THE GLOBAL ECONOMY: GROWTH CONTINUES TO WEAKEN

by **Robert F. DeLucia, CFA**
Consulting Economist

Summary and Major Conclusions:

The outlook for global economic growth is the primary determinant of the direction of world financial markets. The outcome is likely to be binary: Either a synchronized recovery in the world economy will spark a rebound in global equities and interest rates and a decline in the dollar; or continued economic stagnation will result in weakness in equity markets, sustained low levels in world interest rates, and continued dollar strength. A durable recovery in the global economy should also trigger a shift in equity market leadership from the US to the rest of the world.

- The future direction of the global equity, fixed-income, and currency markets is predicated upon the outlook for growth in the world economy. The major countries of the world remain in a synchronized economic slowdown, as GDP growth continues to downshift in all regions.

- Although economic growth has not collapsed, there are no credible signs of a cyclical bottom. Economic conditions worldwide are bifurcated, with growth in consumer spending, services, and employment offset by weakness in manufacturing and export trade.

- World GDP growth peaked in the first half of 2018 at an annual rate of nearly 4%, but has been in a steadily decelerating trend over the past 18 months. Third quarter GDP rose at an estimated rate of 3% and could slow to 2.5% over the next two quarters.

- Deflationary pressures are becoming more widespread, inducing world central banks to introduce extremely expansionary monetary stimulus. Continued weakness in demand could also result in fiscal policy initiatives to boost aggregate spending.

- There are several major contributors to the steady deterioration of economic conditions worldwide, including the ongoing trade war between China and the US; continued uncertainty surrounding Brexit and other geopolitical risks; and the lagged effects of previous monetary and fiscal tightening in China.

- The common denominator of these factors is business confidence. Heightened uncertainty regarding economic policy, domestic politics, and geopolitics has culminated in widespread retrenchment in capital formation and hiring on the part of business firms.

- A vicious inventory cycle worldwide has exerted enormous pressure on the global manufacturing economy. Export-oriented economies such as those of Germany, Japan, China, and South Korea have suffered disproportionately. The world auto sector is at the epicenter of the inventory drawdown.

- Following another two quarters of weakness, world GDP is likely to accelerate during 2020, rising at a 3.3% annual rate. This momentum should culminate in a further pick-up in growth to 3.5% in 2021.

- Deceleration in China's GDP over the past 18 months has not yet reached bottom. It seems plausible to assume that ongoing economic weakness will increase pressure on policymakers to deliver greater monetary and fiscal stimulus.

- China is the main engine of growth for the world economy. A more vibrant Chinese economy will have a powerful domino effect on the world manufacturing economy, providing stimulus for consumption, employment, and capital investment worldwide.

- Fears of a hard landing in China are unwarranted. Consumer spending, services, and real estate investment are all expanding at a rate well in excess of 5%, more than offsetting weakness in manufacturing, fixed-asset investment, and exports.

- A downturn in the global economy is unlikely to push the US into recession. Historically, the US economy has led the rest of the world; global recessions have always originated in America and spread to the world economy, not vice versa.

- The US also enjoys numerous structural advantages over most other countries, including a smooth-functioning, market-based economy; a healthy and resilient private sector; fewer government regulations; consistent capital inflows; an extremely sound banking system; and more favorable demographics.

- The US dollar (USD) appears to be in a long-term peaking process and could face significant downside over the next several years. Sustained depreciation of the USD would be an enormous positive force for the world economy and US corporate earnings.

- The outlook for global growth is the primary determinant of the direction of world financial markets. A synchronized world economic recovery would be the catalyst for a rebound in global equities and interest rates, and a decline in the US dollar.

- A sustained recovery in the global economy should trigger a shift in equity market leadership from the US to the rest of the world. Europe, Japan, and emerging Asia are highly leveraged to the global economy, and also offer far greater value relative to the US.

