ECONOMIC RISKS TO THE 2020 OUTLOOK

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

Summary and Major Conclusions:

Although conditions within the household and banking sectors remain excellent, credit quality within the nonfinancial corporate sector has been in a steady decline in recent years. While not yet at a point of crisis, business finances have deteriorated, with weakness most evident among marginal firms with the worst credit ratings. Corporate debt as a share of GDP is near record highs, while debt service burdens have risen sharply in recent years.

- The US economy should perform better in 2020 than it did in 2019, but there are risks to the outlook. Most of the risks are associated with the age of the business expansion cycle, but others pertain to political and geopolitical factors.

- The current pace of job creation is well above the natural growth in the labor force and implies a steadily tightening labor market and accelerating growth in wages over the next year. Business surveys reveal that a shortage of qualified workers is the biggest problem for firms.

- The primary risk associated with rapid wage growth is a sooner-than-expected and more aggressive tightening of monetary policy by the Federal Reserve, increasing the odds of recession.

- Historically, the onset of recession has always been preceded by a marked deterioration in credit quality. Excessive optimism on the part of both lenders and borrowers results in risky lending, ultimately triggering a rise in delinquencies and defaults. Corporate sector finances are the greatest source of concern.

- The financial risk to the economy is clear: A perceived rise in credit risk will prompt lenders to curtail credit creation. Higher borrowing rates — resulting from a spike in credit spreads — will increase the difficulty for business firms to borrow.

- Continued strength in the US dollar would be a contractionary force for both the US and global economies, while dollar weakness would be a form of economic stimulus. Persistent dollar strength over the past two years has been a severe headwind for the world economy and for dollar profits.

- My forecast assumes that the value of the US dollar will gradually weaken over the next two years, thereby easing financial conditions worldwide. However, this outcome is far from assured. A further strengthening in the dollar would be a serious threat to growth, raising the odds of a global recession.

- The world economy has become more dependent upon China at a time when China is less reliant upon the rest of the world. A healthy recovery in global GDP in 2020 is predicated upon a sustained recovery in domestic demand within China.

- In turn, a sustained economic recovery in China is dependent upon the willingness of policymakers to deliver sufficient monetary and fiscal stimulus to revive domestic demand. Policymakers are constrained by excess debt levels and have been cautious in adopting an expansionary credit policy.

- Regardless of the ultimate outcome, there are risks to the economy and financial markets associated with the 2020 presidential election. Heightened investor fears pertaining to the future direction of government policy should begin to impact financial market sentiment in the months leading up to the election.
- My generally favorable economic and investment outlook for 2020 assumes that there is no further deterioration in trade relations following a preliminary truce between China and the US. However, trade and tariff issues are far from resolved, and the risk of a further setback remains.
- The phase one trade deal is still subject to reneging on both sides. China is notorious for its failure to honor previous agreements, while Trump is notorious for making sudden and random reversals in stated policy. Further deterioration in business confidence would result in cutbacks in investment spending and employment.
- The longer-term strategic, commercial, and geopolitical relationship between the two countries is almost certain to deteriorate in coming years, as each country positions itself for world supremacy in the 21st century.
- Regrettably, it appears that the powerful forces of free trade and globalization that began in the 1970s have peaked and that an era of protectionism, isolationism, and reduced international cooperation lies ahead.

