Mixed economic messages for 2020

2020 is likely to be another year of sluggish growth with continued risk of a sharper downturn. There will be a lot at stake in the 2020 U.S. presidential elections as Republicans and Democrats wrestle to take control of the White House, the Senate, and the House. The outcome will influence everything from Wall Street and the economy to businesses and trade policies. Against this backdrop, the Federal Reserve has signaled a pause on additional interest-rate cuts. And the likelihood of a recession in the United States remains low.

Elsewhere in the world, governments — including New Zealand and Japan — are turning on their fiscal stimulus taps to boost their economies. This shift comes as many central banks join the Fed and the European Central Bank (ECB) in pausing the global wave of monetary easing amid negative interest rates. And finally, understanding the interplay between economic growth, rates, and financial markets will become even more important for investors and central banks alike this year.
High-stakes 2020 elections

The economy will matter in next year’s general elections as both Democrats and Republicans vie to take control of a divided nation.

An unpopular presidency
With Trump, of course, things are not that simple. He is remarkably unpopular and has been throughout his Presidency. In November 2016, he lost the popular vote by a large margin but won the electoral college. That handed him the presidency. He is being impeached, and although it’s hard to imagine that the Senate will convict him, it complicates his re-election campaign, or rather reinforces the campaign strategy he will use.

Impeachment has not been good for the electoral prospects of an impeached president’s party. The Democratic field is crowded, and all the major candidates have some clear disadvantages in a general election. Who emerges as the Democratic candidate will have a large influence on the outcome.

The key battleground states will be more or less the same as in recent elections. The Trump campaign is trying to open up Colorado, New Mexico, and Nevada as contestable states. The Democrats want to make Georgia a presidential, Senate, and House battleground state. The most important states will be Ohio, Pennsylvania, Michigan, Wisconsin, Iowa, and Florida. If those other states come into play, the dynamics of the election would be very different and might well have implications for the House and Senate. Absent a landslide, government will remain divided. The Republicans will likely retain control of the Senate, and the Democrats will likely retain control of the House.

Elections matter for the economy
The off-year elections in Virginia and Kentucky showed a continued suburban backlash against Republicans and President Trump. The gender gap in opinion polls is
also very large. This may be the only development in the elections with broader relevance, and it underscores the Trump strategy: There is simply no point in Trump trying to appeal to moderate voters. If moderate voters are unhappy with the policies proposed by the Democrat candidate, they are more likely to stay at home than to vote for Trump.

If we are correct about these dynamics, then they matter for the economic outlook. In mid-December, the United States and China reached a preliminary agreement in their long-running trade war. A new round of tariffs slated to take effect during the month will not go into effect, and the two countries plan to begin negotiations on more contentious issues. We expect trade issues will continue to simmer in 2020, but not come to a boil, because a recession would significantly harm Trump’s reelection chances.

Second, the chances of a progressive Democrat winning election with working majorities in the House and the Senate are not very high. The Democratic base, like the Republican base, is drifting away from the center. Any candidate with progressive views would reduce turnout among centrist voters for the presidential and down-ticket races. This matters for the Senate, where (very) heavy turnout is needed to produce Democrat victories.

Nonetheless, the strong possibility of a close election, and the fact that economic issues are likely to play a role in the campaign, may well keep corporate investment subdued.

Low recession but high policy risks

All of the above brings us back to U.S. growth prospects. Recession probabilities have not really changed. Our two favored models still show recession risks are low. The models that place a lot of weight on the Treasury yield curve still suggest a recession is certain, even though the curve has steepened recently. Those models use average levels and don’t flip their signal based on a few days’ worth of data. The Conference Board’s leading indicator continues to edge down, largely because of the persistent weakness in manufacturing and some hints of softening in the labor market.

While we are a little less worried about higher policy risks, our concerns have not entirely dissipated. Clearly, the economy is not in recession now, and the models have been providing the right guidance over the course of this year. We still think risks are higher than the models would indicate because of the risks that are present — from the trade war, from monetary policy, and from global political stresses.
Fiscal policy U-turns

Many governments around the world are mulling, or have provided, extra fiscal stimulus to boost their economies as the limits of monetary policy become more evident.

There are countries where some fiscal relaxation will take place in 2020.

Fiscal policy is coming back to policymakers’ agendas. There are many reasons for this, including worries about the inability of central banks to raise inflation despite low and, in many cases, negative interest rates; the need for infrastructure investment; the pressures politicians are under to “do something” in an increasingly fractured global political landscape; and the growing influence of modern monetary theory.

