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Independent Thinking

# August round-up: recessions loom


7 September 2022

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**Recession spotting**

**Let's hear it for globalisation**

**The anatomy of UK recessions**

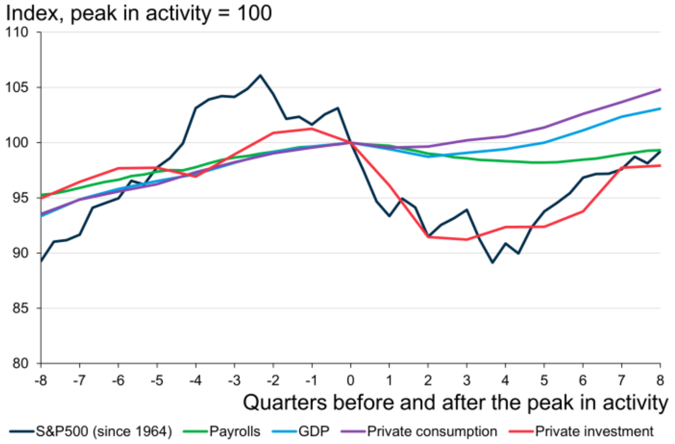
**Weather and gas supply will dictate depth of EU recession**

## **Recession spotting** (3 August 2022)

- After two consecutive quarters of falling output, the US is already in recession by one commonly used yardstick
- But this rule of thumb is less useful than it was, not least because falling trend growth across the major economies over the last 20 years has rendered two consecutive quarters of falling output both more likely and less damaging than before
- The National Bureau of Economic Research (NBER) has a Business Cycle Dating Committee dedicated to identifying peaks and troughs in US economic activity, which they do using a degree of judgment, identifying recessions as the period in between — but its judgments are usually issued long after the event
- In search of timelier ways of tracking recessions, our chart shows how several key indicators have behaved, on average, either side of the peaks in economic activity preceding past US recessions identified by the NBER

**Data around US recessions since 1950**

Index, peak in activity = 100




*Source: NBER / Refinitiv Datastream / Fathom Consulting*

- With personal consumption accounting for close to 70% of all expenditure in the US economy, unsurprisingly the peak in consumption typically coincides with the peak in economic activity and is not a useful forward marker
- Both investment and equity prices can provide a warning sign, however, with investment typically peaking one quarter before and the S&P500 typically peaking seven months before the peak in economic activity
- US investment fell in Q2, while the S&P500 reached a peak in December 2021; so both of these series are behaving in a way consistent with US economic activity peaking about now
- But they are both volatile series and will behave like this at other times too. As Paul Samuelson observed in 1966: "The [US] stock market has forecast nine of the last five recessions"
- Nevertheless, other indicators are flashing red, including the ten-year minus two-year spread, and expected new orders in manufacturing as recorded by the Empire State survey, both of which are at levels that in the past have signalled recession
- At the time of our Summer Outlook, finalised in early June, we saw around a 40% chance that the US would be in recession by Q3 of this year; we are likely to revise up this probability in our Autumn Outlook, which we will be presenting to clients next month
- If the US does enter recession, history suggests we should expect to see a sudden drop in payrolls employment, of the order of 50,000-100,000 within a single month, and a much larger fall in private investment than we saw in Q2
- Should one buy the sound of cannon? A brave, or perhaps a greedy, investor might sit on her hands for a year or so before re-entering the market. A more pragmatic investor, mindful of how fast the Fed can supply liquidity, might do so earlier than that

**Let's hear it for globalisation** (10 August 2022)

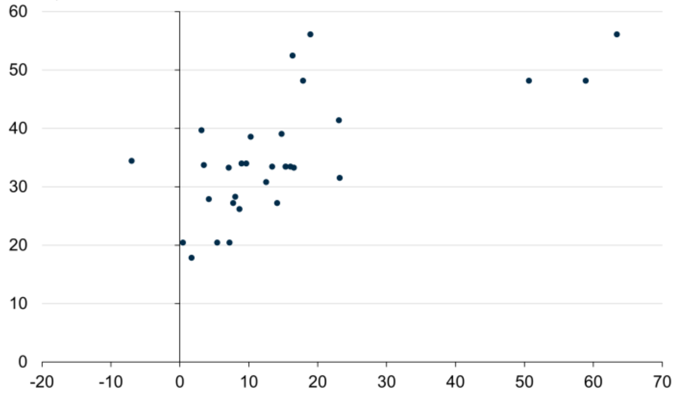
- Global supply chains were stretched during the pandemic and the degree of supply-chain integration was an important determinant of sectoral price movements
- The more a particular sector is integrated into global supply chains (via inputs to the production of the goods and services that sector produces, or via its role in providing inputs into other sectors) the larger was the upward movement in prices during the pandemic period.
- The chart below compares the degree of global supply chain integration (global value chain or GVC)[1] for each of 31 sectors of the US consumer price index[2] against movements in the CPI for each of those sectors – there is a clear positive relationship (which is borne out econometrically too, although interestingly no such relationship obtains pre-COVID)

