



## Principal Global Investors

# 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.

Unless otherwise noted, the information in this document has been derived from sources believed to be accurate as of December 2019. Information derived from sources other than Principal Global Investors or its affiliates is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity. This material contains general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, recommendation or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that Principal Global Investors or its affiliates has recommended a specific security for any client account.

Subject to any contrary provisions of applicable law, Principal Global Investors and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in this document or in the information or data provided in this document.

Past performance is no guarantee of future results and should not be relied upon to make an investment decision. All figures shown in this document are in U.S. dollars unless otherwise noted. Investing involves risk, including possible loss of principal.

This material may contain 'forward looking' information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This document is issued in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- Germany, Austria and the Netherlands by Principal Global Investors (EU) Limited, Sobo Works, Windmill Lane, Dublin D02 K156, Ireland. Principal Global Investors (EU) Limited is regulated by the Central Bank of Ireland. For all other European countries, this document is issued by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorised and regulated by the Financial Conduct Authority ("FCA"). In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). The contents of the document have been approved by the relevant entity. Clients that do not directly contact with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (EU) Limited ("PGI EU") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGI EU, PGIE or PGI EU may delegate management authority to affiliates that are not authorised and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland.
- Switzerland by Principal Global Investors (Switzerland) GmbH which is authorised by the Swiss Financial Market Supervisory Authority ("FINMA").
- Singapore by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act (Chapter 289). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- Hong Kong SAR (China) by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS License No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.
- This document is issued by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organization. This document is intended for sophisticated institutional and professional investors only.
- India by Principal Asset Management Private Limited (PAMC). PAMC offers only the units of the schemes of Principal Mutual Fund, a mutual fund registered with SEBI.
- For other APAC Countries, this material is issued for Institutional Investors only (or professional/sophisticated /qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Insurance products and plan administrative services provided through Principal Life Insurance Co. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities offered through Principal Securities, Inc., 800-547-7754, Member SIPC and/or independent broker/dealers. Principal Life, Principal Funds Distributor, Inc. and Principal Securities are members of the Principal Financial Group®, Des Moines, IA 50392.

© 2019 Principal Financial Services, Inc. Principal, Principal and the symbol design and Principal Financial Group are trademarks and service marks of Principal Financial Services, Inc., a member of the Principal Financial Group. Principal Global Investors is the asset management arm of the Principal Financial Group