INVESTMENT SPOTLIGHT
ANZ CHIEF INVESTMENT OFFICE
NOVEMBER 2019

A TURNING POINT?

The economic news hasn't been good of late with the IMF forecasting the weakest global GDP growth since the GFC. In this Investment Spotlight we look at a range of indicators to see if a recession can be avoided and what it means for share markets.

WEAKEST ECONOMY SINCE THE GFC

After more than 10 years of recovery since the end of the GFC, markets are once again contemplating how much longer the expansion can continue. The economic news hasn't been good of late. Since early 2018 there has been a broad based slowdown across the world economy.

- Business sentiment indicators at home and abroad are well off their highs (Chart 1).
- This month the IMF downgraded its world GDP growth forecast for 2019 to 3%, its slowest pace since the GFC, down from 3.8% in 2017.
- Profit growth has declined sharply. In the United States (US) the trailing earnings for the S&P 500 Index have slowed from a 30% pace early last year to flat in October (Chart 2).

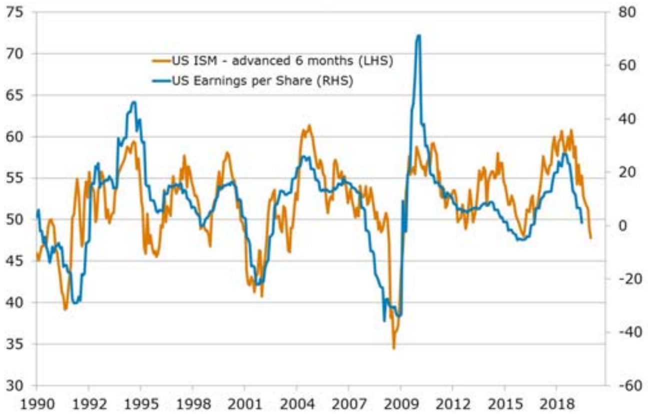
CHART 1: AN ECONOMIC SLOWDOWN

Source: Bloomberg, ANZ Chief Investment Office

EARNINGS CYCLE IS KEY

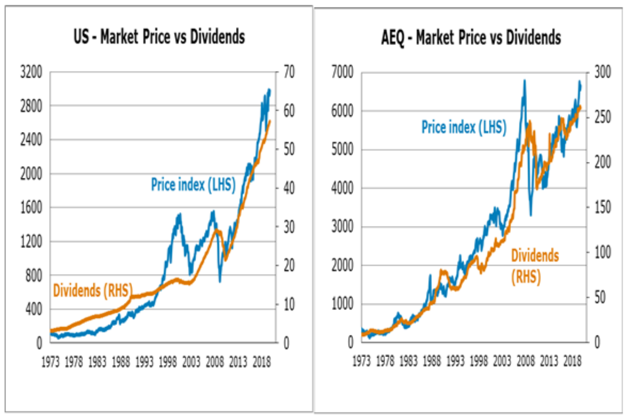
Whether the current slowdown soft lands or ends in recession is pivotal for share markets as recessions can result in real and lasting damage. Chart 2 also shows that during recessionary periods in the US (i.e. when the ISM survey is below 45), earnings fall sharply. In softer landings (i.e. ISM around 50), when profit growth stalls, there may be some short-term weakness, but it's not long lasting.

CHART 2: EARNINGS GROWTH AND THE CYCLE



Source: Bloomberg, ANZ Chief Investment Office

CHART 3: DIVIDENDS AND THE SHARE MARKET



Source: Eikon, ANZ Chief Investment Office

Charts 3 and 4 illustrate how earnings, proxied in these charts by dividends, underpin the trend in the share market. The strength of the US share market in the past decade makes sense from this perspective. This is not to ignore valuations – in the 1990s the Tech Bubble took valuations to extreme levels and there was an eventual reckoning with prices crashing. The S&P 500 now, while certainly not cheap, is only modestly expensive. We can see the same for Australia in Chart 3, with the weaker performance since the GFC largely a result of slower earnings growth.

CHART 4: DIVIDEND GROWTH AND THE S&P 500

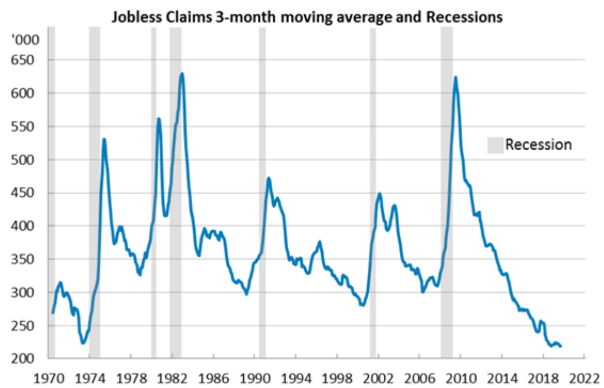
Source: Bloomberg, ANZ Chief Investment Office

LOOKING LIKE A SOFT LANDING

Our view is the global cycle is shaping up to be a soft landing and not a fall into recession.