1. These data are derived from underlying Trade in Value Added (TiVA) data that is available from the following databases: World Input-Output Database (WIOD), OECD-WTO TiVA Database, UNCTAD Eora GVC Database, IDE-JETRO AIIOTs, EUROSTAT FIGARO, EXIOBASE. The GVC data are derived from TiVA data using an R program that can be found here: Global Value Chains Tools (r-project.org).

2. The GVC sectors are output concepts which we have mapped onto the CPI components.

## Global value chain and US CPI

GVC, 2015

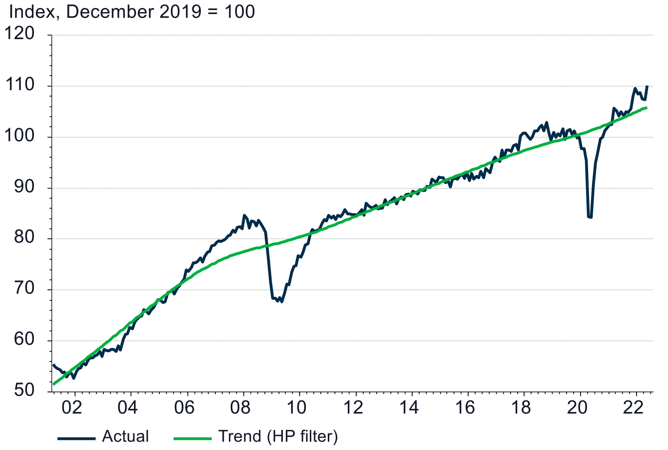



*Source: Refinitiv Datastream / Fathom Consulting*

- However, supply chains were stretched by an increase in demand, not by a contraction in supply
- Global trade volumes fell at the start of the pandemic but later recovered to a level significantly higher than the pre-COVID trend

## Global trade volumes

Index, December 2019 = 100




*Source: Refinitiv Datastream / Fathom Consulting*

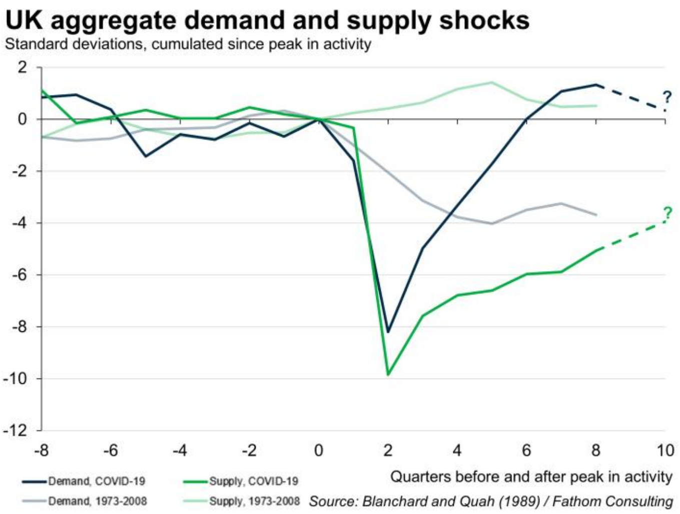
- Part of that increase in trade arose because of a shift in the composition of demand towards (highly traded) goods and away from (less-highly traded) services
- Without well-functioning, globally integrated supply chains, the impact on inflation from that shift in demand would have been far larger than it has been



Continued

**The anatomy of UK recessions** (17 August 2022)

- The sharp contraction in economic activity that took place as the UK economy went into lockdown in March 2020 looks very different from the five UK recessions that preceded it, when examined using Olivier Blanchard and Danny Quah's framework [1] for identifying shocks to aggregate demand and aggregate supply
- Recessions typically began with a sharp contraction in aggregate demand, which temporarily depresses output, before a sequence of positive shocks to aggregate supply raise output sustainably, eventually dragging the economy out of recession
- During the first half of 2020, the UK experienced substantial, simultaneous reductions in both aggregate demand and aggregate supply, as whole industries were instructed to cease production while consumers were prevented from buying their products
- Aggregate demand has since recovered rapidly, far outpacing the recovery in supply and almost certainly contributing to the UK's inflationary problem, and thus creating a dilemma for the Bank of England
- Data for the first two quarters of this year, which remain subject to revision, suggest the tide may be turning, with demand starting to fall, perhaps taking the UK close to recession, and supply recovering a little further
- How much of this, if anything, can be pinned on Brexit? We will cover this topic and many more in our *Autumn Outlook 2022*, due to be presented to clients from early September




