Recession Watch: riders on the storm

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Headlines:

- Crises can happen at any time, but some pre-existing vulnerabilities must exist to tip a country into crisis
- Seemingly small shocks should not be ignored as they could have systemically important consequences
- Europe is one region where current economic circumstances have the potential to exacerbate long-standing vulnerabilities
- The UK, Switzerland and Hungary each pose risks worth monitoring for potential global negative spillover effects

It is only a short step from a downturn to a crisis, but it marks a transition to a state that is significantly more difficult to predict and potentially more damaging. With risks of crisis escalating around the world, Fathom's Financial Vulnerability Index (FVI) provides some valuable lessons and templates for investors and policymakers when it comes to spotting where trouble may occur.

In general, crises arise due to either idiosyncratic or systemic shocks. Countries which enter a crisis tend to have built up pre-existing imbalances, that make them more vulnerable to any type of shock. Not all vulnerabilities lead to a crisis, however — many countries 'live' with their imbalances. Expectations, as elsewhere in the world of economics and finance, play a huge role in escalating a vulnerability into a full-blown crisis. Typically, crises triggered by an isolated shock are the most difficult to predict, but also tend to have a more limited impact. However, they should not be ignored. Sometimes a seemingly immaterial shock could turn out to be large enough to become systemically important. This is the channel through which expectations operate, and that we track through contagion dynamics. Contagion spreads across national borders — think about the 2008 Great Financial Crisis spreading from the US to the rest of the world — and also across types of crises, just as the 2010-11 sovereign crisis in Greece eventually morphed into a European banking crisis. Ultimately, the timing of a future crisis is very hard to predict, so investors and policymakers need to use data and tools like the FVI to monitor closely any shocks with the potential to escalate.

So what is the current situation? COVID has provided an unexpected and systemically important shock which nonetheless has so far failed to trigger any systemic crisis, partly thanks to prompt and large policy actions. Fathom warned, however, through its first series of *Recovery Watch* notes, that this was no time for policymakers to pat themselves on the back. History shows that multiple types of crises can materialise in quick succession — a finding which seems particularly relevant at the moment, as we come out of a rare and deep shock at the same time that geopolitical risks are compounding the economic risks from higher inflation and rising interest rates that had previously lain dormant for decades.

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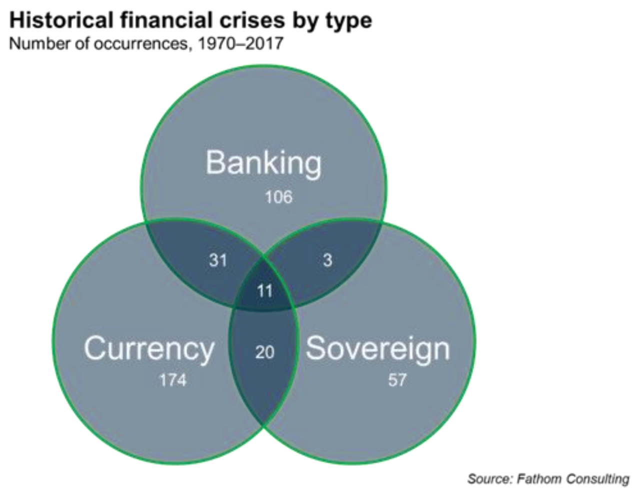
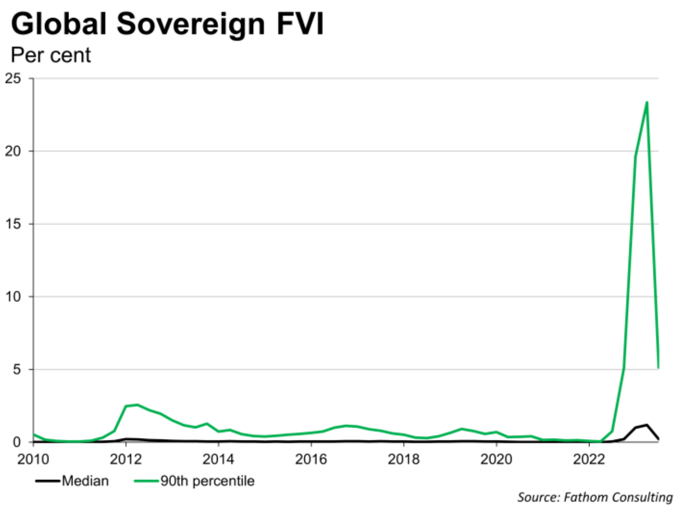


So where is the next crisis likely to come from? Last week's *Recession Watch* highlighted that we are at a particular vulnerable juncture, with a heightened global risk of not only a banking crisis, but also currency and sovereign crises.



