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Independent Thinking

Recession Watch: here we go again

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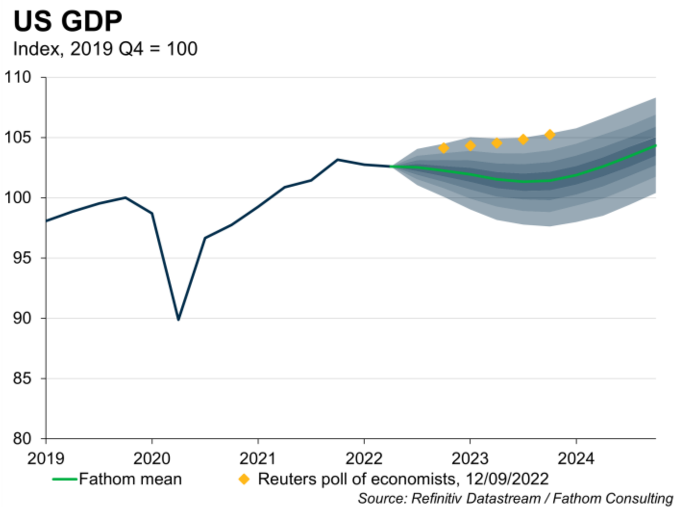
Headlines

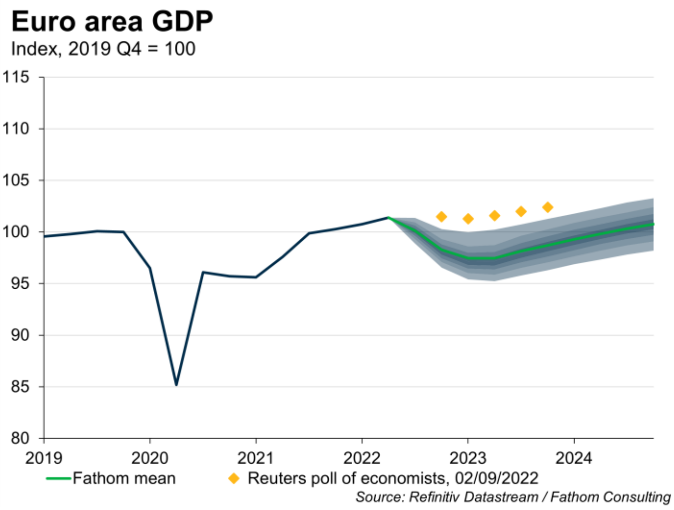
- All major advanced economies are in or heading towards recession
- With recession and high inflation occurring together, policymakers have a dilemma
- Even without that dilemma, this period – a couple of years after a major global recession – would usually see high financial risk
- This time around, that risk is particularly pronounced, as Fathom suggested it would be: expect a wave of sovereign, currency and banking crises
- The banking crises may already be upon us in China; and even, perhaps, closer to home

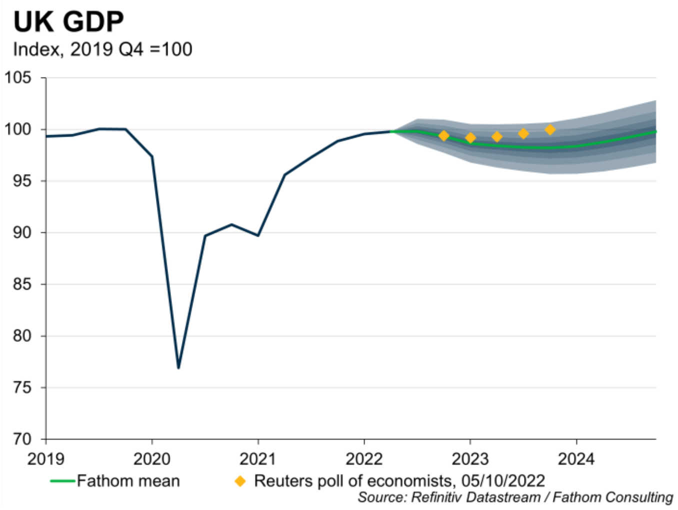
The COVID convulsion of 2020 triggered the steepest global recession followed by the swiftest global recovery of all time: a phenomenon that Fathom called correctly at the outset, and that we tracked – daily, at first – in a series of *Recession Watch* and later *Recovery Watch* notes. Now, two years later, many economies are once more either approaching recession or already in one. So Fathom has started a new series of *Recession Watch*.