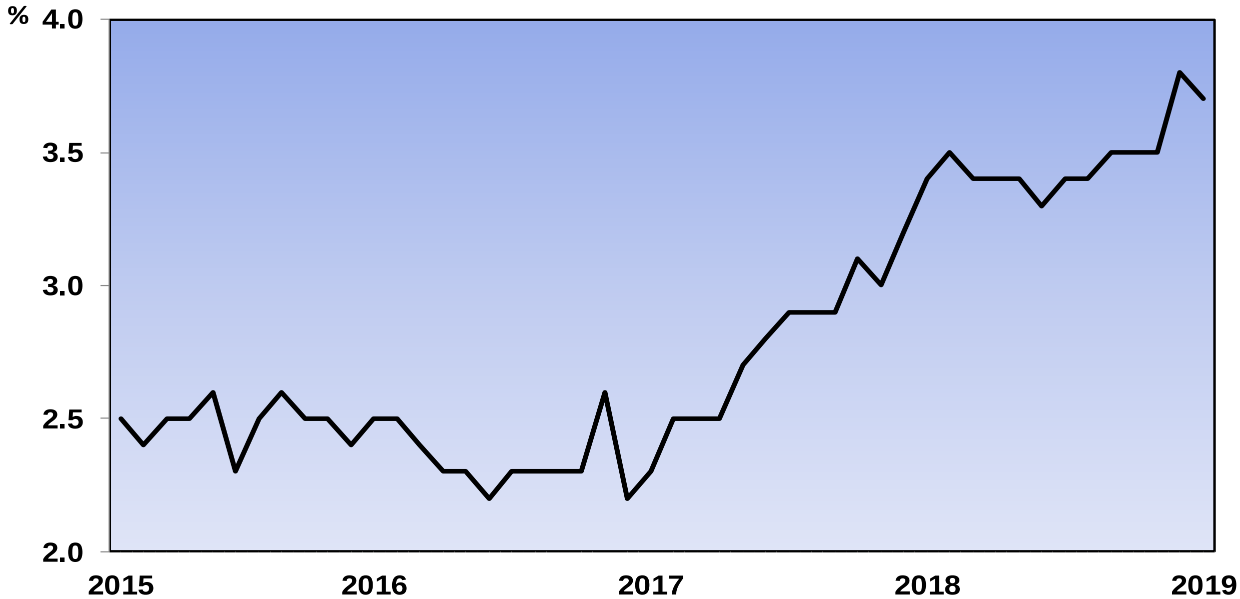
The US economy should perform better in 2020 than it did in 2019, but there are risks to the outlook. Most of the risks are associated with an aging business expansion cycle, but others pertain to political and geopolitical factors and to gradually unfolding long-term structural forces. The implication is that financial market volatility should gradually increase as the year unfolds. This week's *Economic Perspective* explores the most prominent risks to the 2020 investment outlook.

A STEADILY TIGHTENING LABOR MARKET

The demand for labor has remained strong through yearend, with net additions to nonfarm payrolls averaging 200,000 per month over the past six months. This pace of job creation is well above the natural growth in the labor force and implies a steadily tightening labor market during the next year.

- Full Employment: Slower growth in the supply of labor relative to the demand for labor is a growing concern, with the potential to disrupt the domestic economy on numerous fronts. At its current level of 3.5%, the unemployment rate is the lowest in 50 years and well below the government's estimate of full employment of 4% to 4.5%. There are outright labor shortages in key economic sectors and industries.

Chart 1: Rising Wages Will Support Personal Consumption
Average Hourly Earnings, Annual % Growth
Non supervisory Production Workers
Source: Bureau of Labor Statistics



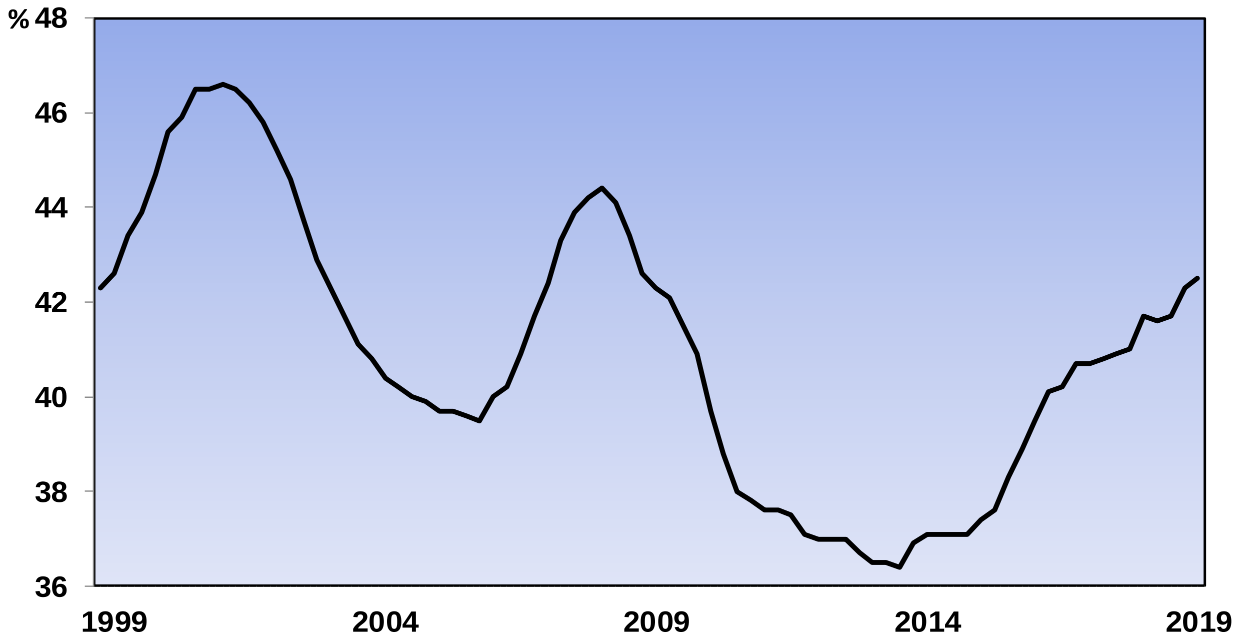
Accelerating Wage Growth: As a result, wages are currently rising at an accelerating pace. Compared with average increases of 2.4% and 2.9% in 2017 and 2018, respectively, average hourly earnings are currently rising at a 3.7% annual rate (for production and nonsupervisory workers). Business surveys reveal that a shortage of qualified workers is the biggest problem for firms. Without improving productivity, rising wages will translate into higher unit labor costs, thereby exerting upward pressure on inflation and downward pressure on company profit margins (see chart 1).

