THE YEAR IN REVIEW: AN ANALYSIS OF THE 2019 ECONOMY

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

Although investor fears of recession continue to linger, the events of 2019 have set the stage for a moderate rebound in economic growth during 2020, which should support higher stock prices and rising government bond yields. The easing of inflationary pressures during 2019 is positive for healthy economic growth. Financial conditions have eased significantly over the past year, courtesy of aggressive monetary easing by world central banks. Manufacturing and world trade should benefit from a significant drawdown of inventories along with a rebound in Chinese domestic demand.

Summary and Major Conclusions:

- Two thousand nineteen was a tumultuous year. World economic growth was the weakest since 2015, while global bond and equity markets experienced exceptionally high volatility, mainly in response to rising geopolitical pressures.
- The year was also unprecedented in many respects. Monetary policy across the globe was the most expansionary since the Great Recession, while threats to free trade and globalization were the most profound in decades.
- The overarching theme of 2019 was a relentless fear of recession and an ongoing attempt by investors to safeguard their portfolios against market losses. The result was a pronounced focus on risk-off investment strategies, accompanied by a stampede out of risk assets.
- Widespread investor anxiety also resulted in a strong preference for safe-haven assets, such as high-quality government bonds and low-risk defensive stock groups. These trends reversed during the final several months of the year, as hysteria over recession risk began to partially recede.
- Recession fears were reinforced throughout 2019 by the steady escalation in the China-US trade war. Trade policy was the major investment theme and hovered over financial markets for the entire year. Financial market volatility ebbed and flowed in response to the latest news report or tweet regarding trade policy.
- The economic impact of the trade war was palpable. World trade declined for the first time since the 2008 financial crisis, while world GDP was reduced by a cumulative 1%. The trade war subtracted roughly 0.5% from US GDP during the year.
- The US economy fared much better than most other major economies because of its lower exposure to manufacturing and trade. However, company profit margins were squeezed by a combination of slower sales growth, rising input costs, and incremental operating expenses associated with supply chain disruptions.
- Nonetheless, certain key segments of the US economy showed considerable resilience. Consumer spending was the star performer in 2019, with average growth of 2.5% over the first three quarters of the year. Business and consumer services remained on a consistent 2% growth path.

- Following a weak 2018, the housing market rebounded strongly during the past year as measured by housing starts, building permits, and home sales. Supply and demand conditions remained unusually favorable.

- An in-depth analysis of underlying trends led to my out-of-consensus conclusion that a recession was unlikely to occur in 2019. Historically, recessions have always been preceded by a systematic deterioration in economic and financial conditions that can be observed well in advance.

- Most importantly, inflationary pressures were non-existent; monetary policy was ultra-accommodative; the yield curve ended the year in a normal upward slope; credit losses remained at historically low levels; and the housing market steadily improved as the year unfolded.

- Business and investor sentiment remained highly cautious during much of the year because of widespread fears of recession. It is somewhat of a paradox that recessions seldom occur when they are widely expected, but rather during periods of widespread optimism, complacency, and euphoria.

- Economic weakness during 2019 was consistent with a classic *mid-cycle slowdown*, rather than an outright recession. The current expansion cycle that began in 2009 has already witnessed two mid-cycle slowdowns — in 2012 and 2015 — each of which was followed by two years of healthy economic growth.

- Despite heightened volatility, world financial markets rallied strongly during 2019. Large-cap domestic equities led all asset classes with a total return of 27.5% through November 30. US investment-grade bonds also performed well, led by long-duration government and corporate bonds.

- Although investor fears of recession continue to linger, the events of 2019 have set the stage for a moderate rebound in economic growth during 2020, which should reinforce the current uptrend in stock prices and government bond yields.

This week's *Economic Perspective* reviews the events and developments of 2019, and provides a summary of the most important trends. The report also summarizes the central investment themes of the past year, along with potential implications for 2020.

Two thousand nineteen was a year of extreme outcomes: World economic growth was the weakest since 2015; global bond and equity markets experienced exceptionally high volatility; geopolitical pressures were elevated during much of the year; monetary policy across the globe was the most expansionary since the Great Recession; and the threats to free trade and globalization were the most severe in decades. World trade was the weakest in more than a decade.

