BearBull
Global Investments Group

Economic Research

WEEKLY ANALYSIS

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Actual risks of recession in the US overestimated

GDP up +2.2% in 2019. Declining nominal and real rates beneficial to the economy. Leading indicators still wavering. Rebound in long-term rates. Beware of PE ratios.

Key points

- Excessive pessimism unfounded but ultimately favourable to economic growth
- Nominal and real rates will support economic momentum
- The Fed confirms +2.2% GDP growth expectations for 2019
- Economic impact of trade war overestimated
- Why does the inversion of the yield curve not signal a recession?
- After two preventive cuts, monetary policy could mark a pause
- Economic indicators still wavering
- Economy more robust than it seems
- Rise in equities mainly due to PE expansion

Excessive pessimism unfounded but ultimately favourable to economic growth

For the last 12 months, the main macroeconomic scenario in financial markets has been that emphasising risks of an economic slowdown and recession in the US. Since October, long-term rates have continuously declined due to massive purchases of investors fearing a recession. The drop in long-term rates in the US has been spectacular, as yields that were close to 3% in September 2018 have now fallen by 50% to only 1.5% at the end of August 2019. Fears of a recession have been fuelled by an ultimately rather limited number of factors, which obviously include the trade war between China and America first and foremost. The inversion of the yield curve has been another main factor supporting the argument of an upcoming recession.

We will come back later to these two elements supporting the theory of a recession expected for 2019 or 2020, which we do not believe in for the moment. First, however, we would like to review a few key elements in terms of assessing the real risks of recession, which will have a significant impact in the next few months on the prevailing economic scenario as well as on the associated outlook for the main asset classes.

First of all, it should be noted that the Sino-American crisis did not have any major effect on financial markets initially in 2018, as it seemed obvious to all that both governments had a common interest in coming to mutually agreeable terms on the trade issue. The rising tensions between the negotiators then gradually exacerbated the fears of investors, who were more worried about the risks posed by trade war to the global economy. This factor became central in the perception of risks of a recession. It was partially accompanied by rising uncertainty and deeply affected the sentiment of decision-makers and purchasing managers, who showed caution by reducing capex as well as orders, among others. This phenomenon has affected the manufacturing sector much more than services or consumption. Hence, the declines in the manufacturing PMIs and in industrial output have been the most convincing elements in the shift of perception that supported the prediction of an upcoming recession. No agreement has been found to this day between the two protagonists, but after more than one year of failed negotiations, the US economy remains robust and has not shown any real signs of a recession, even though the latter has clearly been taken into account in capital markets, as shown by the 50% decline of long-term rates, without a reality check triggering any adjustment in these expectations, for the moment at least.

We believe that this reality check is coming and that it will trigger a reversal in the downward trend of long-term rates.

Nominal and real rates will support economic momentum

Consequently, it should be noted that the decrease in interest rates is actually excellent news for growth since it lowers financing costs quickly for all economic agents – individuals, SMEs, multinationals, public entities and governments. Falling long-term rates will push back potential risks of a recession, and the change in monetary policy announced in July by the Fed will also have a similar impact. Beyond the decline in nominal rates, real rates will likely also provide some indirect support, helping strengthen economic momentum and the real estate market in particular in the next few months. Real interest rates, usually positive, are now negative in the US following the decline in (10-year) long-term rates from 3% to 1.5% and with inflation excluding food and energy at 2.4%.

Excessive unfounded pessimism has thus led to adjustments in nominal and real interest rates which will be favourable to economic recovery in the next few quarters.

Economic impact of trade war overestimated

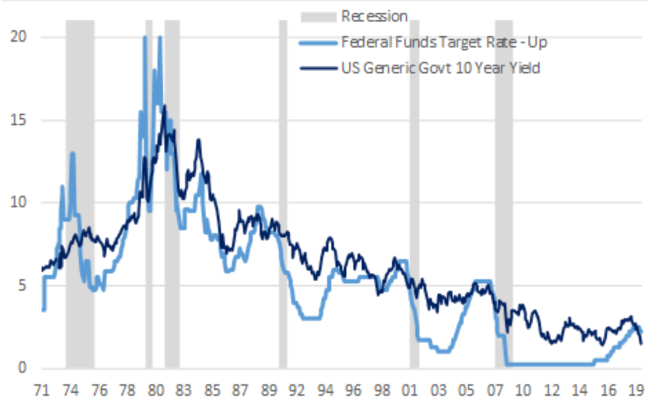
Fears of a recession motivated or triggered by a possible trade war between China and the US feel quite exaggerated if not unfounded to us. Indeed, for several quarters now, media attention has been entirely focused on the chances of success of the negotiations and the risks of them failing. However, a rational analysis of the real potential consequences leads us to put the risks for the economies concerned into perspective. Every year, the US and China generate about USD 20 trillion and USD 14 trillion in GDP, respectively. The economic relationship between the two countries amounts to about USD 550 billion, the main part of which (500 bn) is made up of US imports from China. The magnitude of trade between the two countries thus represents no more than 2.5% of US GDP and 0.3% of China's GDP. Since this trade dispute broke out, these data have been known by all. An increase in tariffs would thus only affect a very small proportion of both countries' GDPs. Nevertheless, the attention given to this issue is such that it has wrongly suggested that risks of a recession might be triggered by the introduction of customs fees that would penalise this trade.

