PRUDENTIAL **INSIGHTS**

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Is a global recession really imminent?

There's no doubt that today's world economy is stuttering, with slowdowns underway across China, Europe, Japan, and more latterly the US. The numbers don't lie. Equally, global growth is under threat from the expanding US-China trade war. However, are we to believe the frightening headlines predicting that a global recession is imminent? Should investors start selling their equities with the expectation that corporate earnings growth will now plummet? At Prudential, we believe the answer to these questions is "no", and here's why.

Are we "due" for a recession?

First, some pundits have predicted that, because this is now the longest expansion in US history at over 120 months, we are "due" for a recession. But economic cycles don't have schedules. They don't happen in a routine way, so the length of a recovery should not be a predictor of the next downturn. As we have seen recently,

central banks have quickly reacted to add more monetary stimulus as necessary (and in China's case a hefty dose of fiscal stimulus too), protecting the recovery and extending it further.
Rather, we should interrogate what the classical cyclical indicators are signalling. If we look at four of these indicators that historically have warned of an overheating economy and therefore a coming recession in the US, three are flashing green and only one is red. Let's compare the current expansion with the previous seven recoveries dating back to 1961.

US growth rate pedestrian, despite recovery
First we note that while US GDP growth has been consistently positive over the past 10 years, it has not approached levels that suggest overheating, or reached the 4%-7% y/y rates seen in previous recoveries. US GDP growth has been decidedly lacklustre, typically between 1%-3% y/y – the most pedestrian recovery in the last 60 years. There has not been a build-up of excess consumer demand that would push prices up and give the Federal Reserve a reason to hike interest rates significantly and put an end to the expansion. This is the first green indicator.

No inflationary pressures
Following from this is the complete lack of inflationary pressures in the current recovery. Averaging less than 2% y/y, US inflation has been lower than during any recovery since World War II. In the past, prices have typically risen inexorably in the latter part of a recovery cycle, but at present the absence of price pressures is puzzling for economists. This is the second green indicator.

Unemployment at 49-year low
The third cyclical recession indicator is unemployment. In the current recovery the US unemployment rate has fallen from 10% to 3.6%, a 50-year low and now the lowest level reached in any previous recovery. This is a classic warning sign of approaching labour market overheating, and so is flashing red.

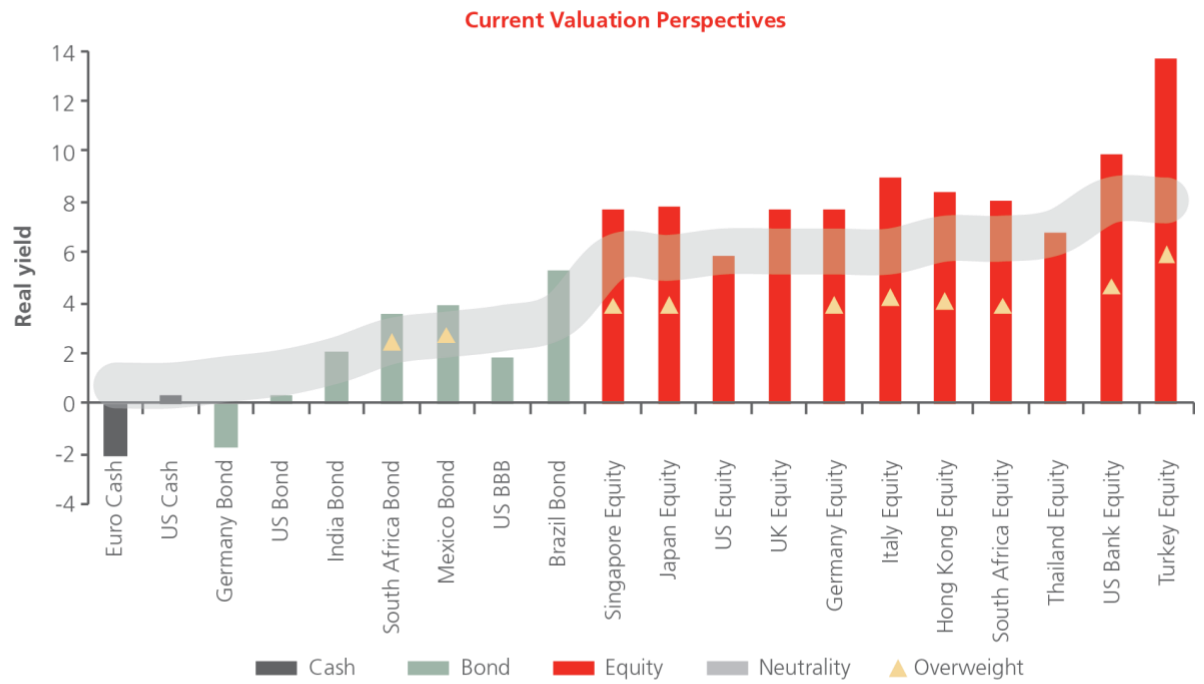
Little wage pressure
However, this very low unemployment rate has not fed through into higher wages in any significant way. Although US wage growth has averaged 2.5% y/y over the past 10 years, it started extraordinarily low and rose only very slowly, remaining at the lowest level of any previous expansionary period since 1961. As a consequence of