The future direction of the global equity, fixed-income, and currency markets is predicated upon the outlook for growth in the world economy. The major economies of the world remain in a synchronized slowdown, as GDP growth continues to downshift in all regions. This week's *Economic Perspective* provides an update on economic and policy trends within the world economy, along with implications for global financial markets.

HOW WOULD YOU BEST CHARACTERIZE WORLD ECONOMIC CONDITIONS?

I would characterize the world economy as follows: (1) World economic growth continues to weaken, with no signs of a cyclical bottom; (2) Economic conditions worldwide are bifurcated, with growth in consumer spending, services, and employment offset by profound weakness in manufacturing and export trade; (3) Deflationary pressures are becoming more widespread; and (4) Monetary conditions are extremely accommodative in most countries.

COULD YOU QUANTIFY THE MAGNITUDE OF THE WORLD ECONOMIC SLOWDOWN?

World GDP growth peaked in the first half of 2018 at an annual rate of nearly 4%, but has been in a steadily decelerating trend over the past 18 months. Third quarter GDP rose at an estimated annual rate of 3% and could slow to 2.5% over the next two quarters, which would be the slowest pace in several years. On a yearly basis, GDP growth peaked in 2017 at 3.8%, and has slowed to only 3% this year. Weakness is evident in all corners of the world, most notably among leading export-oriented economies in both developed and developing countries.

WHAT ARE THE KEY FACTORS RESPONSIBLE FOR THE SUSTAINED SLOWDOWN IN GROWTH?

There are several major contributors to the steady deterioration in economic conditions worldwide:

1. The ongoing *trade war* between China and the US has severely disrupted supply chains and triggered a major contraction in both the export trade and manufacturing sectors.

2. There is enormous uncertainty surrounding *Brexit* — the withdrawal of the UK from the European Union (EU). Business and consumer confidence in Europe and the UK have plummeted since the July 2016 referendum, triggering weakness in capital formation and job creation in the region.

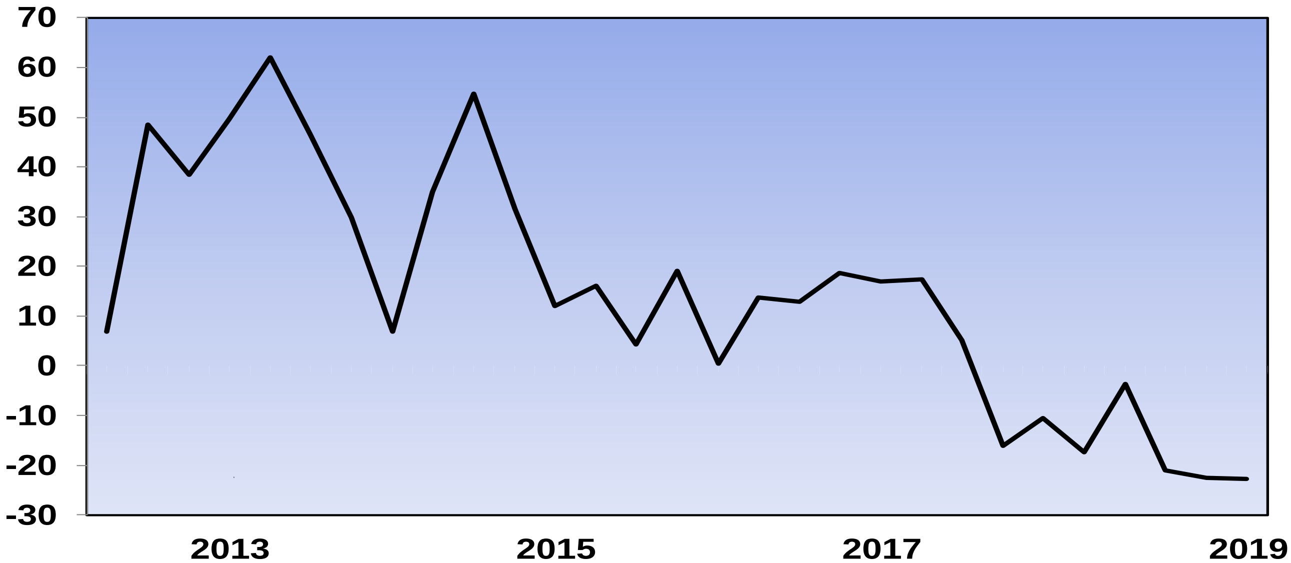
3. The lagged effects of *monetary and fiscal tightening in China* during 2017, a result of policymaker efforts to control excessive internal debt levels, remain a drag on growth. The government has eased credit policy somewhat but not enough to offset the previous period of draconian fiscal and monetary restraint.