The impact of an increase in tariffs on growth prospects has been grossly overstated for several quarters in our minds. The same goes for risks of a recession induced by this factor.

Why does the inversion of the yield curve not signal an upcoming recession?

In previous decades, an inversion in the yield curve triggered by the excessive and inappropriate tightening of monetary policy has indeed often been followed by a recession. In these cases, the inversion in the yield curve was due to an increase in short-term rates (central bank key rates) corresponding to the implementation of restrictive monetary policies aimed at fighting excessive inflation and slowing down the business cycle. Volatility in short-term rates is usually more significant that in long-term rates, in particular because of central banks actively seeking to manage inflation. Monetary policy thus would lead to a rebound in short-term rates that eventually exceed the level of long-term rates to fight inflation.

US recessions, long-term rates & fed funds



Sources: Bloomberg, BearBull

A "classic" inversion of the yield curve thus follows this logic, often exceeding the economic slowdown objective by ultimately triggering a usually short-term recession. In such a case, it is indeed appropriate to fear a recession. However, in the present case, the inversion in the yield curve has not been triggered by an excessive increase in key rates beyond the equilibrium level of long-term rates. The opposite phenomenon has taken place. The Federal Reserve's normalisation policy was rather progressive and measured in an environment where an increase in price indices was completely expected and moderate. A sharp fall in long rates is actually at the root of this phenomenon in 2019.

Hence, the inversion of the yield curve cannot be interpreted in the same way and have the same predictive power of a future recession as it may often have had in the past in different situations. Ultimately, it is the expectations of a recession relating to the US-China crisis that triggered an inflow of capital into bond markets, thus causing long-term yields to fall below short-term interest rates.

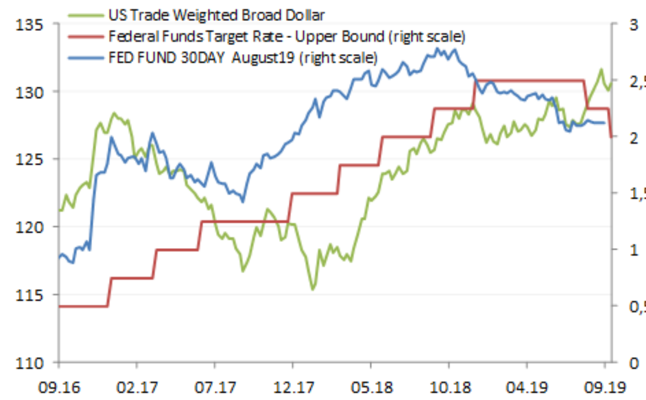
A return to a normal yield curve may already be happening following the Fed's rate cuts and the rebound observed in the first weeks of September.

After two preventive cuts, monetary policy could mark a pause

The US Federal Reserve thus lowered its key rates twice in July and September in a monetary policy move that looks more like a forced preventive action than a real need to shore up the economy. Indeed, GDP in H2 is still increasing by +2%, driven by the strong contribution of consumption.

The Fed's forecasts for GDP growth in 2019 and 2020 are still at +2.2% and +2%, respectively. GDP will likely then grow by +1.9% in real terms in 2021. Nevertheless, the recession probability index with a 12-month time horizon calculated by the New York Fed has increased from about 15% in September 2018 to 37% currently. Risks of a recession indicated in this model have thus increased for the end of 2020.

Fed funds, key rates & trade-weighted dollar



Sources: Bloomberg, BearBull

The probability of a further cut in key rates in October has however fallen from 80% to 50% in one month. The Fed commented on its decision by explaining that it had considered the weakness of investment and exports while noting the robustness of the job market and of consumption.

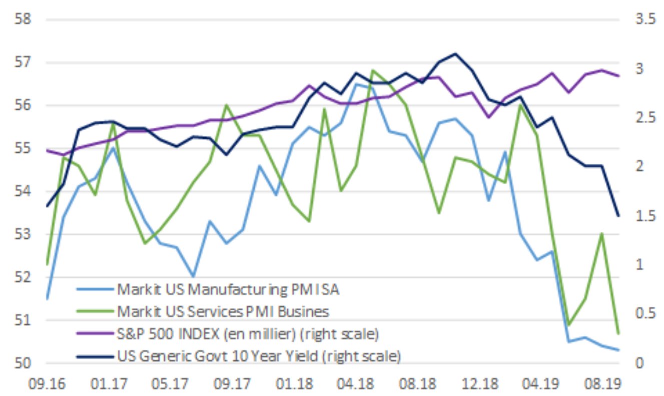
The central bank ruled out the possibility of negative rates in case of a recession, but reaffirmed its commitment to implementing aggressive policies if required. However, FOMC members are divided on the measures to implement for the end of the year between those who favour the status quo and those who would prefer further cuts.