We saw in Chart 1 early signs of bottoming in business surveys. If we dig a little deeper, we find that businesses are well advanced in cutting back on excess inventories, and with orders starting to pick up, a recovery may be likely.

CHART 5: US JOBLESS CLAIMS

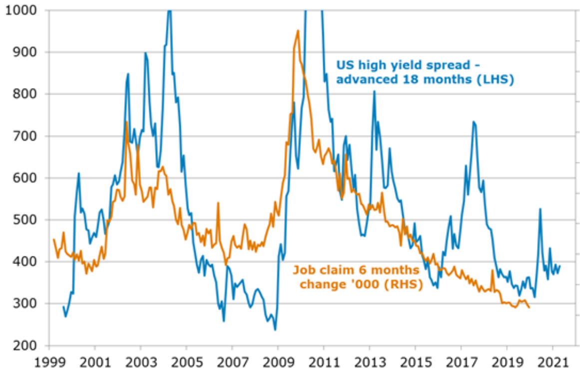


Source: Bloomberg, Eikon

A good contemporaneous read on the US economy comes from the weekly jobless claims series. As Chart 5 shows, jobless claims have begun to move higher in advance of all recessions over the past 50 years. While no longer falling, jobless claims have flattened out with no signs of a sharp deterioration consistent with an approaching recession.

Credit markets look well behaved so far and consistent with a soft landing. Credit typically leads economic developments and Chart 6 suggests the current low level of spreads is underpinned by a strong US economy. There have been false warnings in recent years, notably mid this decade driven by energy companies. For now, spreads point to a slower period of growth but no worse than that.

CHART 6: US JOBLESS CLAIMS AND CREDIT SPREADS

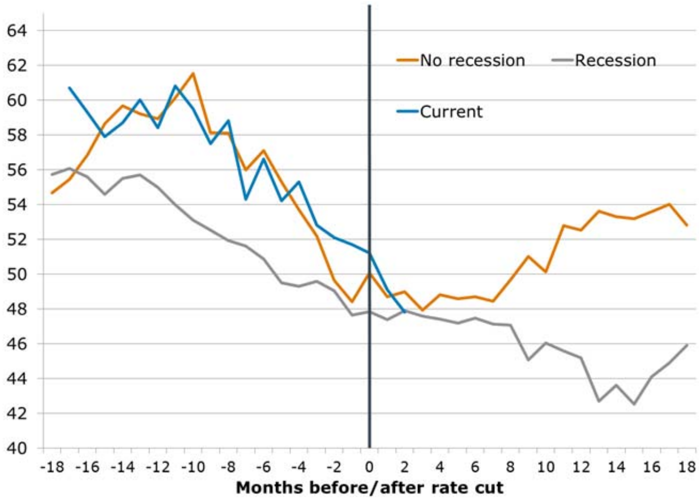


Source: Eikon, ANZ Chief Investment Office

As we discussed back in the July edition of Investment Spotlight in '*What comes following the rate cuts*', when we look at the slowdown in the ISM manufacturing survey, the economy appears to be tracking closely with the historical experience of no recession periods with rate cuts. The tricky thing at this point in the investment cycle is that the current ISM reading isn't displaying a clear 'recession' or 'no recession' path.

However, recessions typically reflect imbalances in the economy with growth well past its peak in the lead-up to a recession, which is not the case this time (i.e. the ISM peak is within the past 18 months).

CHART 7: US ISM CYCLES



Source: Bloomberg, ANZ Chief Investment Office

CONCLUSIONS

While the current pace of economic growth is the weakest since the GFC, we believe that the global economy is in the process of soft landing and that the risk of recession in the next 12 months is modest. Avoiding the sharp decline in earnings that always accompanies a recession also suggests share markets have a diminished risk of a significant decline. It's early days and the year ahead still faces numerous risks, such as trade wars. However, with central banks back into an easing mode and an encouraging trend in the data, the current expansion still looks to have a while to run.

Mark Rider, Chief Investment Officer

Mark is responsible for delivering an overarching investment strategy, including asset allocation, investment themes, investment manager and product selection and monitoring for ANZ Wealth in Australia. Before joining ANZ in 2013, Mark spent 15 years at UBS and 10 years at the Reserve Bank of Australia, making him a well-recognised and respected member of the Australian investment community.