Recession Expectations: *The overarching theme of 2019 was a relentless fear of recession and an ongoing attempt by investors to safeguard their portfolios against market losses*. The result was a mass exodus out of risk assets and a stampede into safe-haven assets, such as high-quality government bonds and low-risk defensive stock groups.

- **Defensive Stock Groups**: These trends reversed during the final months of the year as the ***hysteria*** over recession risk began to subside. In sharp contrast to the first three quarters of the year, economically sensitive stocks outperformed defensive stock groups, and value stocks outperformed growth stocks. For the three months ending on November 30, the S&P 500 Value Index (+10.5%) easily outperformed the S&P 500 Growth Index (+5.5%).

China-US Trade War: The major source of investor recession fear during the year was the steady escalation in the trade war between China and the US. Trade policy was a major investment theme, affecting world financial markets throughout 2019. Financial market volatility ebbed and flowed in response to the latest news report or tweet regarding trade policy.

Tariff Escalation: The volume of imports covered by tariffs increased during the year. Currently, $250 billion in Chinese imports are subject to US tariffs, ranging from 10% to 25%. Chinese imports of US goods currently amount to $110 billion, with tariffs ranging from 5% to 25%.

- **Economic Impact**: World trade declined for the first time since the 2008 financial crisis, while world GDP was reduced by a cumulative 1%. The US economy has fared better than most other major economies because of its lower exposure to manufacturing and foreign trade. Company profit margins were squeezed by a combination of slower sales growth, rising input costs, and operating expenses associated with disruptions to supply chains.

THE US ECONOMY

Two thousand nineteen was a year of disappointing US economic growth, with most key indicators reflecting spreading weakness as the year unfolded. Most pronounced areas of domestic economic weakness were in the manufacturing, capital goods, and export sectors. The manufacturing sector fell into an outright recession, the third contraction for the factory sector since the Great Recession of 2008 (see chart 1).

Chart 1: US Manufacturing Sector Slips into Recession Territory
Purchasing Manager Survey, Manufacturing Sector
Source: Institute for Supply Management

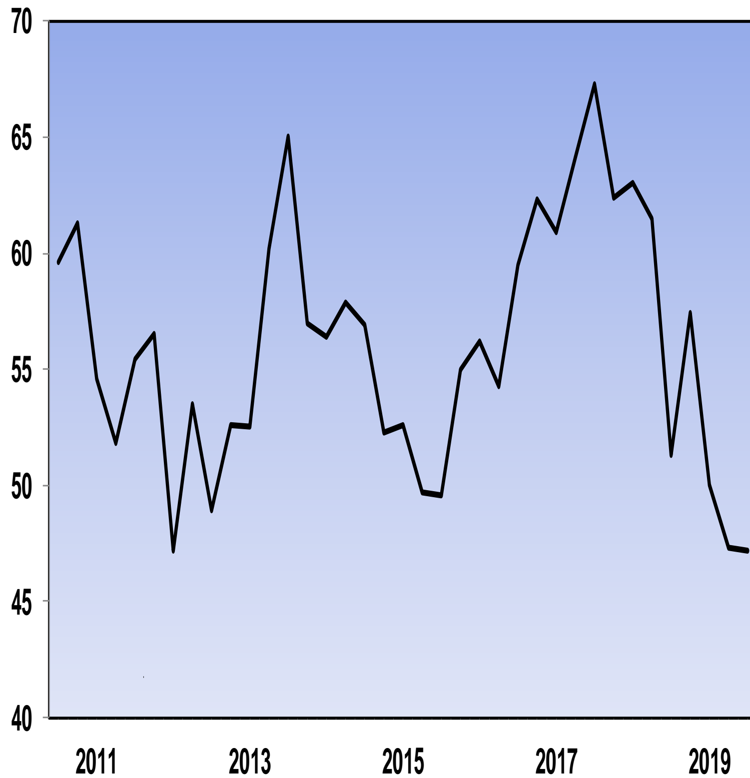
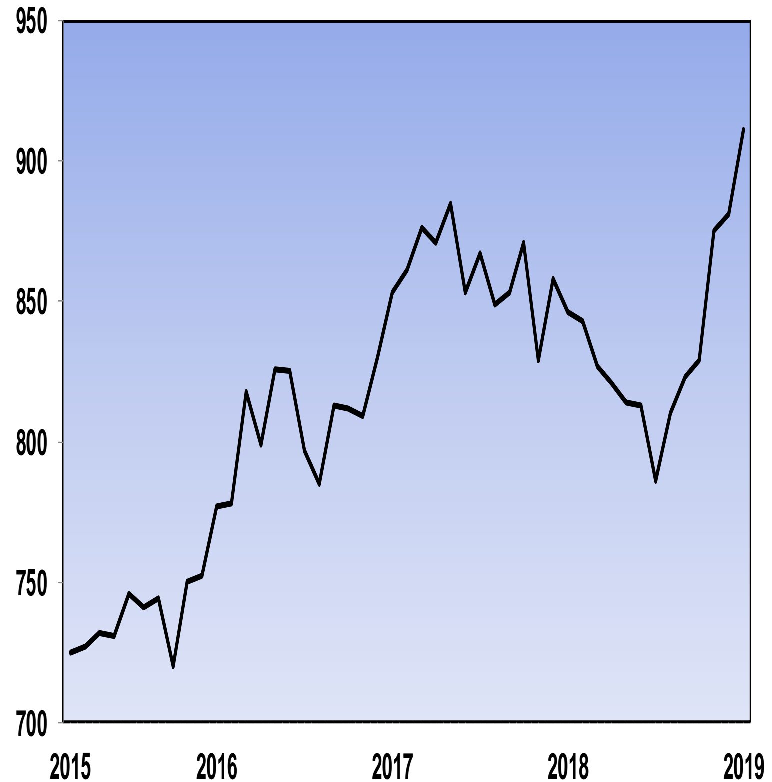


