# RECESSION RISK JUDGED TO BE MODERATE

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IN A NUTSHELL

- A moderation of NIPA corporate profits may well imply lower GDP growth in 2020.
- However, we do not expect a recession in the next twelve months.
- The Fed should stay neutral into 2020; we expect its communication to remain slightly dovish.

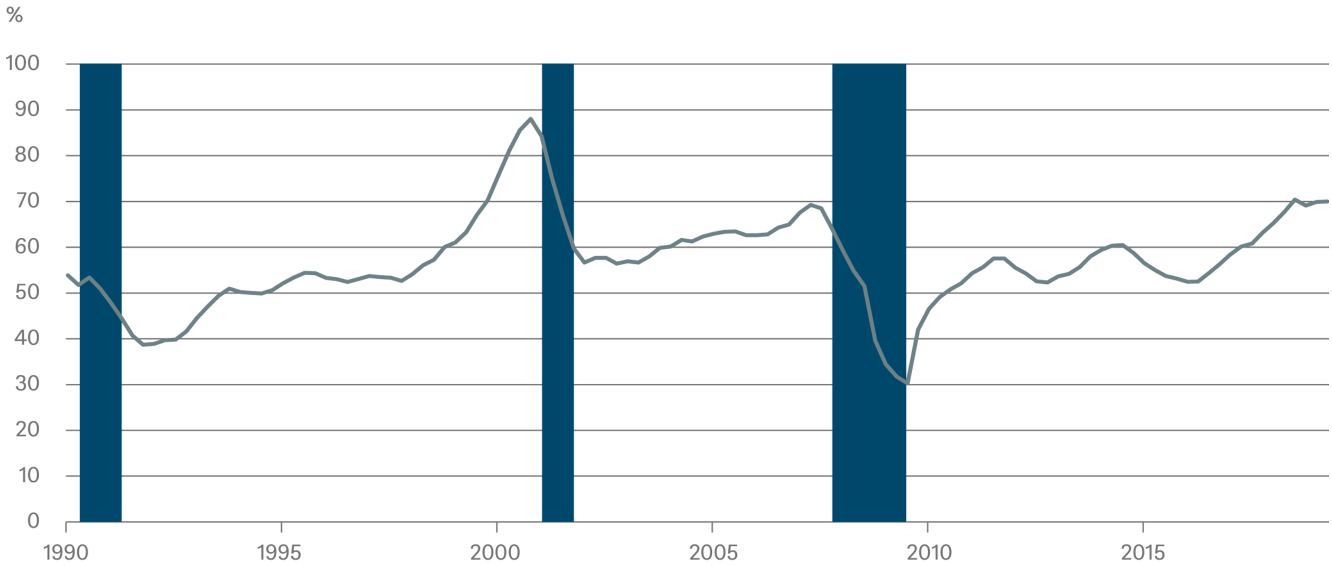
Admittedly, labeling NIPA[1] corporate profits a well-kept secret of financial markets would be a bit of an exaggeration. However, most market participants hesitate to give a clear statement when they move into the center of attention from time to time. Reason enough to highlight the topic and indeed to comment on it. As argued below, corporate profits as reported for taxation can be a meaningful predictor of the business cycle.

While almost everyone observing financial markets is likely to be familiar with the concept of S&P 500 profits, NIPA profits do not enjoy the same popularity. Notwithstanding that, there are some quite important differences. For instance, S&P 500 profit measures are compiled by public available information and are based on financial accounting standards.[2] Therefore, they can allow for a certain degree of flexibility among corporate bean counters. Especially toward the end of an economic cycle, this tends to lead to optimistic interpretations of the earnings situation among individual companies and for the S&P 500 as a whole.

On the other hand, NIPA estimated profits rely primarily on income statistics, provided by the Internal Revenue Service (IRS). Therefore, those numbers could provide a more realistic picture as nobody should have the incentive to soup up profits for tax authorities. In addition, both measures differ quite dramatically in terms of coverage. While S&P 500 profits[3] represent only firms in the index, and thus are limited to a selection of public listed companies, NIPA profits represent the whole private economy. This should be kept in mind as these numbers might be a better predictor for overall employment. After all, S&P 500 companies together only account for roughly 15%-20% of the U.S. workforce. In terms of absolute numbers, S&P 500 profits accounted for about a bit more than half of NIPA profits from 2010 through 2016 and increased to around 70% in 2019 (see below). This development might be a consequence of the tax reform introduced in 2017. One could also cynically argue that listed companies have done a good job in creating sound financial statements while whole corporate America was not able to generate higher profits from a tax perspective.