4. The thrust of *US fiscal policy* has also contributed to global economic weakness, with a typical time lag. The Trump tax cuts that took effect in 2018 have gradually faded over the course of 2019. Similar to China, the US is a major engine of world economic growth.

5. A *vicious inventory cycle* worldwide has exerted enormous pressure on the global manufacturing economy. Export-oriented economies such as those of Germany, Japan, China, and South Korea have suffered disproportionately. The *world auto sector* has been the epicenter of the inventory drawdown, with China, Japan, and especially Germany being the main casualties.

6. A rise in *geopolitical risk* has undermined business confidence, and therefore plans for long-term investment in plant and equipment.

Chart 1: World Business Confidence Remains Depressed
The ZEW Indicator of Economic Sentiment
Source: Centre for European Economic Research



The common denominator of these six factors is ***business confidence***. Heightened uncertainty regarding economic policy, domestic politics, and geopolitics has resulted in widespread retrenchment by business firms in capital formation and hiring (see chart 1).

HOW DO EACH OF THESE UNKNOWN VARIABLES FACTOR INTO YOUR FORECAST?

Although a so-called grand bargain is unlikely, I continue to expect a significant truce between China and the US well in advance of the 2020 election. My assumptions regarding the outcome of the trade war with China have been overly optimistic. Instead of an interim truce as I was expecting, the trade war has escalated over the course of 2019, with leaders in both China and the US adopting an increasingly recalcitrant posture.

The logic for an eventual truce remains intact — improved economic, social, and political stability within both countries — but the timing remains highly uncertain. It seems plausible to assume that the key issue for President Trump is the 2020 election, suggesting a strong incentive on his part to stabilize trade conditions necessary to boost GDP growth, employment, and the stock market.

Continuation of the status quo — or worse, an escalation in trade restrictions — would be consistent with continued weakness in the US economy and ongoing volatility in equity markets. Conversely, an agreement to roll back tariffs would spark a rise in stock prices and an increase in capital spending budgets. Although far from assured, the latter outcome seems most likely, but the timing remains highly uncertain.

DOES THE OCTOBER 11 PARTIAL AGREEMENT WITH CHINA ALTER THE OUTLOOK?

No, I have been anticipating some partial agreement between the two parties for months; last week's meeting at the White House was only a small step forward and far from the breakthrough needed to lift business and investor confidence, and therefore risk-taking. Even without an escalation in tariffs, the current gridlock remains a serious headwind to world trade and to a resumption of healthy economic growth. As a reminder, the status of the December 15 tariffs on US imports of Chinese consumer goods remains uncertain and is another wild card in the outlook.

WHAT ARE YOUR ASSUMPTIONS REGARDING BREXIT?

Most recent developments have been encouraging, following more than three years of political turmoil and uncertainty surrounding the UK's exit from the European Union (EU). Unexpectedly, the UK government and the EU appear to be on the verge of a potential deal that would avoid a dreaded "hard" (no-deal) Brexit.

The situation remains highly fluid and could take a number of turns, but the odds of passing a constructive deal between the UK and the EU have increased significantly. The UK will likely ask for an extension of the October 31 deadline, suggesting that a speedy resolution of the issue is not likely. Although the timing and precise terms are unclear, ultimate passage of a deal should boost business and investor confidence enormously.