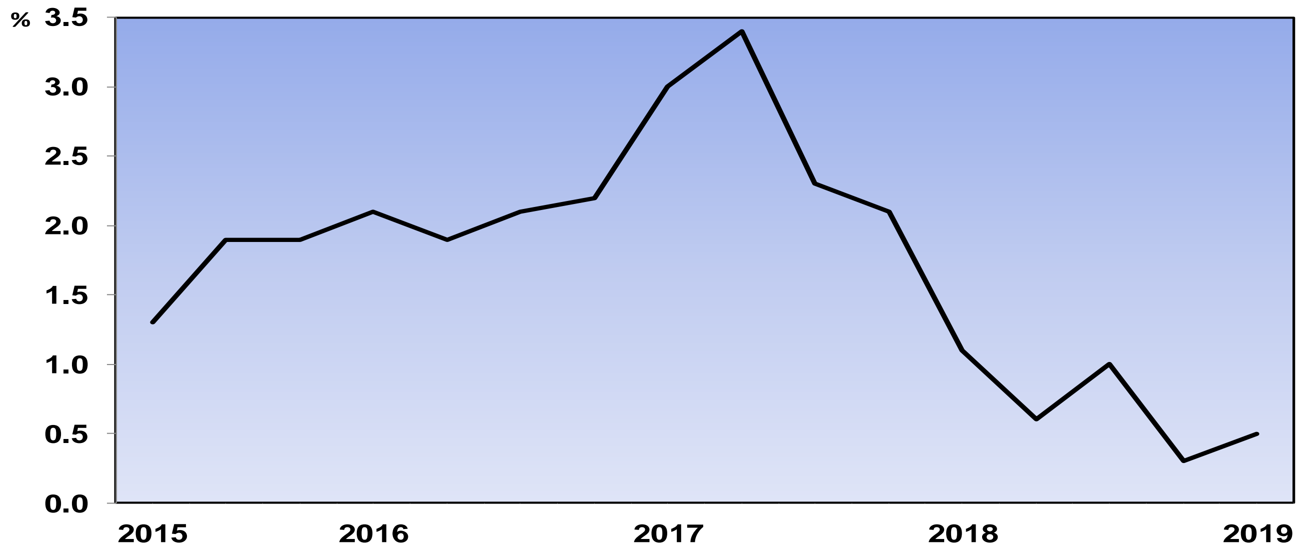
Chart 2: Home Construction on a Solid Recovery Path
New Building Permits, Single-Family Homes (Thousands)
Source: Census Bureau



