No Recession or Bear Market in Sight

January 29, 2020

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As much as we all crave it, asking for another year of continued economic growth and positive equity returns in 2020 may be too much. The start of this year was marked by the American assassination of Iran's Major General Qassim Suleimani. This raised the prospect of a full-scale conflict in the Middle East, but that risk has substantially decreased after Iran's attack on the al-Asad air base and with the Iranian downing of a Ukrainian plane carrying 176 passengers. Oil is back to year-end levels and diplomacy has been initiated. While the December employment report showed that 145,000 new jobs were created, which was below expectations, job creation was still greater than population growth and a modest expansion seems to be ahead for the United States and the world.

Every year we prepare a list of Ten Surprises. These are economic-related events which we believe have a better than 50% likelihood of taking place but which the average professional investor would assign only a one in three chance of happening. We don't do this to get a high score. We're humble enough to realize nobody can predict the future. The objective is to stretch our thinking and the views of others.

Most investors believe the Unites States economy will continue along a 2% growth path in 2020, but we believe that might be difficult to achieve. The disappointing December jobs report may be the first sign that more weakness is ahead. While a reasonable number of jobs were created in healthcare, hospitality and construction, there were only small increases in important sectors like retail, manufacturing and transportation. At this point, most investors believe the Federal Reserve will make no changes in short-term interest rates this year. However, our first Surprise is that we think the weak economy will cause the Fed to cut rates twice, bringing the Fed funds rate down to 1%. Because interest rates are already low, it is unclear how much of an impact that will have on the economy is unclear. Given that this is an election year, Donald Trump will be taking no chances. He will use whatever measures he can to ensure economic growth in the U.S. economy, including cutting payroll withholding taxes to put more money in the hands of consumers and stimulate spending.

China is the focus of the third Surprise. There was a great deal of celebration surrounding the signing of the Phase One trade deal, but we think there is still much to be done to balance the trade relationship between the United States and China. China essentially agreed to buy soybeans and pork — staples of the country's diet — and we agreed not to raise tariffs on several hundreds of billions of dollars of Chinese goods coming into the United States. The signing of a more comprehensive deal involving state subsidies of Chinese corporate activity before the November election is unlikely. Phase One is also vague on provisions for surveillance and enforcement. It took more than two years to get the Phase One deal, so it will be difficult to get a Phase Two deal in the next year. The Chinese are determined to be the leader in digital technology, they hope by 2025, and they need to acquire foreign intellectual property to achieve that goal. The Chinese do not need a Phase Two deal; they can afford to be as patient as they have always been. Finally, we think that both China and the U.S. will take a "hands off" approach to Hong Kong and allow protests to dwindle over time.

We are skeptical about the prospects for the self-driving car, and that is the fourth Surprise. We believe that an autonomous car can operate effectively on highways, but urban driving is another situation altogether. When one considers the many unexpected instances of pedestrians crossing out of nowhere, parked cars suddenly pulling out, snow conditions and other random events, may not be up to the task. The autonomous car will also have to be in perfect working order at all times, or accidents will occur. As most cars age, they develop functional problems to which a driver can adjust, but these accommodations may not be possible if the car were driving itself. If warning lights appear on the dashboard of a self-driving vehicle, the owner may not take care of them immediately. We are not saying the technology will be permanently deferred. We believe the reality of a self-driving vehicle will take place later, rather than sooner, and that some of the companies pursuing the idea may decide that the prospects are not sufficiently favorable to continue the effort. During the development of the Surprises, we became very concerned about Iran. We knew they have been suffering economic hardship because of the sanctions imposed upon them by the United States, and our fifth Surprise was that they were planning some military action targeting the U.S. According to Donald Trump, American intelligence learned that Iran was in fact going to attack four U.S. embassies, and that he and his advisors acted preemptively to avert the "imminent" attacks on foreign embassies that Iran was contemplating. The Secretary of Defense did not confirm specific evidence as to the imminence of such an attack. In any event, Iran's retaliation so far has been mild and ineffective, but that might not continue. One option the Iranians have is to close the Strait of Hormuz and send the price of oil soaring. Oil did increase in price when the attack on Suleimani occurred, but it has settled back since. We don't think this confrontation is over. We expect more trouble ahead, but if diplomacy takes over and Iran resolves the crisis without additional hostilities, we will be gladly wrong, and the world will be a less hostile place.