There are countries where some fiscal relaxation will take place in 2020. New Zealand is about to deploy some fiscal stimulus. In Japan, a supplementary budget for this fiscal year and the initial budget for next fiscal year will provide stimulus that may boost GDP by as much as 0.5% over the next 18 months or so. That along with spending for the summer Olympic Games in Tokyo will improve Japan’s outlook in 2020. Headline GDP growth is likely to be stronger by the second quarter of next year. However, we doubt this round of fiscal spending will be any more successful in lifting Japan’s medium-term growth prospects than the previous round. It is also hard to see inflation getting anywhere close to the Bank of Japan’s 2% target.

Cloudy outlook for the United Kingdom

In the United Kingdom, some fiscal relaxation is certain after the December election. The major parties had engaged in competitive bidding for the attention of the electorate. The Tory Party was actually forced to backtrack on one of its promises when independent analysts pointed out how ludicrous it was. Electioneering aside, there is a widespread recognition now that the austerity policies of David Cameron and George Osborne were inappropriately restrictive.

We can’t be sure how much overall relaxation there will be, and what the balance will be between tax changes and higher spending. Still, there will be some fiscal shift, and it may well be quite large. What impact this will have on the economy is less clear. British Prime Minister Boris Johnson won a decisive majority in the December 12 general election, paving the way for the U.K. parliament to trigger a long-delayed split with the European Union. The Conservative majority is likely to approve the Brexit Withdrawal Agreement.

Some analysts argue that the removal of Brexit uncertainty and a fiscal boost will provide strong economic results
in 2020. We are less convinced, partly because the Brexit Withdrawal Agreement says nothing concrete about future trade relations. They are still to be negotiated, and the claims made by Boris Johnson that a comprehensive and favorable agreement on future relations can be agreed quickly are an empty fantasy. We see little prospect of a sustained recovery in corporate investment until this uncertainty is resolved. Future U.K. and EU relations could support British economic activity, but it’s going to take a while before the new government sets out clearly what it wants to negotiate. The economy may well do better in 2020, but not by much. The long-term outlook for Britain will remain cloudy until these uncertainties are resolved.

Fiscal headwinds in the United States

It is worth noting that the United States had its burst of fiscal activism with the corporate tax cuts passed at the end of 2017. The IMF estimates the fiscal deficit, in cyclically adjusted terms, is now at 6.3% of GDP. This fiscal expansionism brought a spurt of growth. However, it has done virtually nothing for long-term growth prospects because corporate investment was undercut by the trade war, and companies spent their tax gains on stock buybacks. So, investments remain weak. The boost the economy got from the increase in the deficit is now ending. According to the Hutchins Center’s measure (see chart above), the U.S. economy is about to see a fiscal tailwind become a headwind.

The limits of monetary policy

This year has been one of substantial monetary easing. Most importantly, the Fed cut interest rates three times and engaged in aggressive efforts to control the front end of the yield curve. The ECB cut its deposit rate into negative territory and restarted its quantitative easing (QE). India, Brazil, China, and a whole raft of emerging-market central banks have also lowered rates. It was a big year for doves.

The Fed is determinedly on hold in lowering rates further. Of course, if we tumble into a recession, central banks will become much more aggressive, but the conversation about monetary policy is rather different now after this year’s moves. Either way, it’s hard to imagine that 2020 can see a repeat of 2019’s large-scale easing.
The performance of financial markets matters for growth. Interest rates and risk spreads determine the cost of debt capital (borrowings) for the private sector. This includes households, especially mortgages, the corporate sector, and the financial sector, which uses leverage. Equity markets affect the cost of capital and influence household spending via wealth effects. The linkages between real economic growth, economic policy, and asset market performance are complicated, with each variable influencing the others.

These linkages can be quite quick, as we’ve seen recently. Headlines about the China trade deal can push equities up or down, and changes in Fed policy can be felt in asset markets rapidly but take a bit longer to feed through mortgage rates and household behavior. Growth prospects matter; equity pricing depends heavily on the performance of corporate earnings and on the interest rate at which future earning streams are discounted.

**The end of easy money?**

In our view, the relationship between the three factors that we saw in 2019 is unlikely to be repeated. We doubt the monetary easing we saw in 2019 can be repeated. Even the optimists on growth don’t see a major acceleration. Valuations in key asset markets — notably investment-grade credit — are such that there really isn’t much scope for spreads to further narrow. That is not to say that markets will weaken, but if possible spread compression is limited, then risks must be asymmetrically to the downside.