A Tale of Two Economies: However, certain key segments of the US economy showed considerable resilience:

- **Household Sector**: Consumer spending was the star performer for the US economy in 2019, with average growth of 2.5% over the first three quarters of the year.
- **Services Sector**: Spending on services increased by 2% during the year.
- **Labor Market**: Despite a steady slowdown in job creation over the past year, employment remained on a solid growth path.
- **Residential Real Estate**: Following a weak 2018, the housing market rebounded strongly during the past year as measured by housing starts, building permits, and home sales. Supply and demand within the single-family housing market remained unusually favorable. Basic economic drivers — employment, personal income, and credit conditions — remained supportive of continued solid growth (see chart 2).
- **Banking Sector**: The banking system is the healthiest in many decades, as measured by liquidity and capital ratios and an exceptionally low level of delinquencies, defaults, and problem loans.

Chart 3: Sharp Deceleration in German GDP Growth
German GDP Adjusted for Inflation
Annual Percentage Change
Source: Eurostat



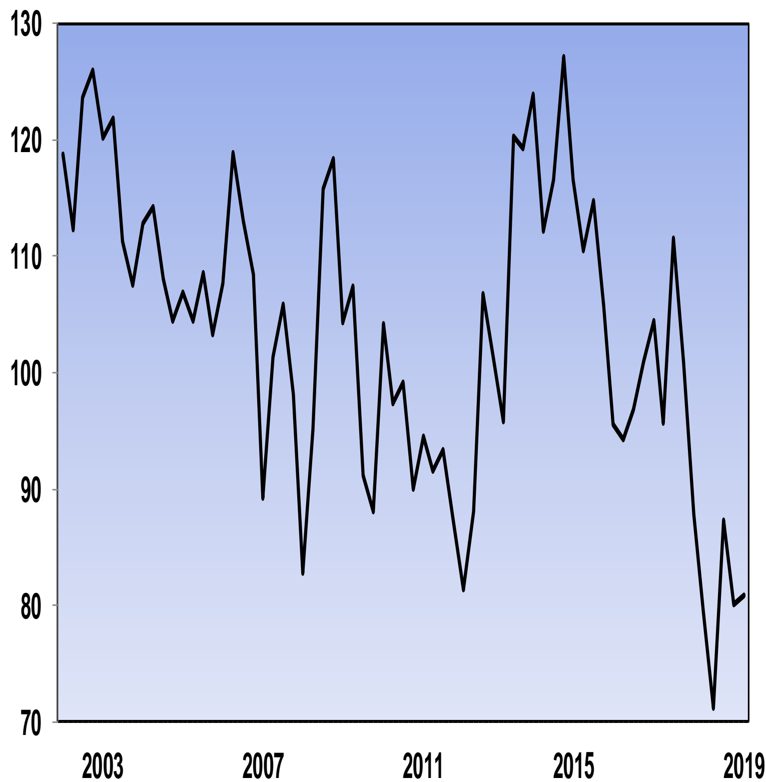
Mixed Performance: Pulling it all together, 2019 was a year of mixed economic performance for the US economy. Real GDP increased at a 2.3% annual rate, down from a rate of nearly 3% in 2018. Inflation was stable and labor market conditions were consistently healthy throughout the year. ***The key point is that the US economy is highly diversified and resilient, and was therefore able to perform relatively well during an otherwise challenging year*.**