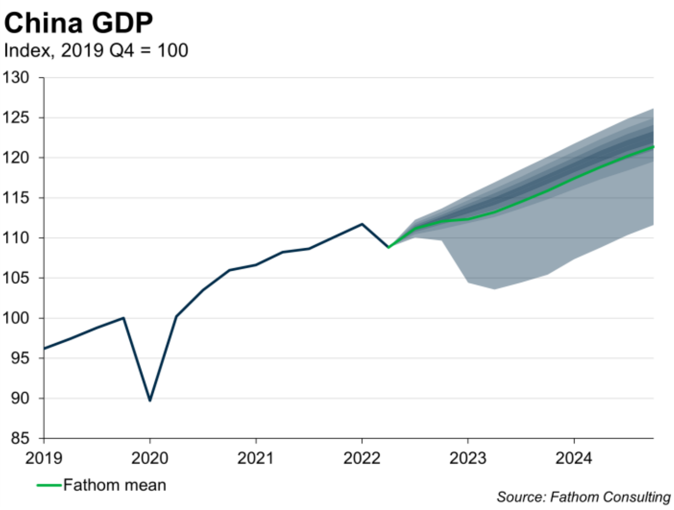
The pandemic recession and recovery also unleashed higher global inflation (again, called correctly by Fathom at the outset), which has been compounded by the impact on energy prices of Russia's pointless and brutal invasion of Ukraine. It is one thing to ask policymakers to respond to a threat of recession: looser policy is the correct medicine. It is another matter to respond to higher inflation, especially if it becomes embedded in expectations: tighter policy is the answer. But recession and inflation together create a policy dilemma. We are on the horns of that dilemma right now.

The fan charts below show Fathom's outlook on the likely course for GDP across the major advanced economies plus China. For each, a recession is in our central case: either right away (the August GDP print for the UK suggests the recession here may already have begun), or within the next year or so. In China's case, there is a large swag of downside risk visible in this chart, which arises thanks to the pronounced risk of a banking crisis there. The gold dots on these charts represent the mean forecast from the Reuters poll of economists. Fathom's central forecast is below the consensus in all cases: in fact, the consensus is often above the range of our 80% confidence intervals captured in the shaded bands of these charts. (For further discussion of the prospects for inflation, see Fathom's forthcoming note 'Inflation: seconds out for round two')









In a sense, the current slowdown is just a ripple from the storm that was the pandemic: a natural consequence of that colossal shock. All major recessions tend to see a rapid recovery and then a pause of sorts, the timing of which tends to be a couple of years after the trough of the recession. That timing of that pause is important: it is a good predictor of financial crisis.

The intuition here is as follows. In the teeth of a major recession, policymakers are highly focused on restoring growth and preventing further damage. They will use whatever tools they have at their disposal, and will have an easy time persuading others that that is what is needed. Moreover, international institutions like the IMF will be on their guard to prevent the recession from escalating in emerging economies, ready to turn on the taps of lending or other kinds of support where necessary. Financial crises are rare during recessions, for those reasons. Scroll forward a couple of years, though, through the most rapid part of the recovery and into the pause; and the frequency of financial crises peaks. It's not the recession: it's after the recession. The risk of financial crisis is related to the magnitude of the recession, but it peaks a couple of years later. It peaks, in other words, now.

Fathom's global Financial Vulnerability Indicator (FVI) has been ringing alarm bells ever since the COVID recession struck about the coming risk of financial crisis, peaking around now.