HOW LONG WILL CHINA REFRAIN FROM MORE AGGRESSIVE MONETARY AND FISCAL STIMULUS?

China has refrained from aggressive monetary and fiscal stimulus because of policymaker fears regarding the massive debt overhang and vulnerability of the banking system. The ratio of debt to GDP has risen sharply in recent years to an all-time high. Moreover, nonperforming loans in the banking system are at dangerous levels, raising fears of a credit crisis or banking sector collapse (see chart 2).

The Chinese economy remains weak and the deceleration in GDP over the past 18 months has not yet bottomed. Under these circumstances, it seems likely that ongoing economic weakness will intensify pressure on policymakers to deliver greater monetary and fiscal stimulus to stabilize China's economy. A sustained rebound in Chinese domestic demand is crucial for a recovery in the world economy.

Chart 2: China Debt Surges to Record Share of GDP
Total China Debt, Percent of GDP
Source: Bloomberg Economics

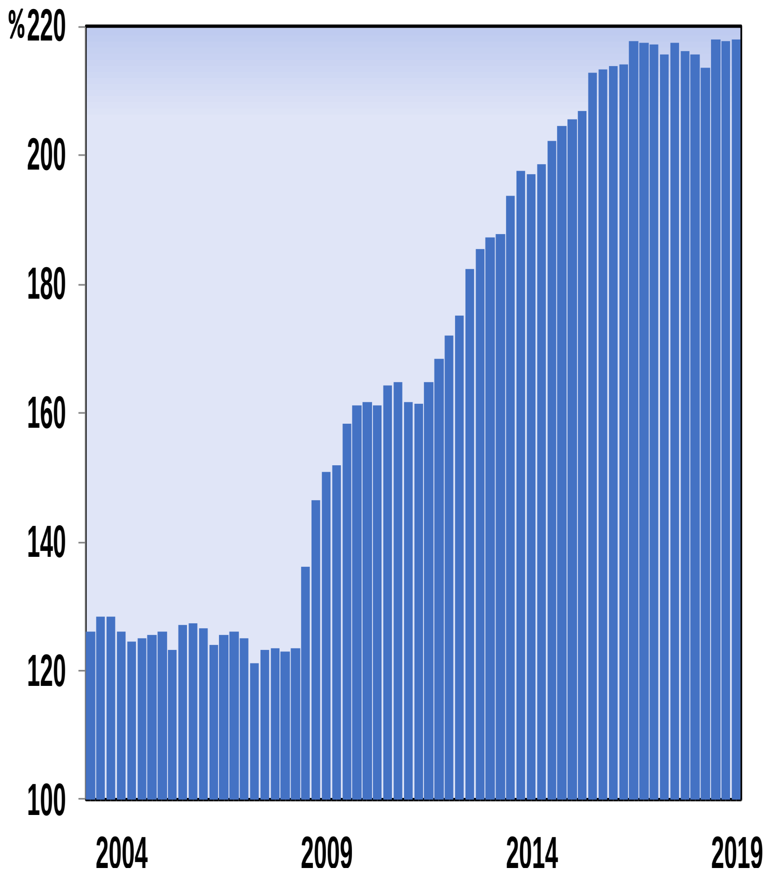
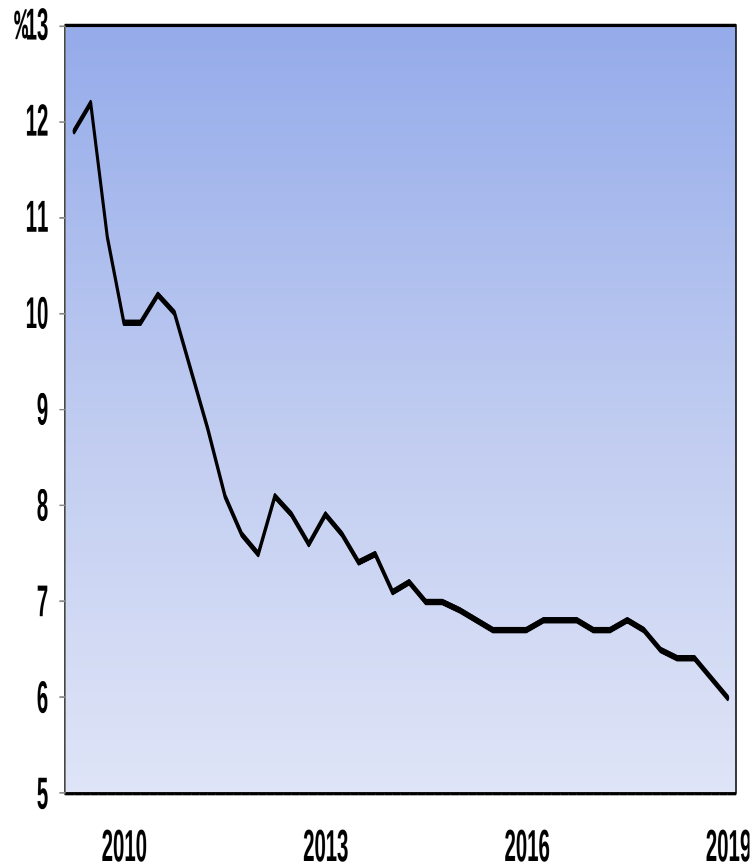


