession seemed possible as global manufacturing contracted and the U.S. yield curve inverted. However, central bank easing, the de-escalation in the trade war and tentative green shoots in global manufacturing suggest we might be on the cusp of another "mini-cycle" recovery through the first half of 2020.

The chart below shows the percentage of central banks from a sample of 32 that have lowered interest rates over the past three months. 2019 has seen the largest amount of central bank easing since the 2008 financial crisis.

Central banks tightening / net %



Source: Refinitiv Datastream, Russell Investments calculations. Diffusion index that calculates the percentage of central banks that have raised rates over the past three months minus the percentage of central banks that have lowered rates. Coverage includes Argentina, Australia, Brazil, Canada, Chile, China, Colombia, Denmark, the European Central Bank, Hong Kong, Indonesia, India, Israel, Japan, South Korea, Malaysia, Mexico, New Zealand, Norway, Peru, Philippines, Poland, Russia, South Africa, Singapore, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom, and the United States. Last observation October 2019.

The interrupted cycle has the following asset class implications for 2020:

- equities should outperform bonds
- higher long-term bond yields, though the rise should be limited by muted inflation pressures and central banks remaining on hold
- steeper yield curves
- a weaker U.S. dollar given its countercyclical nature
- non-U.S. to outperform U.S. equities given the more cyclical nature of non-U.S. stocks and their relative valuation advantage
- pro-cyclical value stocks should beat both growth and low-volatility stocks

Main risks

A step back in China-U.S. trade relations and the outcome of the U.S. presidential election are among the key risks that could accelerate the timing of the next recession.

The main risks to our 2020 outlook, in order of importance, are:

- A re-escalation in the trade war that delivers a fatal blow to global business confidence, investment spending and global supply chains.
- Central banks resume hiking if they believe the growth risks have passed and inflation pressures are building.
- The U.S. presidential election, where the victory of a progressive Democrat, such as either U.S. Senator Elizabeth Warren or Bernie Sanders, could trigger a policy shift that is negative for corporate profits.
- Other geopolitical risks such as an escalation of Hong Kong unrest, which triggers an aggressive China response and subsequent global sanctions on China, or actions by Iran that threaten global oil supply.

Regarding the trade war, our view is that both China and the U.S. have incentives to reach a “phase 1” deal soon. U.S. President Donald Trump would like to declare victory in the trade war ahead of his 2020 reelection bid. He also needs to lift the economic threat that the trade war poses to the near-term outlook.

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President Xi Jinping of China is balancing the short-term requirement for economic stimulus against the medium-term need to reduce debt levels in the Chinese economy. He would like to limit the risk of a further trade-shock. He will probably take a “devil you know” approach to the U.S. election and not want to undermine Trump’s reelection through trade-war escalation. The alternative would be to possibly face a progressive Democrat, who could bring a much sharper focus on human rights and the environment to trade negotiations.

The last innings of this cycle

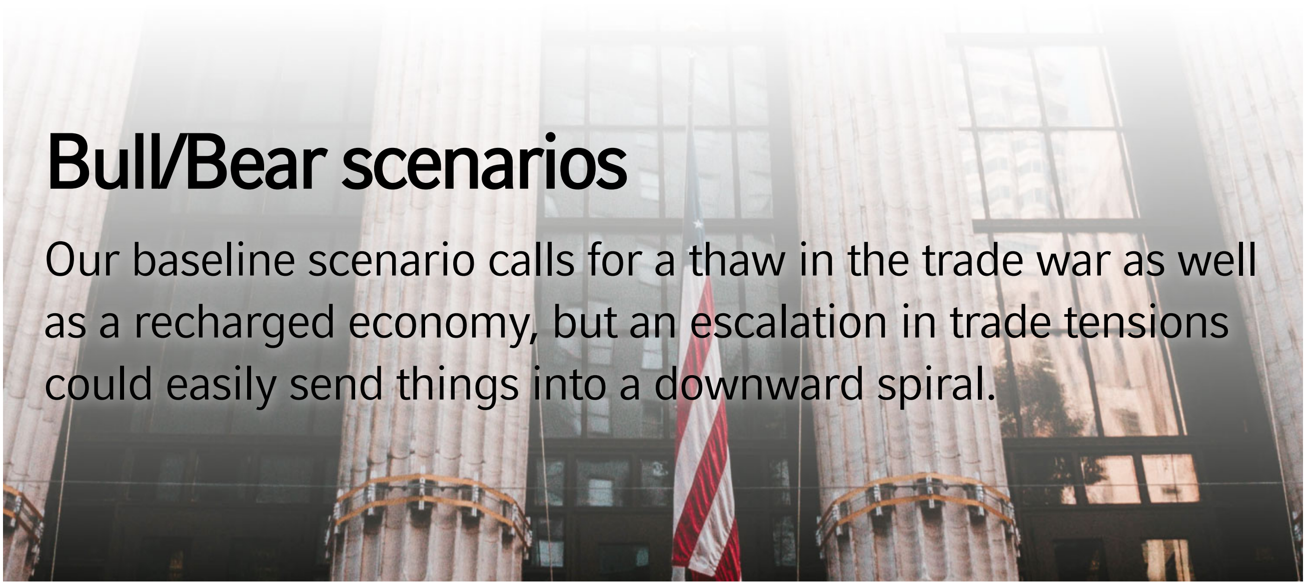
Central banks will probably need to tighten monetary policy by 2021 to combat inflation, which should bring about an end to the long-running economic expansion.