During the year, more attention is paid to cybersecurity and the social media companies. The ability for both political parties and foreign interests to have the skills to influence election outcomes becomes clearer. The government and internet-based companies, however, lack either the tools, the will or the policies to deal effectively with the adverse effects of insidious intervention. Unlike earlier investigations of IBM, Apple and Microsoft where the public was generally indifferent, in 2020 people begin to feel their privacy is being invaded and they are being manipulated. The seventh Surprise is that a proposal is made to increase regulation and government oversight of the big tech companies like Google, Facebook and others. There is unlikely to be a resolution, however, before the election. The entire technology sector will be affected, and because these stocks account for the largest weighting in the S&P 500, the market- weighted index will underperform the unweighted index. There won't be a dramatic shift from growth to value as many observers expect.

Now that Britain has definitively decided to leave the European Union, there is considerable confusion about what that might mean for the United Kingdom's economy. While anticipation of the negative outcome caused a material decline in growth, the actual impact may not be so bad. The likelihood that there will be wholesale moves by the financial sector to Paris or Frankfurt is low. Europe seems less inclined to punish Britain for defecting, which should result in a number of bilateral trade deals that will help both the continent and the U.K. The simple fact that the issue is resolved clears up the uncertainty that prevented companies from making the capital commitments they were contemplating. Growth in the U.K.'s economy rises to 2%. Overall, we see the U.K. coming out a winner as it emerges from the Brexit dilemma, and this is the eighth Surprise. There will be a free flow of goods, services and people back and forth from Northern Ireland. Scotland has more to lose than to gain by defecting and will choose to stay within the Kingdom, despite a strong nationalist movement there. Europe remains weak and its markets other than the U.K. underperform the U.S. and Asia.

The bond market has confounded investors for the past several years as rates have declined or stayed low when almost everyone expected them to rise. The consensus now is that there won't be much change in intermediate rates this year, with the 10-year U.S. Treasury yield remaining about 2% because the economy is sluggish and inflation continues to be low. While we agree that traditional economic factors will not drive rates higher, we believe supply and demand will play an important role. The big buyers at the Treasury auctions are the Social Security Administration, the Federal Reserve, Japan and China. The Federal Reserve will probably do some buying, but we should realize that their bond ownership has climbed recently from $3.8 trillion to $4.2 trillion, even as the Fed's stated objective has been to shrink its balance sheet. China and Japan have been upset with Trump's trade policy and have been less-than-enthusiastic buyers at recent auctions. The Social Security Administration, which has been a perennial buyer of Treasuries, may pull back since its benefits payments will exceed its inflows in 2020. These conditions suggest to us that the yield on the 10-year U.S. Treasury will move somewhat higher to 2.5% during the year, and that is the ninth Surprise.

Every year, we always have a handful of "Also Rans" which don't make the list of Ten because either we don't think they are as important as the Surprises we picked, or we can't bring ourselves to the point where we have more than 50% conviction that they will take place.

The first one concerns India. Our outlook is positive, but Prime Minister Modi is very controversial because of his policies toward religious minorities and his failure to continue to deliver on his economic reforms. Most observers are neutral to bearish on the Indian stock market. We expect the economy to grow at 6% in 2020, and its equity market to rise 20%.

In the second "Also Ran" we label artificial intelligence a paper tiger, much like Y2K, which everyone worried about 20 years ago. We think artificial intelligence has already had a profound role in manufacturing productivity and employment, and it is harder to eliminate jobs in service industries. We do not mean to downplay the tremendous impact that artificial intelligence will have. Rather, we believe that the positives are likely to outweigh the negatives. A permanent and large-scale wave of unemployment caused by artificial intelligence isn't likely to happen in our view. Because the U.S. is already at full employment, some labor pressure relief may actually be welcome.

In the third "Also Ran," we expect the social problems in Russia to escalate. Although we don;t expect the level of popular dissent in Russia to reach that of protests in Hong Kong, we believe the reaction to oppression resulting from harsh rule by the authoritarian Russian government and meager growth and opportunity will intensify.

Vladimir Putin will be forced to direct more resources toward social programs and fewer toward defense. The Russian people feel the country's oil resources have been used for military purposes, rather than for the good of its citizens. Worried about appearing less powerful, Putin moves strengthens ties with China and the two engage in increased coordination to offset the power of Europe and the United States.

The fact that only four years ago we were all terrified by the nuclear threat represented by North Korea is difficult to believe. It has not gone away, but few people talk about it now. We realize that Kim Jong-un will never give up his nuclear weapons, and Kim realizes that if he uses one, his country will be destroyed. Donald Trump will go to North Korea to negotiate a deal where Kim maintains his nuclear arsenal but agrees to suspend his long-range missile program. That is the final "Also Ran."
So, there they are, the Ten Surprises of 2020 and the "Also Rans." We hope they stimulate your thinking about the year ahead. Now let's see how they work out.

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