Neil Dwane on… the US Economy

The perspective from the Global Strategist

15 June 2016

Will the Markets Keep Climbing the "Wall of Worry"?

Neil Dwane investigates whether the long-running US equity rally – although still the best game in town over recent years – may be running out of steam. A new batch of worrisome results has brought the US economy's health into question, especially with the Fed keen to raise rates, but so far unsure how quickly it can do so.

Despite the continually dull economy in the US, its risk markets are still doing well and outperforming other global opportunities. Yet even as the S&P 500 flirts with all-time highs, a plethora of poor economic data points are making some investors concerned about the markets' ability to continually climb a "wall of worry".

Indeed, I've been asking AllianzGI's chief investment officers every month about their outlooks, and their response has been both one of confidence (that we will not face a global or US recession in the next year) and concern (that their portfolios may be faced with an economic downturn of some sort).

So how is one to reconcile this duality, and what if the situation changes? Perhaps a brief look back will show us the way forward.

How did we get here?

It has been clear for several years that the US has not, is not and will not be enjoying a normal recovery from the Global Financial Crisis and its sibling recession – as we anticipated when we formed our Financial Repression thesis:

- US equities have been sustained by low interest rates, by truly enormous share buy-backs – nearly USD 1 trillion per annum, funded from the credit markets – and by expectations that heroic monetary policies would create "escape velocity".
- Yet "escape velocity" has not been generated sufficiently to allow the Fed to move far from close to the zero bound, despite both a tightening labour market and solid levels of consumer inflation.
- US fixed-income markets have been hamstrung by the Fed's vocal desire to start raising rates and by the presence of a shale-oil borrowing binge, which has raised the sinister spectre of defaults and bad debts.

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- For global investors, US Treasuries and high-yield bonds seem a bargain when compared to yields in "NIRP-y " (Negative Interest Rate Policy) Japan and Europe, where negative interest rates and Quantitative Easing are still the norm.
- This international demand is suppressing the yield level of US bonds, which would more accurately reflect the all-time highs we are seeing in the S&P 500... right?

Where are we headed?

Despite these record highs – and despite an equity market rally that has been one of the most unenjoyable of all time for institutional and retail investors, who have generally sold while hedge funds remained neutral – we are seeing poor economic and corporate results:

- Non-Farm Payrolls had a bad showing in May, and the trend in this employment measure has been falling since last October – and moving toward lower-paying sectors.
- The Fed's own regional activity surveys have now turned negative, as has the positive momentum from independent surveys such as Markit's, which show that US industrial production, though only constituting about 15 per cent of the economy, has been negative in 2016 – historically a sign of a recession.
- US corporate earnings have been in decline since the fourth quarter of 2014 and actually fell seven per cent in the first quarter of this year. A further drop is expected in the second quarter, even as the usual "rose-tinted optimists" expect more than 10 per cent growth in the second half.
- More than 70 per cent of the US economy is driven by consumption, which has been dull and is now causing enormous strain on retailers, from Walmart to Ralph Lauren to Macy's. Indeed, it seems fair to postulate that real-world US retailers are being hurt by the price-transparent disruptive hammer of firms such as Amazon and the anvil of actual consumption, limited by low wage growth.
- While housing seems to be okay at the moment, affordability notwithstanding, investment by Government and corporations remains sub-par as they await a new administration in 2017, and as companies continue to prefer buy-backs to boost returns immediately rather than to invest for the future.

What should investors do?

Bull markets do indeed climb "walls of worry", as the saying goes, but history also rhymes. Investors should review for themselves the actual health of the US economy, particularly given this late stage in the economic cycle and a central bank that is keen to raise rates. In many ways, the US is over-owned, expensive and at greater risk of economic disappointment than either China or Europe – and it is still in the midst of a vicious election cycle. As such, AllianzGI's CIOs may be right to have a US recession on their radar.

Nevertheless, the ongoing presence of Financial Repression means that, for investors, there remains no viable alternative to taking risk. With no "escape velocity being achieved", whether investing in US markets or elsewhere, focusing on growth, quality and income are good ways to navigate markets where owning risk assets is a necessity to earn a return and employing flexible, active strategies can help investors guard against the volatility that will almost certainly continue over the short to medium term.

- Neil Dwane

Neil Dwane | Global Strategist

Neil is the Global Strategist for Allianz Global Investors and part of the Equity Investment Management Group. Neil coordinates and chairs AllianzGI's Global Policy Committee, which formulates the Allianz Global Investors house view, as well as leads and directs the agenda setting for the bi-annual Investment Forums. Neil still manages some European equity portfolios, and thought leadership articles written by Neil are published regularly.

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