[1] National Income and Product Accounts (NIPA) https://www.bea.gov/data/income-saving/corporate-profits
[2] Source: Petrick 2001 – Comparing NIPA Profits with S&P 500 Profits https://apps.bea.gov/scb/pdf/national/niparel/2001/0401cpm.pdf
[3] Comparing operating profits

## RELATIVE VALUATIONS ON THE RAISE AGAIN




■ Recession ■ S&P 500 operating earnings to NIPA after-tax corporate profits *

Sources: Bureau of Economic Analysis, Haver Analytics, Standard & Poor's, Bureau of Economic Analysis, National Bureau of Economic Research as of 11/19/19
* with adjustments for inventory valuation and capital consumption, quarterly moving average

While the divergence between both measures is insightful per se, we find the development of NIPA profits over time, and its relation to employment growth, to be even more interesting. Following the simple logic that profitable corporations hire more people and less profitable corporations hire fewer (optimistically speaking), one can observe a similar pattern in recent history.

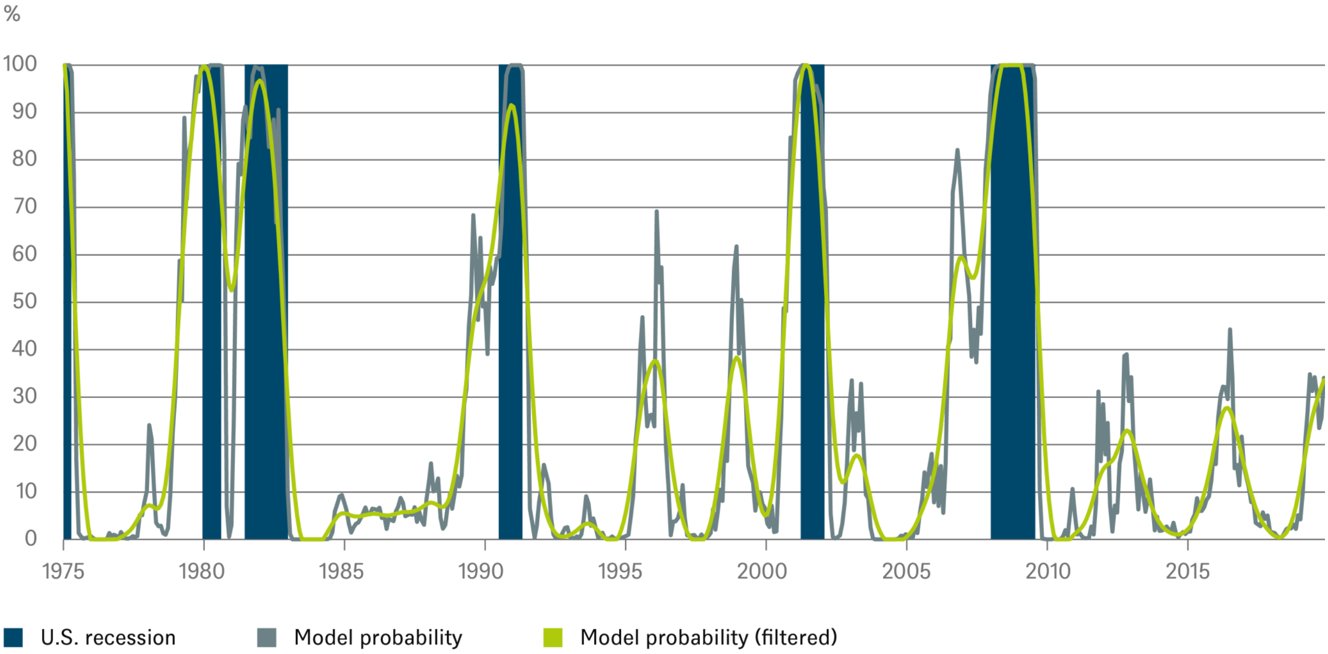
## PROFITS DRIVE EMPLOYMENT


■ Recession ■ Private industry employment * ■ NIPA after-tax corporate profits to nominal GDP (right axis) **

Sources: Bureau of Economic Analysis, Bureau of Labor Supply, Haver Analytics and National Bureau of Economic Research as of 11/19/19
* year-over-year
** with adjustments for inventory valuation and capital consumption; quarterly moving average

As the second chart suggests, either corporations anticipate lower profits and start to save costs (reduce hiring, like in e.g. 2008 or 2015/2016) or they are forced to do so if being surprised by lower profits (like in e.g. 2000). A bit of number crunching shows that the effect is more pronounced – faster and higher in magnitude – in the manufacturing sector than in the service sector.[4] Looking at the recent trends, it is likely that we are already seeing the beginning of a similar adjustment right now. Hiring in manufacturing is weak while service sector employment remains in relatively good shape, for now. Of course, the easiest explanation for the recent decline in corporate profits would be negative fallout from the trade war. Other factors worth keeping in mind are a fading fiscal impulse and a record old cycle.[5] In this light, the trade war most likely acts as an accelerator rather than a cause.