The pace of gains in risky asset prices over 2019 was quite tightly linked to central bank balance sheets. The Fed’s shift in rhetoric at the beginning of the year allowed risky assets to recover from the December 2018 meltdown. Still, the Fed’s two rate cuts over the summer didn’t do a lot for equities. In September 2019, the S&P 500 Index traded at similar levels to September 2018. The real upward movement in U.S. and European equities came...
after the ECB re-started its QE program and the Fed began its aggressive open market operations to control short-term rates.

There has been much hand wringing over whether the Fed has effectively resumed QE. But whether it is QE or not, it clearly is a balance sheet expansion and an injection of liquidity into the system. That liquidity found a home in risky asset markets. The balance sheet expansion was, in some sense, a monetary easing.

In the absence of an acceleration in (actual or expected) economic growth stimulated by these actions, we end up with asset markets dependent on financial system leverage that is, in turn, dependent on central bank action. This is a risky configuration — not because there are any binding real constraints on the size of a central bank balance sheet, but because there are important institutional and political constraints.

**Monetary policies support financial markets**

The Fed wants to reduce its balance sheet and has repeatedly argued that the most recent expansion will be unwound early in 2020. What if the Fed is wrong? It will put us back to a point where the central bank wants to run a tighter policy than the markets can withstand. Implicit in this argument is that it’s not really monetary policy that is the problem with global demand growth, but it is monetary policy that is keeping asset prices where they are.

The sluggish pace of global demand growth can be traced to a range of factors including aging demographics and the structural slowdown in China’s growth. The household sector has still not recovered from the global financial crisis; that shock has encouraged households to be much more cautious in their savings behavior and in their willingness to take on debt. The pace of technological and the Trump trade war are also playing a role.

In a “normal” cycle, central bank easing pulls economic activity from the future into the present, kick-starting an economic recovery and allowing the central bank to return to a more normal policy stance (and a more normal balance sheet). But what if the recovery doesn’t come or is not strong enough? Then a further dose of easing takes place, and the asset markets become a more important channel through which the policy operates.

**Until something happens to push global demand growth on a stronger trajectory, high asset returns will only be possible with increasingly accommodative monetary policy.**

And what if recovery still doesn’t come? That’s the position we are in now. The initial trade deal between the United States and China would provide only temporary relief because it would not put the global economy on a sustainably stronger path. Until something happens to push global demand growth on a stronger trajectory, high asset returns will only be possible with increasingly accommodative monetary policy. And there isn’t a whole lot of scope for that in 2020.
The Putnam Global Risk Appetite (RA) Index is a proprietary quantitative model that aims to measure investors’ willingness to invest in risky assets, including equities, commodities, high-yield bonds, and other spread sectors. With a composite view of risk-appetite signals across a broad mix of asset types, Putnam’s RA Index provides a framework for discussing investor preferences and can signal trend changes in broad market sentiment.

Risk appetite remains positive in November

SHORT-TERM TREND
“Risk-on” sentiment continues to recover amid signs of stabilization.

Risk ON OFF

• U.S. assets, including equities, rallied and outperformed global markets.
• The U.S. dollar gained against most international currencies.
• Sovereign bond yields rose across the board, including in emerging markets.
• Emerging-market assets overall underperformed other global markets.

LONG-TERM CYCLE
This 10-year illustration captures the cyclicality of investors’ appetite for risk.

Source: Putnam. Data as of November 30, 2019. To create the Global Risk Appetite Index, we weigh the monthly excess returns of 30 different asset classes over 3-month T-bills relative to the trailing 2-year volatility of each asset class. The higher the excess return and the lower the volatility, the greater the risk appetite; conversely, the lower the excess return and the higher the volatility, the stronger the risk aversion.
Global growth continues to stabilize

**SHORT-TERM TREND**
Growth will probably trend sideways.

Among G-10 economies, the United States and Britain had a disappointing month. In the United States, data flow was mixed. The Bloomberg Consumer Comfort Index improved, while the ISM manufacturing and services sectors faltered. In the eurozone, the services PMI, business sentiment, and consumer confidence gained. China’s growth held steady.

2.25%

**LONG-TERM CYCLE**
This six-year illustration captures GDP gyrations since the financial crisis.

Source: Putnam. Data as of November 30, 2019. We base our Global GDP Nowcast on a tailored methodology that captures daily data releases for the most essential growth characteristics for each of 25 countries — including purchasing managers’ index data, industrial production, retail sales data, labor market metrics, real estate price indexes, sentiment indicators, and numerous other factors. The mix of factors used for each market may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.
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