Monetary Policy: The primary risk associated with rapid wage growth is a sooner-than-expected and more aggressive tightening of monetary policy by the Federal Reserve, thereby increasing the odds of recession. Slower growth in employment caused by worker shortages would also contribute to slower economic growth, accompanied by spreading weakness in company earnings. Investors should closely monitor the monthly *labor participation rate* to gauge the risk of a labor supply-induced economic slowdown.

A SUSTAINED DETERIORATION IN CREDIT QUALITY

As clearly demonstrated by all recessions since 1960, sustained economic growth is dependent upon a healthy financial system, in which the supply of credit is abundant and available for all creditworthy borrowers. *A basic principle of business cycle theory is that the onset of recession is always preceded by a marked deterioration in credit quality*. Excessive optimism on the part of both lenders and borrowers results in risky lending, ultimately triggering a rise in delinquencies and defaults.

Chart 2: Corporate Debt Service Burdens in a Rising Trend
Percentage of Corporate Cash Flow for Debt Service
Source: Bloomberg Economics

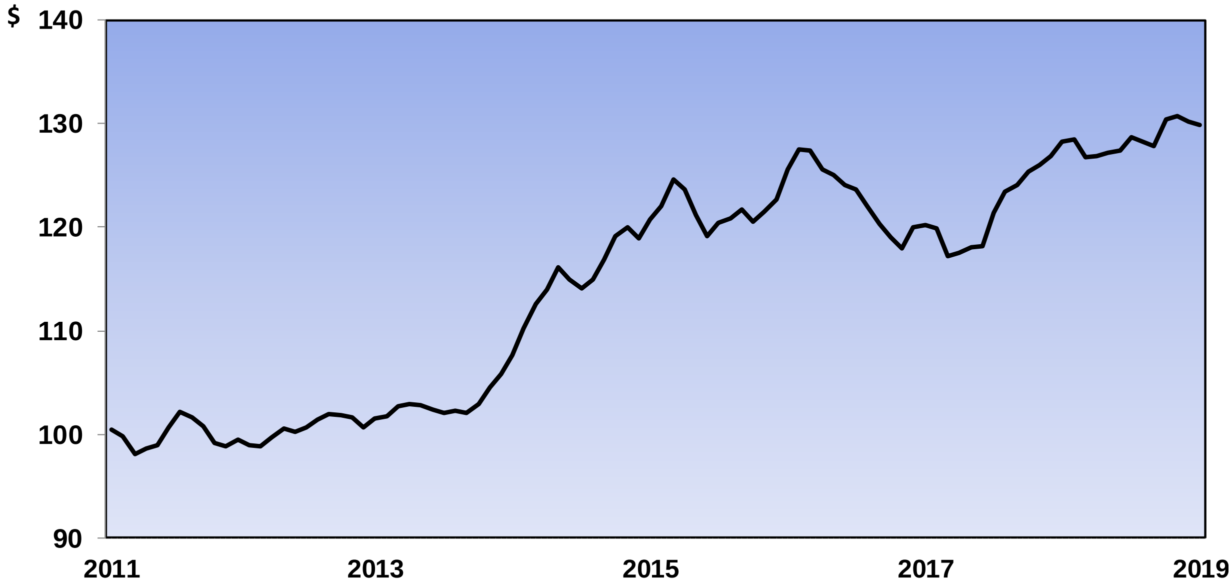


Corporate Debt: Although conditions within the household and banking sectors remain excellent, credit quality within the *nonfinancial corporate sector* has been in a steady decline in recent years. While not yet at a point of crisis, business finances have deteriorated, with weakness most evident among marginal firms with the worst credit ratings. Corporate debt as a share of GDP is near record highs, while debt service burdens have risen from an average of 36.5% in 2013 to 42.5% currently (see chart 2).