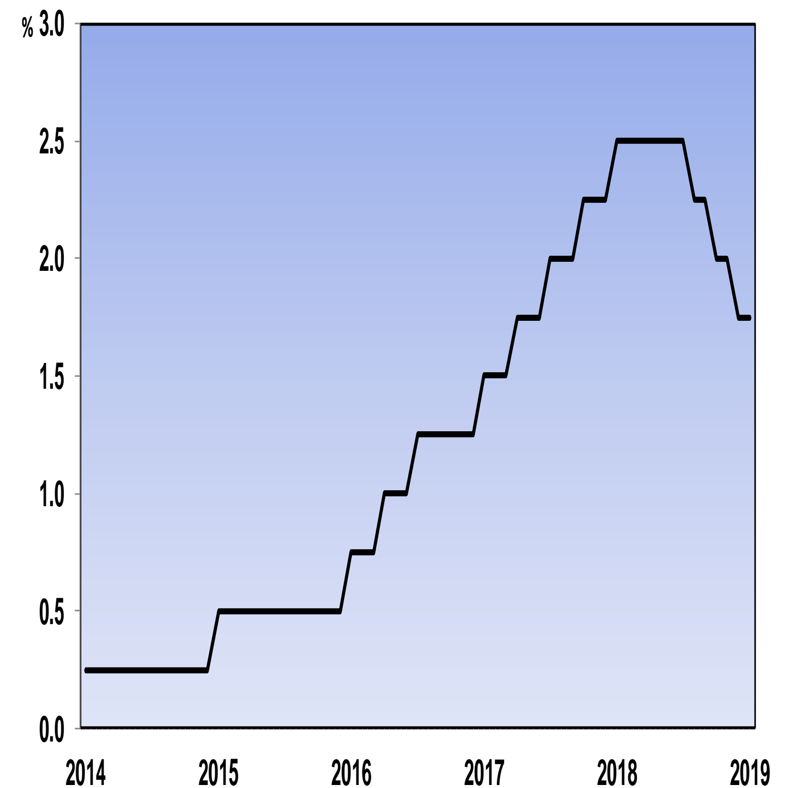
- **Germany Versus the US**: Germany serves as an interesting comparison. Next to the US, Germany is fundamentally the strongest and healthiest economy in the world. However, ***the German economy is not diversified***: More than **25%** of the economy is manufacturing based, while **45%** of GDP is comprised of exports. Unsurprisingly, the German economy has suffered considerable pain over the past 12 to 18 months as a result of the global recession in manufacturing and trade. Germany's GDP has risen by only 0.5% over the past year, down from a late 2017 peak of 3.5% (see chart 3).

RECESSION INDICATORS

Financial markets were obsessed with the risk of recession for much of 2019; convinced that an economic slump was imminent, investors allocated portfolio assets accordingly. Manifestations of widespread investor mentality were clearly evident in financial asset prices:

- A plunge in market yields on ultra-safe government bonds worldwide to all-time lows

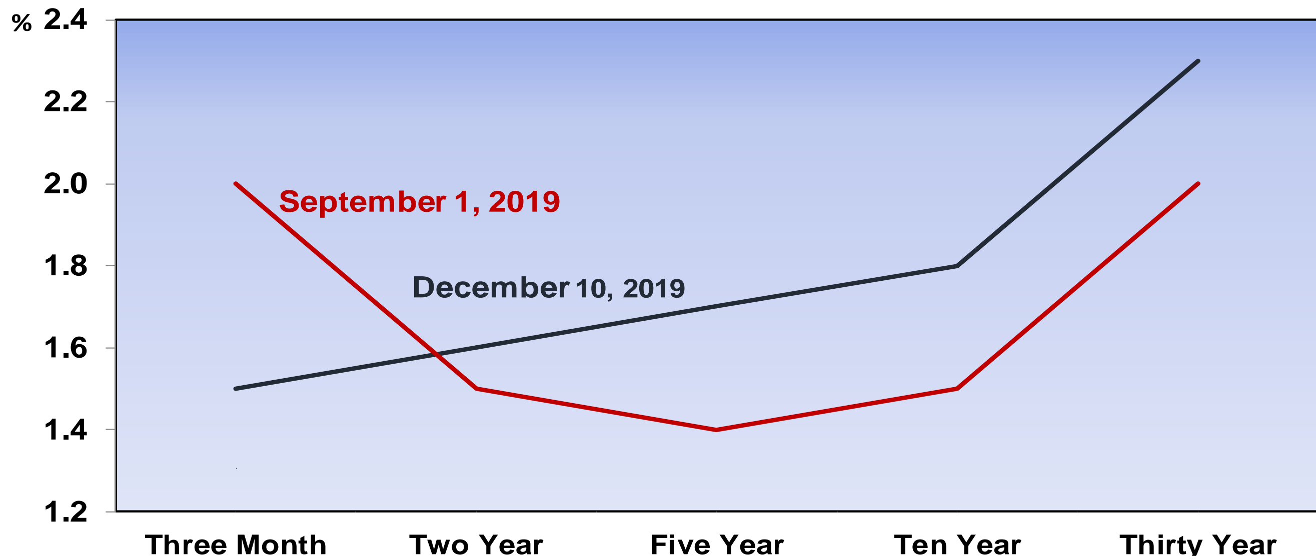




- Strong preference among equity investors for safe-haven economic sectors, most notably utilities, consumer staples, real estate, and technology
- A strong aversion to economically sensitive stock groups, including industrials, materials, energy, transports, and financials
- Surveys of investor sentiment continue to reflect heightened levels of fear, caution, and risk aversion (see chart 4)