Chart 3: Slowest Economic Growth in China in Nearly Three Decades
China GDP Growth, Adjusted for Inflation, Annual Rate
Source: China National Bureau of Statistics

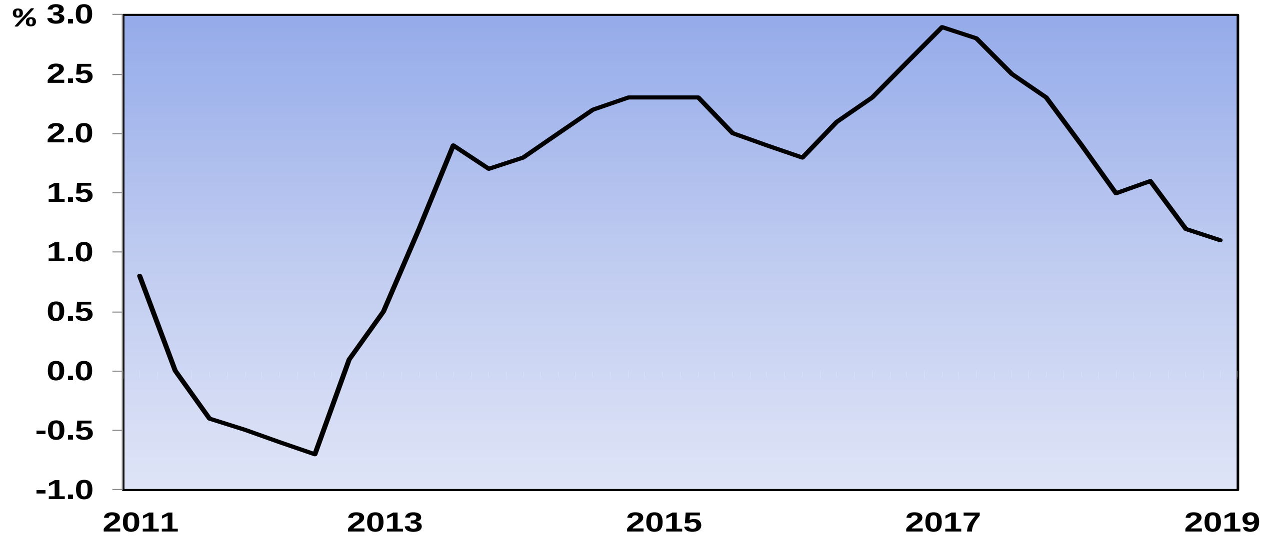


China is the main engine of growth for the world economy, accounting for one-third of global GDP growth annually. As such, a strengthening of its economy would culminate in a powerful ***domino effect*** on the world economy, initially boosting world manufacturing activity, which would then provide stimulus for consumption, employment, services, and capital investment worldwide.