Tightening Credit Conditions: The risk to the economy is clear: A perceived rise in credit risk will prompt lenders to curtail credit creation. Higher borrowing rates — resulting from a spike in credit spreads — will increase the difficulty of business firms to borrow. A decline in credit creation culminates in a retrenchment in business spending and expansion plans, which would be a catalyst for a recession.

Favorable 2020 Outlook: While an outright credit crisis is likely to precede the next recession, the timing appears likely in the years beyond 2020. The risk of a credit crisis in the short term is mitigated by the following factors: Borrowing costs are still depressed; monetary policy remains highly accommodative; and business profits and cash flow have flattened, not declined, and should improve during the year. A reversal of these trends will increase the odds of a credit crisis in the years beyond 2020.

Chart 3: The US Dollar Overvalued
US Trade-Weighted Dollar Index
Source: Federal Reserve



CONTINUED US DOLLAR STRENGTH

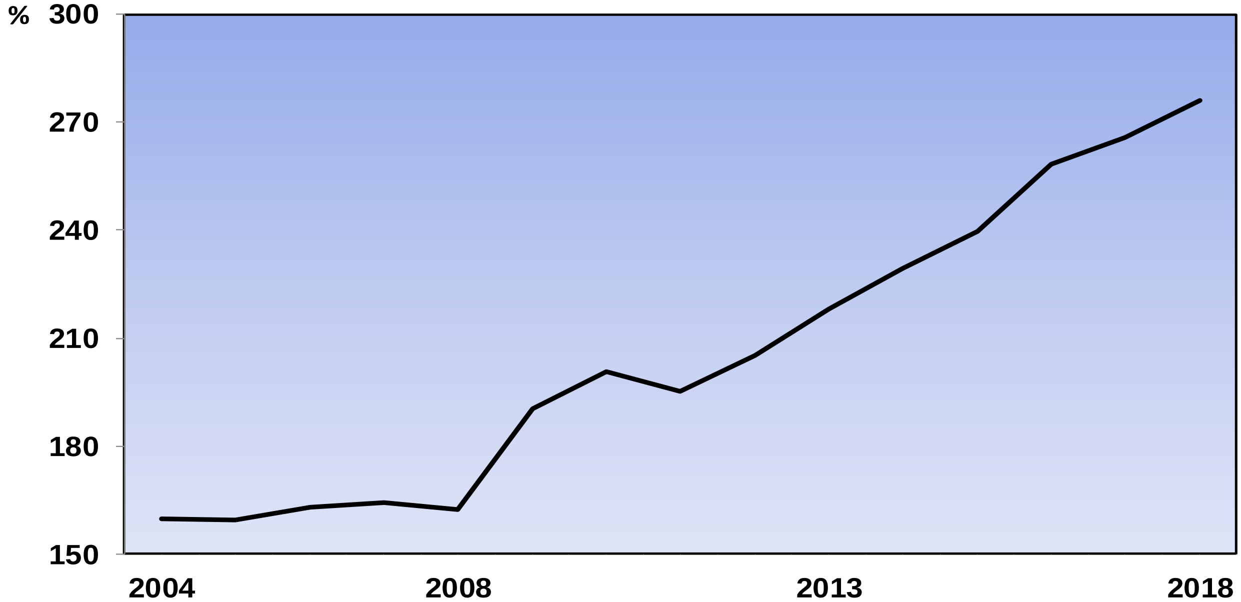
The economic influence of the US dollar on the world economy is not fully appreciated. _A strong dollar is a contractionary force for both the US and global economies, while dollar weakness is a form of economic stimulus_. The impact of a strong dollar on the domestic economy is more widely understood in terms of its negative effects on net exports, domestic manufacturing, corporate profit margins, and business capital investment.

