Principal Global Investors

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2020 Outlook: **Expect a modest recovery, but watch corporate profits**

Commentary by **Robin Anderson , Ph.D.**, senior global economist

Investors can look forward to some rebound, but high expectations are likely to be disappointed. It's likely to be modest and brief. Signs of a slowdown still loom.

Global growth slowed over the past couple of years. We expect a rebound but it won't be as strong as in the past. The rebound will be muted in 2020 for a few reasons. First, Chinese stimulus has been more constrained. Whereas China previously pursued big infrastructure projects that boosted commodities demand worldwide, it's now turning to other measures such as modestly lowering interest rates, tax cuts, upping reserve requirements, or raising the bond limits that cities and provinces can borrow for improvements. While these may have domestic impact, they won't have as much of a global impact as earlier stimulus packages. Second, recovery is happening as the United States is entering late cycle. Job growth is decelerating, profit growth is showing signs of weakness, bank lending standards are tightening, and there was a yield curve inversion earlier this year.

Given the environment, we recommend investors stay defensively positioned, preferring large-cap stocks and high-quality credit. Real estate is another good defensive bet if growth falters in 2021.

Watching corporate profits

Corporate profits are an important measure of overall business sentiment. As such, we're keeping a close eye on profit growth in 2020 and beyond. Profit margins have been under pressure from rising wages in a tight labor market. Thus far, employee compensation is up 28%, outpacing a 16.5% rise in revenue. Unless revenue picks up, we'll be watching for signs that margins are weak enough to affect business hiring/ firing decisions and investment.

Though domestic corporate profits peaked in 2014, they've been mostly flat since and are currently at recessionary levels. If at any time domestic corporate profits decline by 0.8%, it would be enough to trigger a recession signal in our dashboards. Signs of corporate profits weakening may be one way the U.S. slides into a recession by 2021. In the recent past, a decline in corporate profits has preceded a recession by 15 to 18 months. Right now, they're down 3.1%.

Weak corporate profits could put a damper on stock prices in 2020, too. Right now, small cap profit margins (sectors such as energy) are already under significant pressure. That's one more reason to prefer large cap stocks.

Another signal we're watching closely is the manufacturing sector, which makes up nearly 17% of domestic corporate profits. Manufacturing hasn't recovered since the last slowdown in 2015 and 2016. There's been a 44% decline in manufacturing profits since 2014.

If global growth picks up, manufacturing profits could bounce back a bit. But, like with corporate profits, any recovery in manufacturing is likely to be short-lived, as higher wage costs continue to eat into margins. We're looking for signs that corporate profits are worsening enough that it eats into hiring and investment decisions—things like less reinvestment and hiring.

Any pickup in global growth would have implications for other asset classes as well. We'd potentially expect the dollar to weaken. Ex-U.S. stocks, both developed and emerging, may also outperform the U.S. for a little while.

Interest rates

Another trend we anticipate is central banks moving away from going deeper into negative interest rates. We expect to see more of a shift toward fiscal stimulus in Europe, while in the U.S. we expect the Federal Reserve (the Fed) to hold off on further rate cuts.

With inflation pressures constrained and plenty of negative rates outside the U.S., we don't see the U.S. ten-year moving much above 2% or 2.25% at most. The yield curve may steepen mildly. We believe it's more likely that the Fed will cut rates if there are signs of a recession, but we don't anticipate that in 2020.

The inverted yield curve caused worry earlier in 2019, then faded from view, but we see it as an almost-infallible indicator of recession. The duration of the inversion—around four months—was quite significant, making it even more important as a signal. Inverted yield curves typically precede recession by a long lead time, so we see this as more of a risk for 2021.

Recession likely isn't on the horizon next year. Credit stress is minimal. We wouldn't underweight corporate credit relative to government bonds. But, given where we are late in the cycle, we like high quality credit. Companies with strong balance sheets and healthy cash flows are more likely to outperform.

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