Northern Trust | Receding Recession Risk

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The short-term drivers of market performance are not always clear, but an improving outlook toward economic growth seems to be an obvious contributor to the recent equity rally. We remain of the view that the economy will not dip into recession, and we are overweight stocks and underweight bonds as we head towards 2020.

A rapidly slowing manufacturing sector has raised concerns over the outlook for global growth, which has also been reflected in a very flat yield curve. Recent data has suggested some stabilization in the global economy, with more positive signals toward US growth. The outlook amongst US service sector companies improved notably in October, and the October jobs report was a positive surprise.

Economic prognostications from reading the shape of the yield curve have also turned more positive, as reflected in the New York Fed's recession odds model. We have never believed the yield curve was a definitive proof point of impending recession, as credit markets have remained strong. In addition to improving economic sentiment, investors have also gotten more hopeful about the US-China trade dispute and the outlook for Brexit.

It may be the approaching 2020 US election at work, but signals from the US and Chinese negotiators are indicating the potential for a phase one deal to be signed this year. The important component isn't the level of agreed agricultural purchases; it is what happens to the current and future tariffs. The elimination of pending tariff increases would seem to be a likely outcome of any phase one deal, while the rollback of existing tariffs seems much less likely.

Brexit negotiations have also developed in line with our expectations, which include an extension of the EU deadline to January 31 and a new UK election this December. Avoiding a hard Brexit has led to a rally of 5% in the British pound.

We still think the outlook for risk-taking is positive. Continuing the global easing cycle underway this year, the Federal Reserve cut interest rates late last month, contributing to the steepening of the yield curve. With inflationary trends still very muted, central bank policy is unlikely to be a headwind to risk-taking for some time. We expect continued trade tensions, along with the 2020 US election, to keep uncertainty high. We therefore continue to favor lower-risk risk assets, such as US equities and high-yield bonds.

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