Global Financial Conditions: Persistent dollar strength over the past two years has been contractionary for the world economy. Combined, developed and developing economies hold more than $12 trillion in US dollar-denominated debt. _A strong dollar raises the cost of capital for non-US business firms, resulting in a tightening in global liquidity conditions_.

- **Higher Debt Burdens**: It also raises the real effective level of debt and cost of servicing this debt. Dollar weakness has the exact opposite effect, reducing the effective cost of capital, expanding global liquidity, and easing financial conditions.

Dollar Overvaluation: The US dollar has appreciated by 12% over the past two years and by 30% over the past five years, and appears overvalued by more than 15%. However, overvaluation is a necessary but insufficient condition to trigger depreciation in the value of the dollar; an external catalyst is necessary. The most likely catalyst would be a strengthening in the world economy, which would systematically reduce the safe-haven demand for dollars (see chart 3).

Chart 4: China's Debt Rises to Dangerous Levels
Total Chinese Debt as a % Share of GDP
Source: Bloomberg Economics



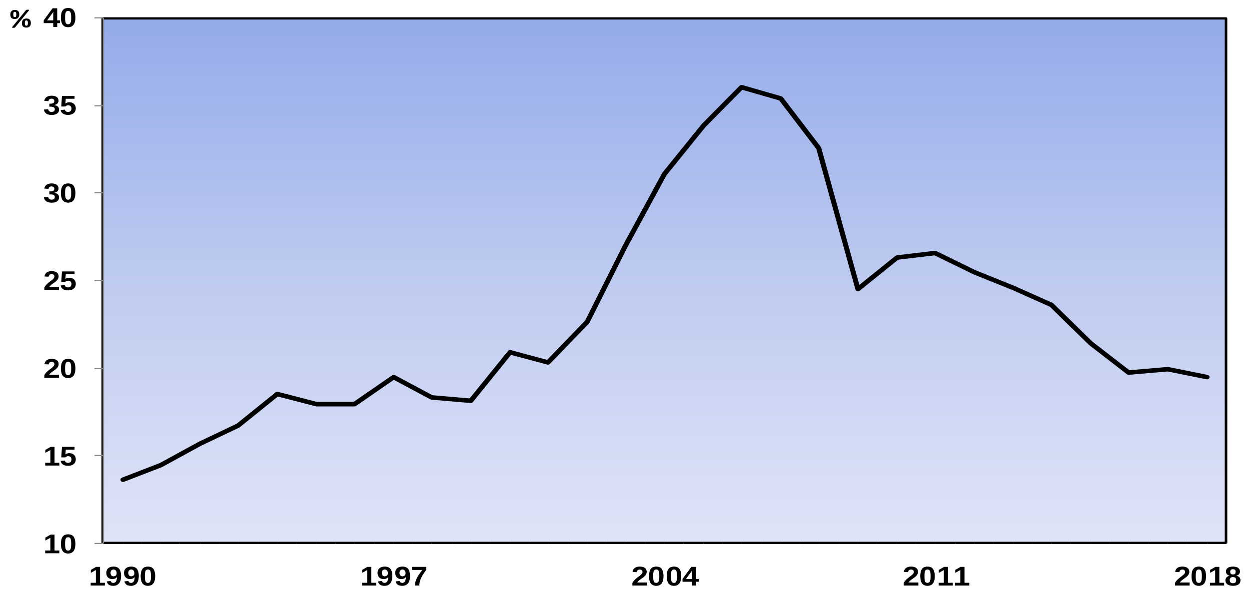
My forecast assumes that the value of the US dollar will gradually weaken over the next two years, thereby easing financial conditions worldwide. However, this outcome is far from assured. While it is possible for the global economy and world trade to stage a rebound in 2020 without a reversal in the dollar, *further strengthening in the dollar would be a serious threat to growth and increase the odds of a global recession*.

FAILURE OF CHINA TO PROVIDE STIMULUS TO THE WORLD ECONOMY

China has undergone a structural transformation over the past decade, gradually shifting to a consumer- and services-oriented economy and one less reliant on manufacturing, mining, capital formation, and export trade. *The result is that economic growth is more dependent upon domestic demand rather than on industrial output and exports to the rest of the world*. As a share of GDP, Chinese exports have declined from a peak of 35% to 20% (see chart 4).