The central bank easing of 2019 may prolong the aged cycle, but this could be the final "mini-cycle" before the turning point of the "major cycle", potentially in 2021. The main reason for the longevity of this cycle has been the persistence of economic slack. This has allowed the U.S. and other developed economies to grow without generating significant inflation pressure. This has deterred the Fed from lifting interest rates by enough to cause a recession.

The trade war has been a cycle-extending global deflationary shock, in that it forced the Fed and other central banks to reverse previous tightening before monetary policy became restrictive.

Economic slack, however, is limited at this advanced stage of the cycle. Nowhere is this more apparent than in the United States, where the 3.5% unemployment rate for November 2019 is at levels last seen in the 1960s and wage pressures are building. It's likely that central bankers, worried about "secular stagnation" and "Japanification[2]", will take a cautious approach to the next tightening phase and wait until inflation is clearly lifting before acting.

Tighter monetary policy will eventually be required, either by late 2020 or early 2021, which we believe should ultimately push the global economy into recession.



Bull/Bear scenarios

Our baseline scenario calls for a thaw in the trade war as well as a recharged economy, but an escalation in trade tensions could easily send things into a downward spiral.

Our subjective probabilities on the following three scenarios for the next 12 months suggest some caution is warranted.

- **Bull** (35%): A trade deal sets the scene for a deeper agreement on intellectual property rights and market openness. Uncertainty clears. Purchasing Managers' Index (PMI) surveys rebound as monetary stimulus kicks in. Corporate earnings rebound through 1H 2020.
- **Central**(40%): Mini-deal puts trade tensions temporarily on hold and does not reverse tariffs. The global economy responds to monetary easing, but trade-war uncertainty remains. Central banks maintain easing bias.
- **Bear**(25%): Q4 trade talks fail. The trade war escalates further. The global economy dips into a mild recession. PMIs decrease. Corporate earnings suffer a double-digit decline.

"The challenge of investing late in the cycle is that the upside for equity markets is likely smaller than the downside."