## RISK OF A RECESSION CURRENTLY JUDGED TO BE MODERATE




Source: DWS Investment GmbH as of 11/19/19

However, we believe there is no need to panic as we still do not expect a recession in the next twelve months. While we estimate the probability of a recession to remain slightly elevated, at above 30%, we do not observe critical imbalances that could harm the economy in a 2008 fashion. We rather anticipate a moderate slowdown of economic growth towards, if not slightly below, potential growth by the end of 2020.[6] The same is expected for the labor markets – we think of a rather gradual moderation than a sharp deterioration. As overall economic activity looks set to moderate, we expect (core) inflation to slowly converge close to the U.S. Federal Reserve's (Fed's) target of 2% while a temporary overshoot cannot be ruled out.

Of course, the main risk to this outlook remains the trade war. While we do not expect a further escalation, there could be a partial removal of some of the recently introduced tariffs. We caution, however, that the so called phase one deal most likely does not resolve all uncertainties surrounding the topic. This deal might preserve the status-quo while not providing the necessary confidence businesses need to restart investments on a larger scale. Furthermore, we do not expect a major fiscal package to boost the economy in 2020. Political maneuvering during the election campaign will most likely prevent decision makers in Washington from reaching a broader consensus on higher spending required in light of the 2018 mid-term results (We are not talking about elevated public-debt levels in general). However, possible announcements of the intention to implement a fiscal stimulus of the yet to be elected president could at least foster an expectation-driven increase in economic activity – most likely supporting consumption.

The implications for monetary policy, for the time being, are that the Fed follows their well telegraphed "modus operandi" of staying neutral into 2020. While we expect the Fed's communication to remain slightly dovish due to global weakness, low inflation and the lingering effects of the trade war, incoming data might support a wait-and-see approach. This strategy would also give the Fed the comfort of not being suspected to intervene in the 2020 elections by demonstrating data dependence. Once growth approaches its potential, which we would expect to happen by late 2020, we can well imagine more rate cuts and further monetary easing to return as topics for discussion. Of course, a lot can still happen until then, which is why it is well worth to remain on the alert for positive and negative surprises. Data-dependent, in other words.

[4] Impulse response function of a Vector Autoregression Model that relates a 1% permanent drop of NIPA corporate profits to employment in the services and goods sector.
[5] The estimated fiscal impulse for 2018 was around 1% GDP, for 2019 0.4% and for 2020 virtually not existence any more.
[6] Estimates of potential growth vary substantially depending on the source between 1.6% and 1.8% year-over-year. Our estimates remain at the lower end of that range.

## OVERVIEW: KEY ECONOMIC INDICATORS

| | 2018 | | 2019 | | | | 2020 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4F** | Q1F | Q2F | Q3F | Q4F |
| GDP (% qoq, annualized) | 2.9 | 1.1 | 3.1 | 2.0 | 1.9 | 1.2 | 1.8 | 1.6 | 1.6 | 1.2 |
| Core inflation (% yoy)* | 1.9 | 1.9 | 1.6 | 1.6 | 1.7 | 1.8 | 1.9 | 1.9 | 1.9 | 1.9 |
| Headline inflation (% yoy)* | 2.0 | 1.9 | 1.4 | 1.4 | 1.4 | 1.6 | 1.6 | 1.4 | 1.3 | 1.4 |
| Unemployment rate (%) | 3.7 | 3.8 | 3.9 | 3.6 | 3.6 | 3.6 | 3.7 | 3.8 | 3.9 | 4.0 |
| Fiscal balance (% of GDP) | -3.8 | -4.2 | -4.1 | -4.3 | -4.6 | -4.6 | -4.8 | -4.6 | -4.8 | -4.6 |
| Federal funds rate (%) | 2.00-2.25 | 2.25-2.50 | 2.25-2.50 | 2.25-2.50 | 1.75-2.00 | 1.50-1.75 | 1.50-1.75 | 1.50-1.75 | 1.50-1.75 | 1.50-1.75 |

* PCE Price Index
** Forecast

## GLOSSARY

Dovish refers to the tone of language used to describe a situation and the associated implications for actions. For example, if the Federal Reserve Bank refers to inflation in a dovish tone, it is unlikely that they would take aggressive (contractionary) actions.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

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## IMPORTANT INFORMATION – APAC

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