Missing Recession Catalysts: However, a rigorous analysis of underlying trends led to my conclusion that the probability of recession in 2019 was low. In principle, there is a crucial difference between an outright recession versus a period of temporarily sluggish economic growth. _Historically, recessions have always been preceded by a systematic deterioration in economic and financial conditions that can be observed in advance_. _The classic preconditions for recession were absent during most of 2019_:

1. Inflation remained under excellent control for all of 2019.
2. Rather than becoming restrictive, monetary policy became more accommodative as the year unfolded (see chart 5).



3. The artificial inversion of the yield curve faded late in the year and was replaced by a normal upward-sloping curve (see chart 6).

4. Housing market data improved steadily as the year unfolded. *There has never been a recession with the housing market in a healthy rising trend*.

5. Employment increased at a very respectable rate. The number of workers on nonfarm payrolls increased at a monthly rate of 185,000 through November, well in excess of the estimated 110,000 new workers entering the labor force each month. As a result, the unemployment rate fell from 4% in January to a 50-year low of 3.5%.

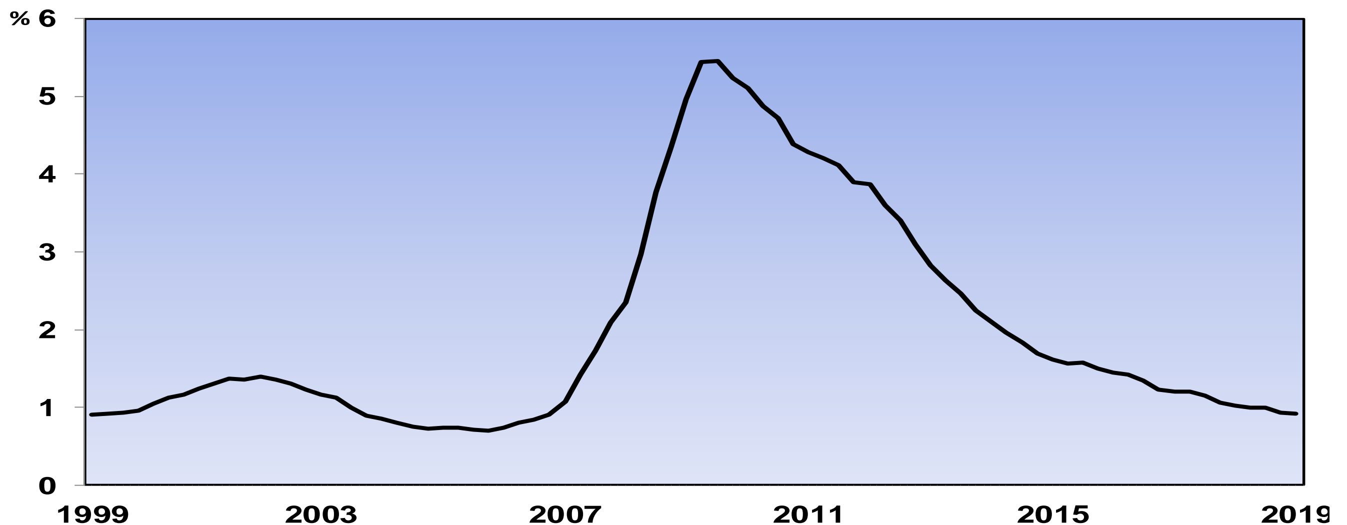
6. Private sector balance sheets remained in good health during all of 2019.

7. Wages increased at an average annual rate of 3.3% through October, well above the inflation rate. After adjustment for inflation, household income increased at an annual rate of nearly 3%, slightly in excess of the growth in consumer spending.

8. Credit conditions improved as the year unfolded. Credit was in abundant supply and available to virtually all borrowers.