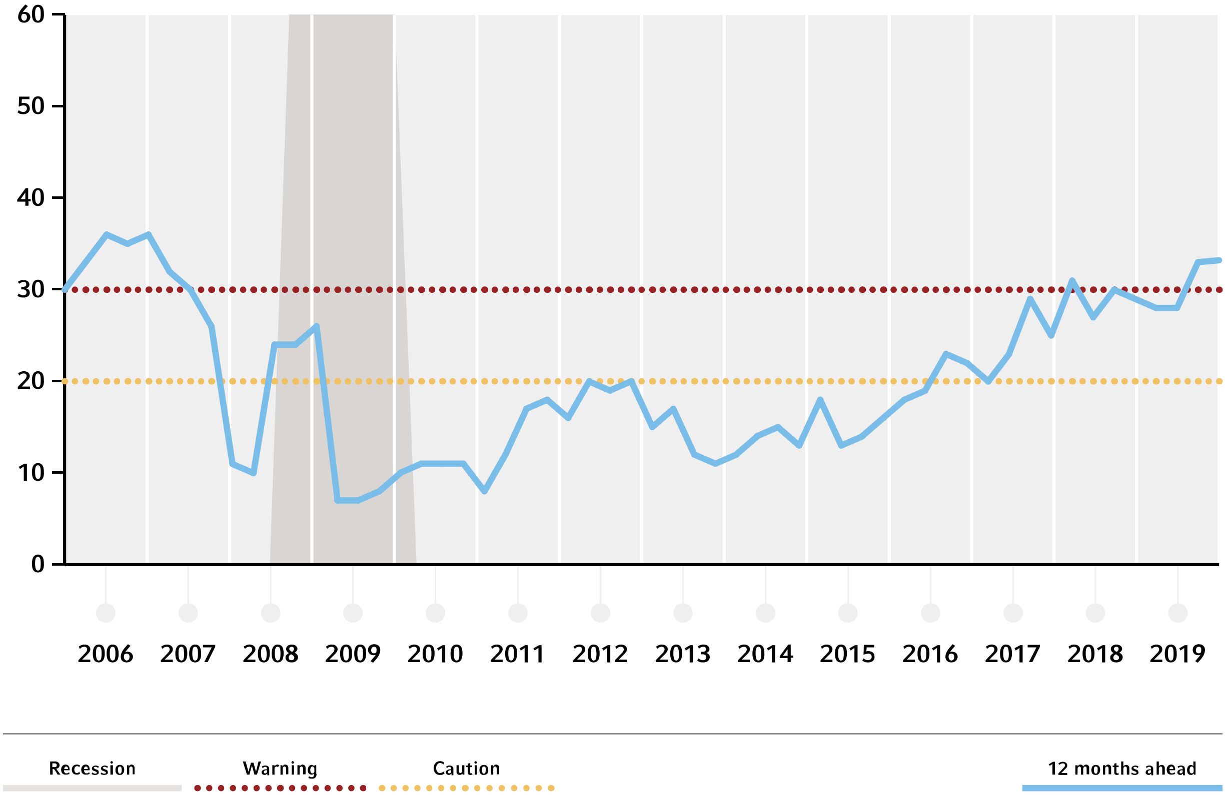
- Andrew Pease

We're giving the Bear scenario a significant 25% probability despite our bias toward a glass-half-full 2020 outlook. There are several factors that suggest an elevated risk of a recession and bear market:

- This year's inversion of the U.S. yield curve
- The damage already sustained to business confidence and global supply chains from the trade war
- High corporate debt levels that create vulnerability to rising interest rates or declining profits

The signal that concerns us most is flashing from the Business Cycle Indicator (BCI) model. This model estimates U.S. recession probabilities based on the yield curve, credit spreads, bank credit risk, consumption growth and employment. The BCI forecasts a 33% probability of recession in one year, which extends slightly above the model's warning threshold. The rising recession probability looks similar to the model's predictions in mid-2006 prior to the 2008 Financial Crisis.

BCI model historical forecasted recession probabilities / Recession probability (%)



Source: Russell Investments, as of December 2019.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

We suspect the model is overestimating recession risk given the lack of consistent yield curve inversion. The 10-year/3-month curve has spent most of 2019 inverted, but the 10-year/2-year curve was only very briefly inverted in September. We also suspect that the three 'insurance' rate cuts by the Fed and the easing in trade tensions have reduced recession risks. There are similarities to 1998, when the yield curve inverted, but recession was avoided. The Fed quickly cut rates three times, and the issues that triggered recession fears in 1998 – the Asian economic crisis, the Russian bond crisis and the Long-Term Capital Management collapse – turned out to be less damaging than feared.

The challenge of investing late in the cycle is that the upside for equity markets is likely smaller than the downside. The last five bear markets saw the S&P 500® Index fall by an average of 43%. An optimistic assessment would give global equities, at most, low double-digit upside. This asymmetry adds a degree of caution to the outlook.

Regional snapshots

We expect a rebound in growth across the eurozone and the UK as political uncertainty fades, while economic growth in China is likely to remain unchanged.

United States

Fed rate cuts and the easing of the business sentiment drag from the China-U.S. trade war should support the U.S. economy over 2020. There will be headwinds from the fading of the 2017 Trump tax cuts and lingering uncertainty over future tariff policy.