modest wage growth and low but positive productivity growth, unit labour costs have averaged about 1% growth per year since 2009, so pressures on company margins have been muted. Consequently, wages comprise the third green indicator.

From the above, we can conclude that the classic warning signs of an overheating US economy, and therefore impending global recession, are not yet present. That is not to say that there are no reasons for concern, however. There are some cyclical and structural forces driving global growth that are flashing amber or red.

Forces driving global growth: Both negative and positive

Three worrying cyclical factors include the rise of protectionism and slowing global trade growth (historically the largest force propelling global GDP growth), and monetary policy paralysis due to the historically low interest rate prevailing in developed countries making it more challenging to offer monetary stimulus in the event of a downturn. Longer-term structural issues weighing on growth are: a declining percentage of working-age people around the world; and the high levels of government debt that are constraining the ability of fiscal policy to spur growth in many countries around the globe. Debt levels are already higher now than they were before the 2007-2008 Global Financial Crisis (GFC).



Source: Prudential Investment Managers

Counteracting these headwinds are some long-term structural trends that are underpinning global growth prospects. Not the least of these is the enormous growth potential still to be unlocked in China and India, as well as other emerging markets, as they continue along their developmental paths. They have huge open roads ahead of them as expanding markets for consumer goods and services. At the same time, the march of technological progress and automation is steadily improving human productivity, another force for growth, and this is helping to diminish global inflation levels: the US has experienced durable goods disinflation of around -2% p.a. over the past 20 years. Finally, the spread of democracy to many more countries these days provides additional impetus for global expansion, since politicians are held to account (to varying degrees) by their citizens and are therefore more likely to implement growth-friendly policies, although there are signs of some roll back of political freedoms in a post-GFC World that deserve careful monitoring.

Don’t be nervous about global equities

Investors shouldn’t be nervous about investing in global equities because of the growth outlook. On the contrary, we believe it’s an excellent time to hold these assets in a portfolio for anyone with a long-term timeframe. However, this is based on the current attractive valuations of global equities – we don’t believe in investing based on macroeconomic forecasting, which is highly unreliable. Instead, we invest on the basis of asset valuations. And if we examine recent global equity valuations, as shown in the accompanying graph, the high risk premia and prospective real yields now available from many equity markets (particularly emerging markets), make this an excellent opportunity for investors to take advantage of, especially where exposure can be obtained by taking underweight positions in global government bonds. While US equities are somewhat expensive compared to their history, our client portfolios are overweight in markets including Singapore, Hong Kong, South Africa and Turkey, as well as Germany, Italy and Japan, which are all priced to deliver prospective real yields between 7%-13% in US dollars over the next three to five years. Although we don’t know exactly how or when these returns will be delivered over time, history has shown that current valuations should produce investor returns well above the long-term average. And let’s not forget that global equity is an excellent diversifier for any investor with a long-term view willing to tolerate its relatively high volatility.

For more information speak to your financial adviser. Alternatively, feel free to contact our Client Services Team on **0860 105 775** or email us at query@prudential.co.za.

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