HOW LIKELY IS AN OUTRIGHT RECESSION IN CHINA?

Although China's economy has weakened considerably over the past 18 months, a hard landing appears unlikely at this time. GDP growth is likely to fall below 6% in coming quarters — the slowest rate in nearly three decades — but economic growth should stabilize within a range of 5% to 6%. Consumer spending, services, and real estate investment are all expanding at a rate in excess of 5%, more than offsetting weakness in manufacturing, fixed-asset investment, and exports. Assuming at least a partial end to the trade war, growth should accelerate modestly in 2020 and 2021, back to a cyclical peak of 6.5% (see chart 3).

Chart 4: Continued Slowing in Eurozone Economic Growth
Eurozone GDP, Adjusted for Inflation, Annual Rate
Source: Eurostat



IS THE EUROZONE ECONOMY CAPABLE OF EXPANDING AT A FASTER PACE?

Investors should not expect a robust economic recovery in Europe, but economic conditions should stabilize around yearend and gradually improve during 2020. Financial conditions are steadily improving, courtesy of exceptional monetary ease by the European Central Bank (ECB). Domestic demand and employment have been resilient in the face of a recession in manufacturing and slump in export trade.

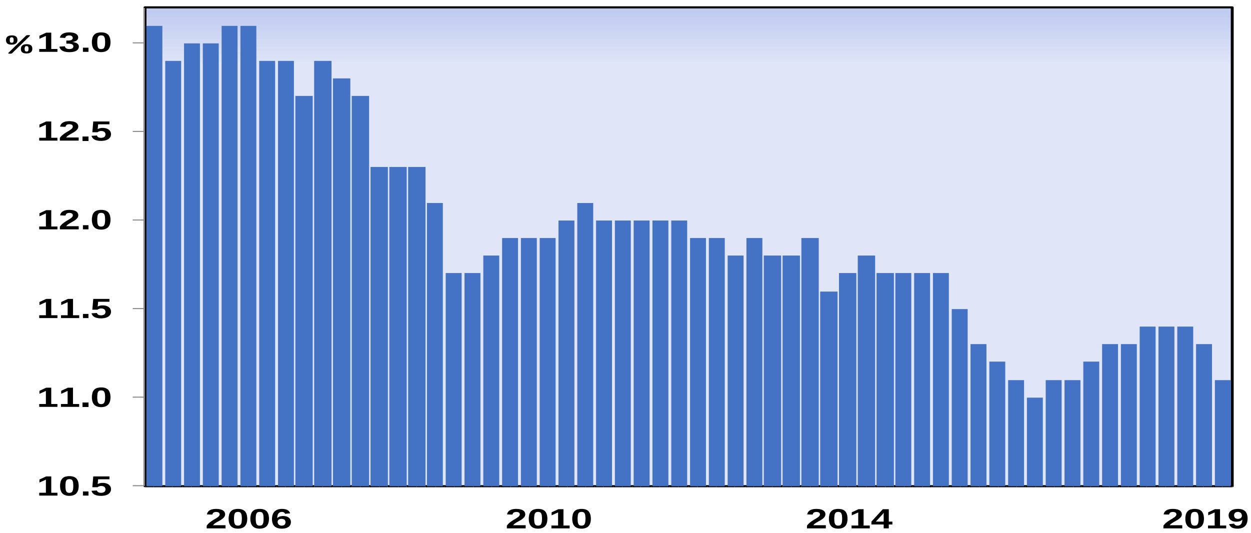
With business inventories in liquidation, stronger domestic demand in China and the US should support eurozone manufacturing and trade. Continued progress in Brexit negotiations should also support growth by lifting business confidence. Compared with only 1% this year, GDP growth could accelerate to 1.5% in both 2020 and 2021 (see chart 4).