Domestic Demand: The implication for the world economy is crucial: *For the first time in two decades, the world economy is now more heavily dependent upon China than China is reliant upon the rest of the world*. *Stated differently, a healthy recovery in global GDP and world trade in 2020 is dependent upon a sustained recovery in domestic demand within China*, which would spark a revival in exports from the eurozone, Eastern Europe, Asia, and Latin America. The global manufacturing slowdown of the past two years can be directly attributed to China.

Chart 5: China's Economy Less Dependent Upon Exports
Exports as Percent of GDP
Source: World Bank Group



Policy Constraints: In turn, a Chinese economic recovery in 2020 is dependent upon the success of policymakers in delivering sufficient monetary and fiscal stimulus necessary for a revival of the Chinese economy. The Chinese government has proceeded cautiously in administering stimulus to its economy because of deep concerns regarding credit risk.

- **High Debt Levels**: *Fiscal and monetary policy are severely constrained by numerous serious imbalances within the Chinese economy, the most important being debt accumulation*. As a share of GDP, total Chinese debt outstanding has risen from 160% in 2008 to 280% currently, propelled by massive accumulation of debt by households, state-owned businesses, and local governments (see chart 5).

Balancing Act: The combination of excessive debt levels along with a rapid build-up of nonperforming loans within Chinese banks raises the specter of a credit crisis. As a result, *policymakers have been walking a tightrope: Progressively easing credit conditions, but at a cautious and deliberate pace because of excess debt*. One of the critical unknown economic variables for 2020 is whether policymakers will be able to revive the Chinese economy — with profound implications for world economic growth in 2020.

THE 2020 ELECTION

Regardless of the ultimate outcome, there are significant risks associated with the 2020 presidential election with respect to the future direction of economic policy. It seems highly likely that domestic politics and the election will impact financial market sentiment in the months leading up to the election. Escalation of partisan political rhetoric and growing speculation in the media regarding the outcome is almost certain to accentuate financial market volatility. The thrust of economic policy in future years is heavily dependent upon the election outcome. And there are economic and investment risks associated with each political party.

- **Trump Reelection**: A Trump victory would likely imply a continuation of expansionary fiscal policies — including additional tax cuts and spending — culminating in a further escalation in the budget deficit and the national debt. It would also imply a continued risk of tariff weaponization and arbitrary constraints on immigration. Finally, Trump's random policy threats and actions are disruptive to investor psychology.

- **Democratic Victory**: A Democratic win would likely result in a shift toward populist/socialist policies that would undermine business confidence. Specific initiatives could include higher tax rates on businesses and upper-income families; reinstatement of regulations that were eased under Trump; a wealth tax; more stringent anti-trust policy for large companies; a ban on hydraulic fracturing; and major reforms of the healthcare system. Trade tensions with China would likely continue, but with a reduced emphasis on protective tariffs as a negotiating weapon.

In short, *policies unfriendly to financial markets could materialize under either a Republican or Democratic administration*. Because of their forward-looking tendencies, financial markets will begin to react to predictions regarding the election outcome and the associated implications for government policy on the equity and fixed-income markets in coming months.

RENEWED PROTECTIONIST PRESSURES

My generally favorable economic and investment outlook for 2020 assumes that there is no further deterioration in trade relations between China and the US. It also assumes that President Trump does not use tariffs as a weapon against European automakers or other countries to achieve his own personal, political, and narrow strategic goals. It does not assume any further progress on trade relations until after the November elections.

A Fragile Deal: The phase one truce reached between China and the US in December does not mean that trade policy has ceased to be an important economic and investment issue. For one thing, the deal is highly fragile and subject to reneging on both sides. The Chinese government is notorious for its failure to honor previous agreements. For his part, President Trump is notorious for making sudden and random reversals in stated policy. Because of political considerations, *the odds of a setback in US-China trade relations in 2020 are nontrivial*. The greatest casualty would be business confidence, which would result in cutbacks in investment spending and hiring.

The Struggle for World Supremacy: Beyond the phase one trade truce, the longer-term strategic, commercial, and geopolitical relationship between the two countries is almost certain to deteriorate in coming years, as each country positions itself for world supremacy in the 21st century. Because of the crucial geopolitical role of science and technology, it is possible that China will never agree to concrete concessions regarding intellectual property theft and forced technology transfers. In short, it appears likely that the multi-decade trends of globalization and free trade have peaked and that an era of protectionism, isolationism, and reduced international cooperation lies ahead.

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.

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.