Mixed Market Signals Pose a Conundrum for Investors

Money managers grapple with the likelihood of recession vs. short-term drop in stocks

By Ira Iosebashvili
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Investors are trying to determine whether recent contradictory signals on U.S. growth mark the start of a prolonged slowdown or another speed bump in the 10-year economic expansion.

For many who have ridden stocks to near records, it feels like a turning point is close. Signals of slowing growth or even recession have mounted: The latest came last week, when data showed steep declines in the U.S. manufacturing and service sectors. Other investors point to the rise of short-term Treasury yields above longer-term ones, a phenomenon known as an inverted yield curve that typically precedes recessions.

At the same time, Friday’s U.S. jobs report showed employers continuing to add jobs at a steady pace. Unemployment remains near multidecade lows and wages show little sign of pushing up inflation—data that did little to bolster the case for an impending downturn or a shift in the Federal Reserve’s wait-and-see approach to interest-rate policy that many expect to continue boosting share prices.

Investors hope that minutes from the Fed’s most recent monetary-policy meeting, to be released on Wednesday, will shed light on the central bank’s thinking. Meanwhile, several said that betting against stocks has been a losing strategy over the past decade, even during previous occasions when it appeared that eurozone troubles or a sharp slowdown in Chinese growth would drag the rest of the world into a recession.

“We’ve seen this market shift from periods of worry to periods of ebullience over the years,” said Michael Farr, president of the money management firm Farr, Miller & Washington. “That has resulted in some short-term fragility but hasn’t made a dent in the long-term trend.”
investors fear slackening growth will hurt demand for raw materials—have underscored that message. A Bank of America Merrill Lynch survey of fund managers earlier this month showed recession concerns at the highest level in a decade.

That doesn’t mean investors should abandon stocks or other riskier investments, several fund managers said.

Even without a thaw in trade tensions, many expect growth to slow but not stall. The most likely scenario, analysts at UBS Global Wealth Management believe, is that the U.S. will implement its already announced tariffs by year-end. That outcome would push U.S. growth to below 1% in the first half of 2020 from 2% in the second quarter but is unlikely to tip the economy into recession, the bank said in a recent report.

More tariffs or another breakdown in talks, however, could be enough to end the recovery and shave between 15% to 20% from global stocks, the bank said.

While the bank has reduced exposure to equities, “we also do not recommend investors hold significant underweight positions as if they were preparing for a recession, and believe that from a strategic perspective it is important to stay invested,” wrote Mark Haefele, the firm’s chief investment officer.

And investors’ worries could help cushion the blow when a recession does come, said Campbell Harvey, a Duke University finance professor whose 1986 dissertation at the University of Chicago showed that an inverted yield curve preceded a recession by 12 to 18 months.

A Duke quarterly survey of chief financial officers in September showed that nearly 70% expect the U.S. to enter a recession by the end of 2020. Optimism among finance chiefs stands at its lowest level in three years, with a less-than-1% increase in capital spending expected over the next 12 months. That compares with an expected 5.7% increase in September 2018.

That could make a downturn more likely as companies, investors and consumers curb spending and investment ahead of an expected drop-off in growth, Mr. Harvey said. At the same time, it could curb potentially risky behavior such as excessive borrowing, helping to make the next downturn less severe. “The key thing is that if there’s a recession next year, it’s not going to be a surprise,” he said.

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