Low inflation should keep the Fed on hold during 2020, although it may move to a tightening bias by year-end if bond market inflation expectations rise toward 2.2% from their current 1.7%. We expect non-farm payrolls growth to remain above 100,000 per month, which should lower the unemployment rate to levels not seen since the Korean war in the early 1950s. A Fed on hold and improving economy should lead to higher Treasury yields and a steeper yield curve. The 10-year Treasury yield could rise to around 2.25%.

The November presidential election is likely to be a major source of uncertainty. Low unemployment and trend economic growth favor Trump's reelection. The Democrat frontrunners in the primary race all favor at least a partial repeal of the 2017 corporate tax cuts, which would have negative implications for corporate earnings growth in 2021.

Eurozone

Europe's exposure to trade and reliance on manufacturing made it a casualty of the trade war and the global downturn in automobile production. 2019 saw the European Central Bank (ECB) take policy rates further negative and re-start quantitative easing. The Eurozone should benefit in 2020 from easier monetary conditions, the recovery in global manufacturing, the lifting of trade-war uncertainty and Chinese policy stimulus that increases import demand from emerging markets.

The easing of political risk is also a boost to the outlook. This time last year, Italian 10-year government bond (BTP) yields were heading toward 4% and creating concerns about the solvency of Italian banks. BTP yields are under 1.2% in late 2019, mirroring declines across Southern Europe and supporting financial conditions. This is being reflected in declining non-performing bank loans across Spain and Italy. The potential lifting of Brexit uncertainty is also a positive.

Overall, we look for a gradual pick-up in growth across the Eurozone during 2020. The absence of inflation pressure means the ECB is unlikely to consider lifting interest rates.

United Kingdom

The lifting of Brexit uncertainty and increased fiscal stimulus should support the U.K. economy in 2020. Both major parties in the December 12 general election are proposing pathways to Brexit resolution and the end of fiscal austerity. The Conservatives are offering a relatively quick and clear path to Brexit, albeit with uncertainty about the future trading relationship with Europe. A Labour administration, most likely in a minority government, opens the possibility of a second referendum and a potential "Remain" outcome.

A significant boost from fiscal policy is likely regardless of the election outcome, which would reverse a decade of deficit-reducing "austerity". Labour is proposing a radical program of public investment, while the Conservatives' more modest plans would still represent an economic boost.

A post-election economic revival combined with low unemployment and relatively high inflation could have the Bank of England considering policy tightening by the end of 2020.

Japan

Japan's economy is suffering the after-effects of the consumption tax hike on October 1 and its exposure to the global manufacturing downturn. The uncertainty around the China-U.S. trade negotiations as well as Japan's own tensions with South Korea have weighed on economic sentiment.

Easing trade tensions and an improvement in global manufacturing should support Japan's economy, as will a boost to spending and tourism from hosting the 2020 Olympics. There is also speculation that Prime Minister Shinzō Abe's administration will launch a sizeable fiscal stimulus. Japan, however, is likely to remain an economic laggard relative to other developed economies and we expect persistent disinflationary pressures will keep the Bank of Japan in ultra-accommodative mode.

China

Chinese policy makers are balancing the short-term requirement for stimulus against the medium-term necessity to reduce leverage in the economy. The net result is that stimulus will likely be modest—enough to stabilize or provide a small boost to the Chinese economy, but smaller than the previous stimulus episodes in 2016 and 2012. Credit growth is unlikely to accelerate sharply, but the authorities have already reduced bank reserve requirements and cut policy rates. They are also likely to increase local government bond issuance to boost infrastructure spending. Gross domestic product (GDP) growth, however, is unlikely to rebound and should remain near 6%.