[1] See Blanchard, Olivier J and Danny Quah (1989) 'The dynamic effects of aggregate demand and supply disturbances', *American Economic Review*, Vol. 79, pp. 655-673. The authors propose a neat way of measuring shocks to US aggregate demand and US aggregate supply, based on the idea that only shocks to aggregate supply can have a permanent effect on output. We apply their technique to UK data.



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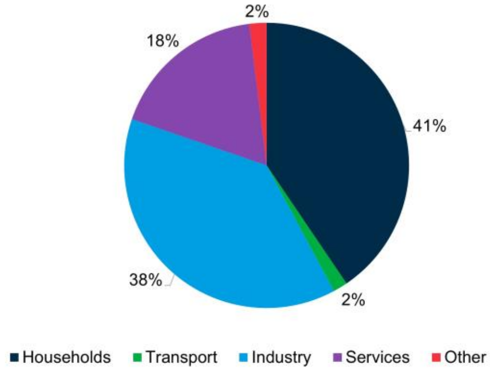
**Weather and gas supply will dictate depth of EU recession** (24 August 2022)

- In Fathom's *Global Outlook, Spring 2022* we warned that a Russian energy embargo would lead to a European recession
- While a full embargo has not yet been implemented, it is likely that economic contraction has nonetheless already arrived; the record price of natural gas is set to dent demand further in the coming months
- The EU aims to reduce gas consumption by 15% this winter, but achieving this goal will be hard; consumption declined by less than 3% in 2020 when most of the bloc was in lockdown for several months
- Moreover, many of the EU's plans to reduce energy use, such as turning down air conditioning and turning off lights and computers, relate to electricity rather than specifically gas
- Even ramping up the use of coal and extending the life of nuclear power plants are also electricity-related; every little helps, but only 14% of natural gas consumed in the EU is used for electricity generation – most natural gas is used for heating and by industry
- Should Russia's gas supply to Europe reduce further, or the winter be particularly cold, higher energy prices and a recession may still be insufficient to equilibrate supply and demand, raising the prospect of involuntary cuts to energy use
- If rationing was implemented, and households shielded, then industry (which accounts for around 40% of the EU's natural gas use and is already struggling from weak global demand) would face additional headwinds in the coming quarters

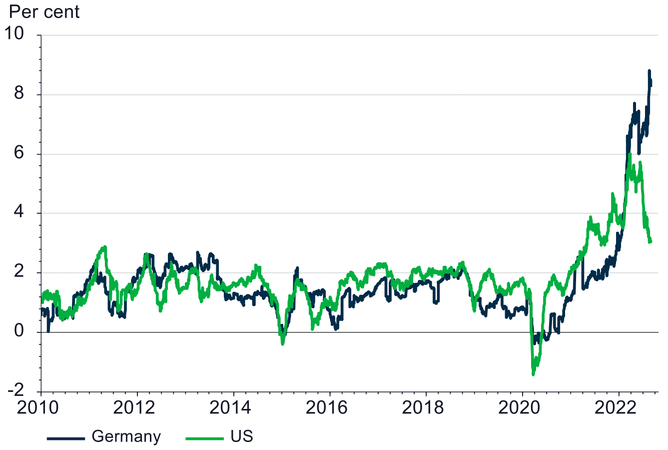
**EU natural gas consumption, by sector**
Per cent of total, 2020




Source: European Commission / Fathom Consulting

- The natural gas shock is idiosyncratic to Europe, and has led to an unprecedented divergence in expected inflation between Germany and the US

## One-year inflation swaps




*Source: Refinitiv Datastream / Fathom Consulting*

- A divergence in economic activity appears likely too, with the US outperforming; we will be laying out more detailed prospects for the global economy, including how risks vary by region, in our forthcoming *Global Outlook, Autumn 2022*

***Chart authors: Andrew Brigden, Erik Britton, Brian Davidson***

**Further reading:**

Challenging times for hedged equity investing

Euro area stability — a tale of two leaders

**In case you missed it, here's last month's round-up:**

How green tech boosts democracy

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