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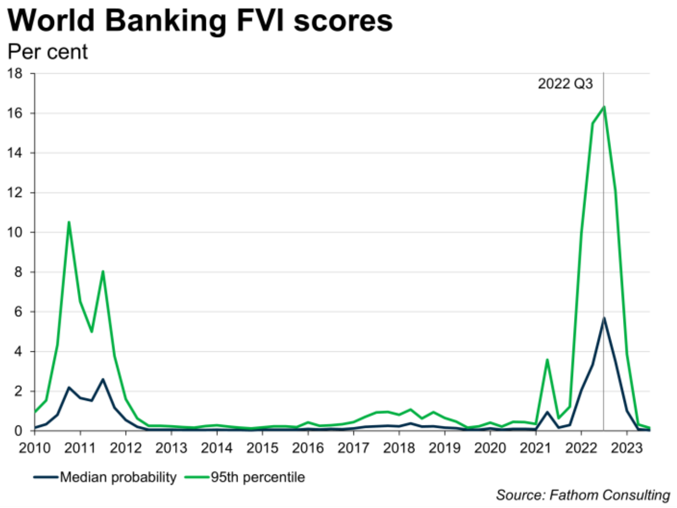
The chart below shows the median and 95th percentile risk of a banking crisis, the peak of which is in this quarter, and is higher than it has been at any time since the Great Financial Crisis of 2008/09.



It is one thing to be concerned about the immediate risk of financial crisis around the world; it is another to make judgements about where the crisis might first appear. Markets data help to pick out individual banks that are judged to be at risk, based on the CDS spreads attached to those institutions. But individual banks can be stressed or even fail without necessarily having any systemic implications. Fathom's approach to this problem is to use a technique called 'minimum spanning trees' (MST), which exploits the correlations between movements in equity prices across a selected pool of entities, in this case banks. The MST for any network is the path of highest correlation across the system that connects all the entities in it without ever creating a 'circle'. You can think of it as the most likely path through which a shock would travel. And it helpfully identifies key 'nodes' – entities that are central to the system. Entities situated at the nodes have two important features: they are disproportionately exposed to shocks that originate elsewhere in the system; and shocks that affect them, or originate with them, can be disproportionately impactful at the system level. These are the 'systemically important' entities.

For the major banks in the global financial network (all of those deemed systemically important by the IMF), the current MST is shown below.