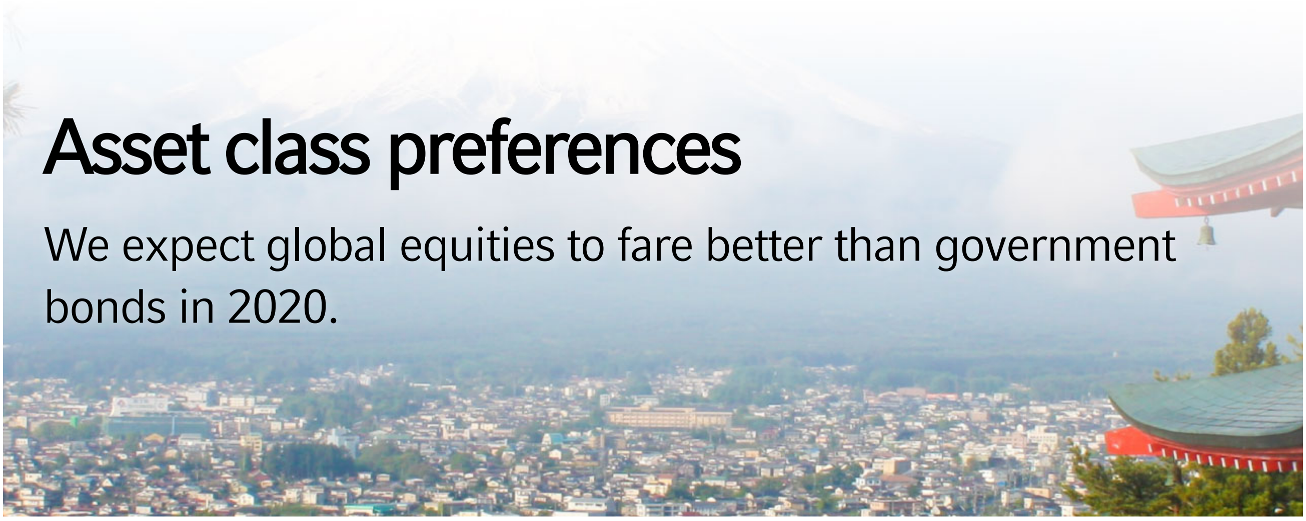
Australia/New Zealand

The outlook for the Australian economy remains soft. We expect consumers will remain cautious given high debt levels and slow wage growth. Potential income tax cuts could provide a boost, but a sluggish economy will have the Reserve Bank of Australia considering another interest rate cut.

Business confidence in New Zealand is at the lowest levels since the 2008 financial crisis, and we expect further rate cuts from the Reserve Bank of New Zealand.

Canada

The Bank of Canada (BoC) has been an outlier. It has the highest policy rate among the Group of Seven[3] countries and has resisted cutting rates despite softening global and domestic economic conditions. The hesitation is in part due to fears of stoking increased household debt. Although the housing market has reaccelerated, lackluster consumer and investment trends should eventually force the BoC to consider rate cuts.



Asset class preferences

We expect global equities to fare better than government bonds in 2020.

Our cycle, value and sentiment investment decision-making process in late 2019 has become more optimistic on global equities and is shifting toward a negative view on government bonds. Our equity sentiment measures are becoming over-bought, but the signals are not yet strong enough to offset positive price momentum.

- We have a small underweight preference for **U.S. equities** in a global portfolio, driven mostly by relatively expensive valuation, but also because the cycle conditions appear firmer outside of the U.S. We favor **non-U.S. developed equities**. U.K. equities offer good value as demonstrated by the 5% dividend yield. Valuation is neutral in Japan and Europe. Both should benefit from China policy stimulus, which will help bolster export demand, and the fading of trade-war concerns.
- We like the value offered by **emerging markets (EM) equities**. Regional central banks are easing policy and EM markets likely will benefit from China stimulus. The smaller scale of the China stimulus, however, limits the upside for EM.
- **High yield credit** is slightly expensive and at risk from slowing corporate profit growth.
- **Investment grade credit** is expensive, with a slightly below-average spread to government bonds and a decline in the average rating quality.
- **Government bonds** are universally expensive. U.S. Treasuries offer the most attractive relative value.
- The **Japanese yen** remains our preferred currency. It remains undervalued despite this year's rally and has safe-haven appeal if the trade war escalates. A mini-cycle recovery as the trade war is resolved, at least temporarily, could see the U.S. dollar weaken, given its counter-cyclical tendency. **British sterling** is very undervalued, but it should have upside on most scenarios following the UK's December 12 election.

[1] Economic slack refers to the amount of resources in the economy that are not used. Machines left idle in a factory or people who cannot find a job represent slack to an economist. The reason slack exists is usually due to insufficient demand relative to what the economy is capable of producing.

[2] Japanification is the term economists use to describe the country's nearly 30-year battle against deflation and anemic growth, characterized by extraordinary but ineffective monetary stimulus propelling bond yields lower even as debt burdens balloon.

[3] The Group of Seven (G7) is an international intergovernmental economic organization comprised of the following advanced economies: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

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