COULD AN OUTRIGHT RECESSION IN THE WORLD ECONOMY TRIGGER A RECESSION IN THE US?

A downturn in the global economy is unlikely to push the US economy into recession. *Historically, the US economy has led the rest of the world; global recessions have always originated in America and spread to the world economy, not vice versa*. There are at least three reasons why a world recession would not culminate in a US recession:

1. **Export Trade**: The US economy is also far less dependent upon exports when compared with other major economies. Because the current slowdown is heavily influenced by weakness in world trade, the *strong domestic orientation* of the US has sheltered GDP.

Chart 5: Manufacturing Comprises Only 11% of US Economy
US Manufacturing Output, Percent of Total US GDP
Source: Bureau of Economic Analysis



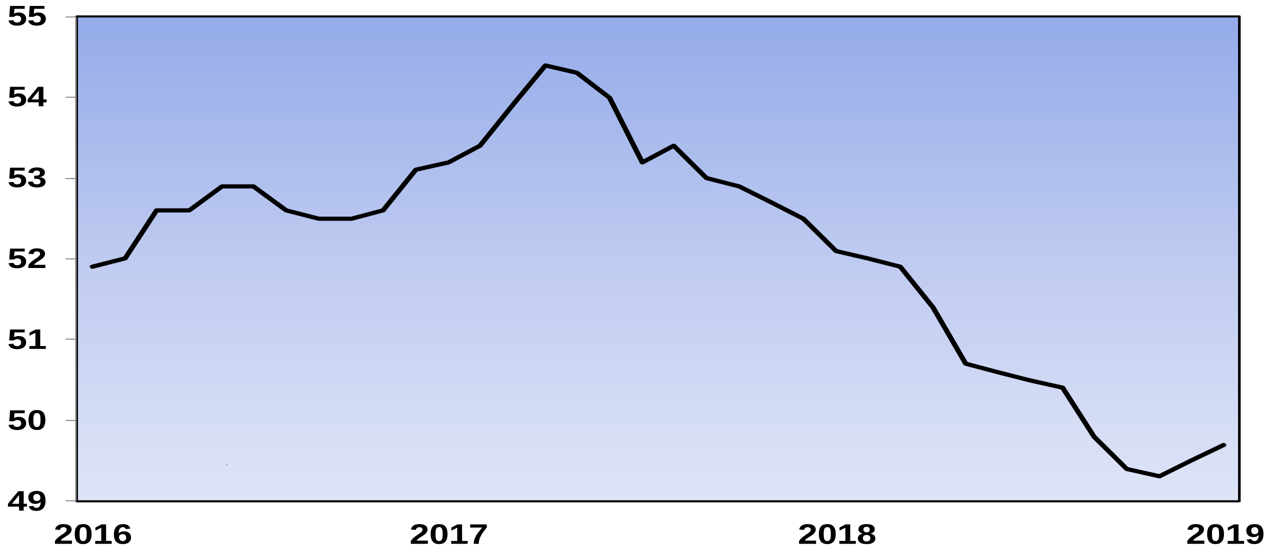
2. **Services Versus Manufacturing**: In contrast to virtually all major economies, the US economy has a low exposure to manufacturing and a *very high exposure to services*. Compared with 80% for services, manufacturing comprises only 11% of US GDP. Spending on services is relatively stable and seldom contracts (see chart 5).

3. **Export Trade**: The US economy is also far less dependent upon exports when compared with other major economies. Because the current slowdown is heavily influenced by weakness in world trade, the *strong domestic orientation* of the US has sheltered GDP.

4. **Structural Advantages**: The US also enjoys numerous structural advantages over most other countries, including a smooth-functioning, market-based economy; a healthy and resilient private sector; fewer government regulations; an extremely sound banking system; steady inflows of international capital; and more favorable demographics. The US economy is also far more diversified than other major economies.

Consequently, with current GDP growth of 2%, the US economy is expanding at close to potential. *By comparison, GDP growth in most major economies has declined to rates that are below potential*. While manufacturing and trade weakness in the global economy could eventually contaminate the US economy to an increasing degree, the probability of an outright recession is less than 50%.