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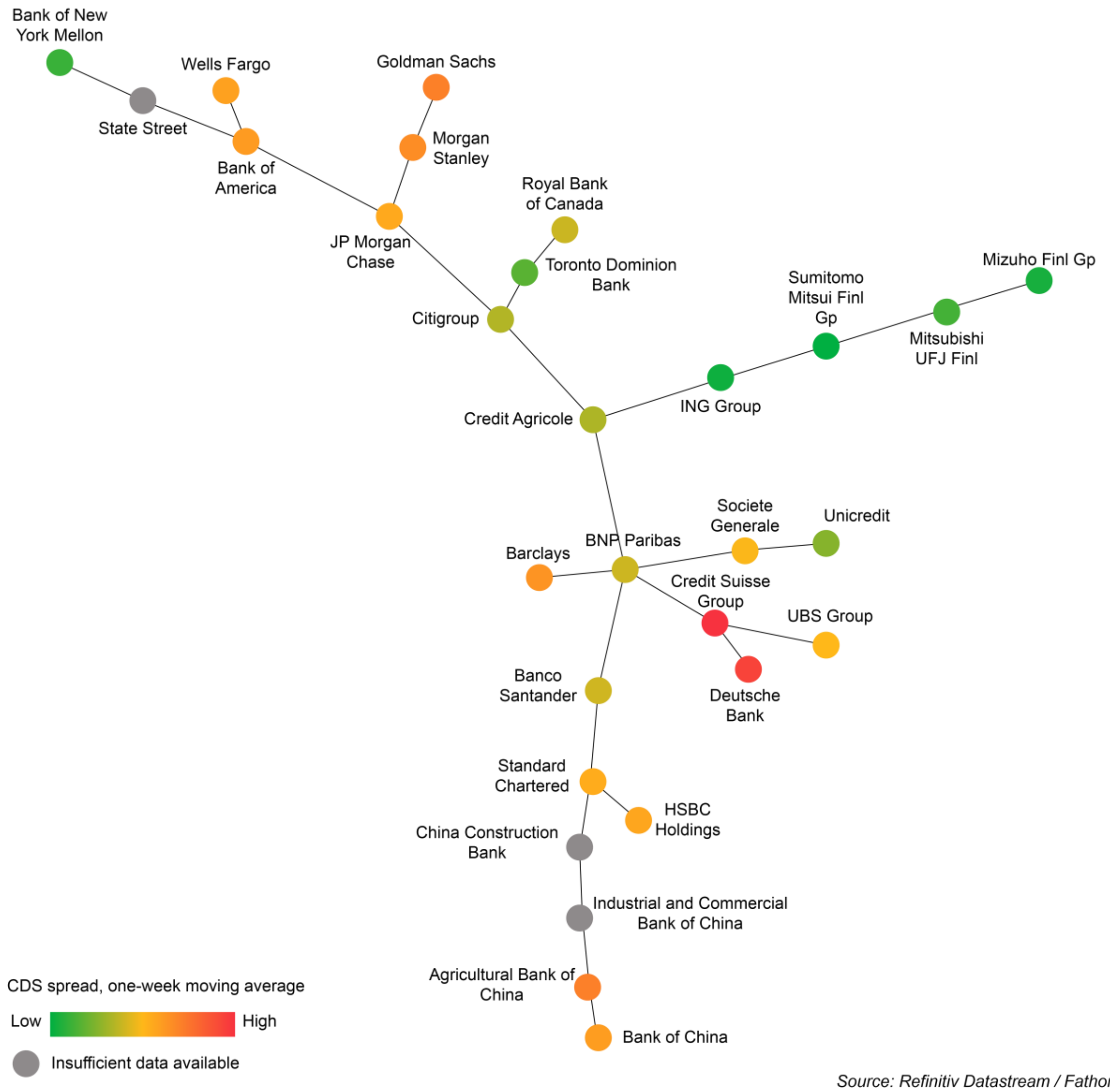
International banking network

Correlation of equity price movements



Source: Refinitiv Datastream / Fathom Consulting

The MST above is colour-coded according to the CDS spread attached to each institution, so that you can easily see the entities that the market currently perceives as stressed: Credit Suisse and Deutsche Bank stand out as under particularly pressure. And the systemically important nodes are those from which many long branches spring: BNP Paribas, Credit Agricole, Citigroup and JP Morgan Chase pop out in this respect.

The stress to the global banking system is already visible in Credit Suisse and Deutsche, but it has not yet reached the systemically important nodes: keep an eye on BNP Paribas.

Incidentally, the four major Chinese banks are all out on a limb together and are not particularly stressed at present. This is despite a nascent banking crisis within China. But the big four are underwritten by the Chinese government, so there is no risk to them. The risks in the Chinese banking system lie elsewhere – there will be further analysis on this point to follow in a future edition of *Recession Watch*.

Continued

Further reading

- How the markets reacted to the UK 'mini-budget' – Fathom Consulting (fathom-consulting.com)
- The UK loses its magic money tree – Fathom Consulting (fathom-consulting.com)
- Housing could cause a China banking crisis – Fathom Consulting (fathom-consulting.com)
- Global Outlook Autumn 2022: Spiralling…out of control? – Fathom Consulting (fathom-consulting.com)
- Euro area stability – a tale of two leaders – Fathom Consulting (fathom-consulting.com)
- The 2022 Nobel Prize in Economics: for research in banking and financial crises

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