9. At the same time, private sector credit increased at a moderate rate, thereby reducing the odds of overheating in household spending and capital formation.

Chart 7: Record Low Ratio of Bank Problem Loans to Total Loans
Nonperforming Bank Loans as a Percent of Total Bank Loans
Source: FDIC



10. Credit quality remained very strong with few signs of deterioration for households, businesses, and banks. The ratio of delinquencies to total bank loans is currently at the lowest level in 25 years (see chart 7).

11. Finally, business and investor sentiment remained highly cautious during much of the year because of widespread fears of recession. Recessions seldom occur when they are widely expected.

In short, despite persistent recession fears, classic leading indicators of recession remained benign during the year, with very few red flags. ***The overarching conclusion is that economic weakness during 2019 was consistent with a classic mid-cycle slowdown, rather than an outright contraction in spending, output, and employment***.

THE WORLD ECONOMY

World economic growth slowed precipitously during the past year, as GDP growth fell to the slowest pace since the Great Recession. As in the US, decent growth in consumer spending and employment in the major economies was offset by a contraction in manufacturing and trade. Because most non-US economies are more heavily dependent upon manufacturing and trade, GDP growth slowed more sharply elsewhere than in the US.

Compared with 2.3% for the US, GDP growth slowed to only 1% in the eurozone, Japan, South Korea, Canada, and the UK. China's GDP fell to 6%, the slowest growth rate in nearly three decades. GDP growth in emerging market economies also declined, from 4.5% in 2018 to 3.5% this year. Overall, world GDP expanded by only 2.5% this year, down from 3.5% in 2018 and 3.8% in 2017.

WORLD FINANCIAL MARKETS

World financial markets performed exceptionally well during the first 11 months of the year, including domestic and international equities, domestic fixed income, and precious metals. The NASDAQ and S&P 500 stock indexes led all markets with total returns of 32% and 27.5%, respectively. US small-cap stocks lagged the large-cap indexes but generated a respectable return of 22%. International equities also lagged with a total return of 20%.

Fixed-income markets also performed well during 2019, with a total return of nearly 9% on the Barclays Capital Aggregate Bond Index. All sectors of the bond market participated in the gains, led by long-duration Treasury bonds (+18.5%), investment-grade corporate bonds (+14.2%), high-yield corporate bonds (+12.2%), and emerging market bonds (+12.5%). [*All investment returns through November 30*.]

IMPLICATIONS FOR 2020

Although investor fears of recession continue to linger, the events of 2019 have set the stage for a moderate rebound in economic growth during 2020, which should support higher stock prices and government bond yields. The easing of inflationary pressures during 2019 is positive for healthy economic growth. Financial conditions have eased significantly over the past year, courtesy of aggressive monetary easing by world central banks.

Manufacturing and world trade should benefit from a significant drawdown of inventories both domestically and worldwide. A rebound in the Chinese economy would also bolster the world economy. It is only a matter of time before progressive monetary and fiscal stimulus by the Chinese government will be manifested in stronger growth in aggregate spending, output, and employment. Europe, Japan, and emerging market economies will benefit from a revival in the Chinese economy.

Finally, while the outlook for trade policy remains a wild card, I remain cautiously optimistic that a partial truce will be reached, although the timing is highly uncertain. It seems reasonable to assume that both China and the US will become increasingly incentivized to sign an agreement, necessary to prevent further weakness in economic growth and employment in both countries. A partial resolution to the trade conflict should spark a revival in business confidence needed to reverse the decline in capital investment worldwide.

Stronger economic growth worldwide will have a positive impact on corporate profitability. While a strong rebound is unlikely, US corporate earnings could increase by close to 10% over the four quarters of 2020. The bond market will likely respond to signs of faster growth with a steady rise in market yields. Because the Federal Reserve is likely to be on hold for all of 2020, the yield curve could steepen considerably, another positive for both the economy and world equity prices.

Note to Readers: This week's report is the final *Economic Perspective* for 2019.
The next report, to be distributed during the week of January 6, 2020, will be the *Annual Economic and Market Outlook*. The Prudential Retirement Economics Team would like to take this opportunity to extend to our readers all good wishes for a happy holiday season and a New Year filled with joy, peace, and good health.

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.

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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.

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