Chart 6: World Manufacturing Slump in a Bottoming Process
Index of World Manufacturing
Source: JP Morgan



WHAT IS YOUR FORECAST FOR THE WORLD ECONOMY?

World GDP is on track to expand by less than 3% this year, down from 3.5% in 2018 and a peak growth rate of 3.8% in 2017. Eurozone GDP could expand by 1.2%, down from a peak growth rate of 2.8% in 2017, while China's GDP has slowed from nearly 7% in 2017 and 6.5% in 2018 to 6% or less this year. *I continue to assume that world economic growth will accelerate in 2020 following another two quarters of weakness, with GDP rising at a 3.3% annual rate*. A further pick-up in growth to 3.5% in 2021 is possible. There are preliminary signs of a cyclical bottom in global manufacturing (see chart 6).

WHAT ARE YOUR ASSUMPTIONS PERTAINING TO FOREIGN EXCHANGE MARKETS?

Leadership within foreign exchange markets is likely to change significantly over the next two years, based upon the following fundamental considerations:

- The US dollar (USD) has risen by nearly 15% over the past 18 months and is at a multi-year high. The USD is a classic *countercyclical currency*, appreciating during periods of economic weakness and financial stress, and declining during periods of economic strength.

- The USD is significantly *overbought and overvalued*, as global investors seek the safety of high-quality investments in the US.

- As the anti-dollar currency, the euro exhibits a strong *negative correlation* with the USD. The euro is undervalued by more than 15% on a purchasing-power-parity (PPP) basis, and appears attractive for patient investors.

- The pound (GBP) has declined by 28% since 2014 and is also undervalued against the USD. Assuming a reversal of the Brexit referendum, the GBP offers significant appreciation potential over a two-year period.

- Developing economy currencies are undervalued versus the USD and would benefit significantly from a world economic recovery.

Pulling it all together, the USD appears to be in a long-term peaking process and could face significant downside over the next several years. Sustained depreciation of the USD would be an enormous positive force for the world economy and US corporate earnings. A weak dollar is consistent with improving global liquidity and an expanding global economy, which in a ***virtuous cycle***, would exert further downward pressure on the dollar, providing stimulus for global growth.

WHAT ARE THE KEY INVESTMENT IMPLICATIONS?

The outlook for global economic growth is the primary determinant of the direction of world financial markets. The outcome is likely to be ***binary***: *A synchronized recovery in the world economy would be the catalyst for a rebound in global equities and interest rates, and a decline in the US dollar*. Conversely, continued economic stagnation would result in weakness in equity markets, sustained low levels in world interest rates, and continued strength in the US dollar.

A sustained recovery in the global economy should trigger a shift in equity market leadership from the US to the rest of the world. While US stocks are viewed as safer and more defensive, European, Japanese, and emerging Asian equities are more cyclically oriented, and more tightly correlated to global economic trends. Each of these markets also offers far greater value relative to that of the US.
I expect non-US equities to begin to outperform the domestic equity market as evidence of a world economic revival becomes more apparent and widespread.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

This material is intended to provide information only. This material is not intended as advice or recommendation about investing or managing your retirement savings. By sharing this information, Prudential Retirement® is not acting as your fiduciary as defined by the Department of Labor or otherwise. If you need investment advice, please consult with a qualified professional.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Certain information contained herein may constitute "forward-looking statements," (including observations about markets and industry and regulatory trends as of the original date of this document). Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making any decisions. No representation or warranty is made as to future performance or such forward-looking statements.

The financial indices referenced herein are provided for informational purposes only. You cannot invest directly in an index. The statistical data regarding such indices has been obtained from sources believed to be reliable but has not been independently verified.

Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. Past performance is not a guarantee or reliable indicator of future results.

The information provided is not intended to provide investment advice and should not be construed as an investment recommendation by Prudential Financial or any of its subsidiaries.