Economic indicators still wavering

The manufacturing PMI released for the month of September shows the first significant rebound since the beginning of the year, increasing from 50.3 to 51 after the small upswing observed in August. The stabilisation of this indicator, the main stress factor in terms of recessionary risks, is encouraging. It comes at a time when industrial output rebounded significantly by +0.6% in August, clearly above the consensus expectations of +0.2%.

However, the improvement of manufacturing PMIs in all the sub-groups (consumer goods, equipment, construction, materials, etc.) is unfortunately still very weakly corroborated by a rise in the services PMI from 50.7 to 50.9. Altogether, the composite index still increased from 50.7 to 51, moving away from the threshold of 50. The economic activity index calculated by the Chicago Fed has also risen above the growth threshold again, pointing to higher than average activity in August. However, consumer confidence indicators have unsurprisingly fallen in the context of the trade war and given the widespread reporting on the risks of recession.

Long-term rates, PMIs & S&P500



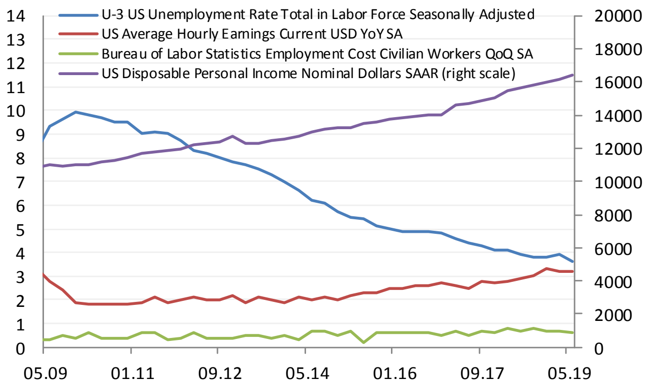
Sources: Bloomberg, BearBull

Economic conditions more robust than it seems

Employment remains particularly satisfactory, as noted by the Fed Chairman in his press conference following his decision to lower key rates. Job creation posted its greatest increase in four months (195,000).

Wage pressures are increasing, and with rising disposable income, consumption will likely remain strong, driving price indices up. In the context of a relatively tight employment market, wage growth is naturally continuing in the US, reinforcing the outlook for private consumption, which remains the main driver of growth. In this context, the increase in average hourly earnings (+3.2%) in August is close to the decade's highest levels.

Unemployment, earnings, labour costs, income



Sources: Bloomberg, BearBull

The economic surprise indicator sheds an interesting light on the current situation and confirms that the statistics published in September seem more robust than expected, in our minds. The chart below shows a clear trend since July. It can be explained on the one hand by the growing awareness of recessionary risks and the downward revisions of economic expectations, and on the other, by the better actual results. In other words, the statistics published in the last three months contradict investors' negative expectations.

Economic surprise indicator

Sources: Bloomberg, BearBull

For the moment, the prevailing economic scenario in rate markets is still that of a slowdown in growth. We nevertheless believe it is likely that an increase in ten-year rates will be associated with better economic statistics in the next few months.

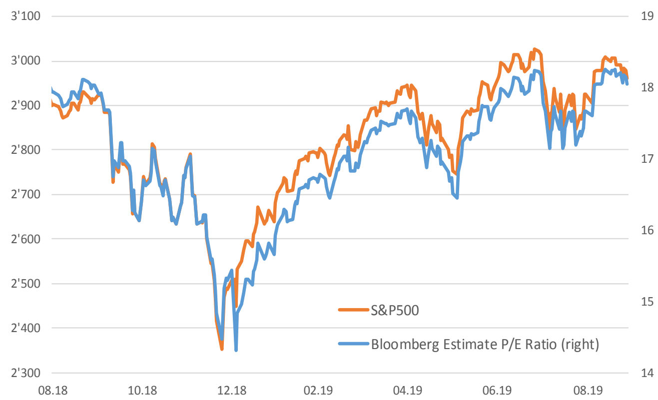
Rise in equities mainly due to PE expansion

The return of equity indices to highs for the year places the asset class back into a high-risk zone and increases the probability of a price correction. If the slowdown turns out to be real, valuation levels for equities will not withstand the likelihood of profits collapsing. If conversely, the economy remains stable, the rebound in interest rates that will likely materialise will indeed have a negative effect on multipliers.

The rise in PEs associated with the drop in long rates in the last few months will be replaced by a unavoidable contraction that will accompany the rebound in rates. The impeachment proceedings against Trump that have finally been activated by the Democrats are very unlikely to succeed. It is unlikely to add much uncertainty and to be a major destabilising factor for financial markets.

Reduced exposure to equities seems appropriate in this context, which seems unlikely to trigger a new wave of appreciation of prices beyond 3,000 points on the S&P500 index.

S&P 500 & P/E



Sources: Bloomberg, BearBull

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