In this note, we suggest that Europe should be one region to keep an eye on, given its pre-existing vulnerabilities and the potential for isolated, idiosyncratic shocks to cascade into more systemic problems. Europe has long-standing vulnerabilities, in the form of a less proactive institutional framework, high debt and low growth. In Fathom's *Global Outlook, Autumn 2022*, we also put forward the idea that European vulnerabilities are increasing relative to other regions. One of our scenarios shows how Europe is most at risk of a slowdown, not only because it is most exposed to the commodity shock from the Russian invasion of Ukraine, but also because European consumers have generally accumulated significantly lower savings buffers to absorb any further shocks.

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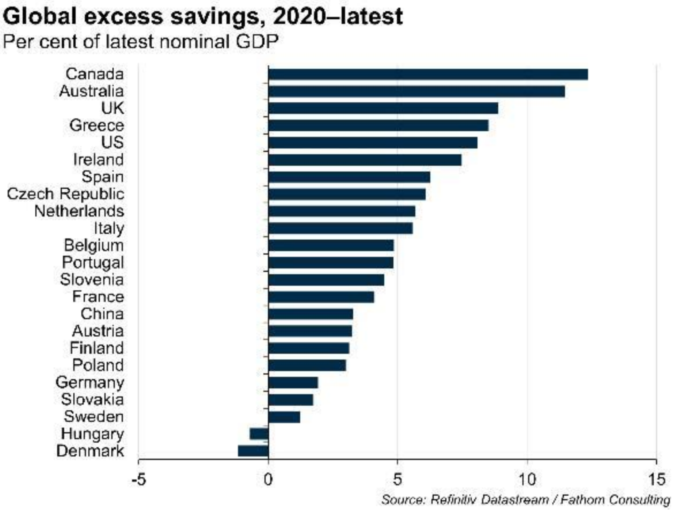
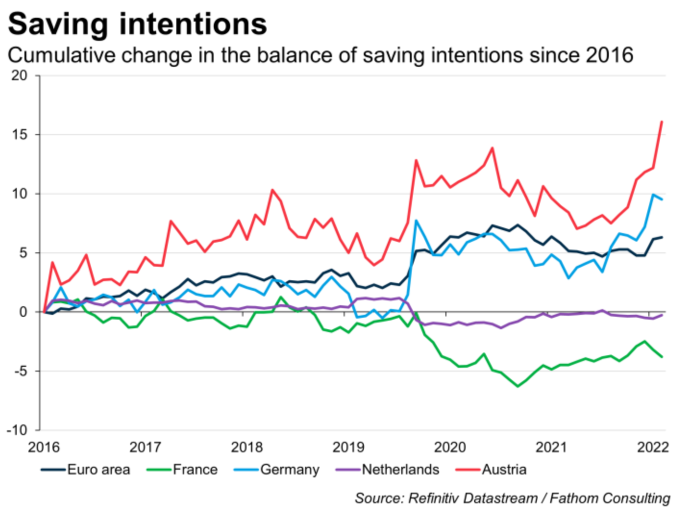


In our more optimistic scenario, the US can just avoid a recession thanks to these extra savings, but an economic downturn in Europe is an almost inescapable outcome. Keeping an eye on consumption and saving behaviour is therefore likely to provide clues about the severity of the European recession. To turn less bearish, we would need evidence of a countercyclical type of consumer behaviour. But should European consumers increase their savings as a result of the current uncertainties, then recession is almost inevitable and may be deeper than many expect.

The data is mixed in this respect. The bad news is that consumers' intentions to save have indeed started to climb again across Europe since August. The increase has not been homogenous across all European economies, with notable increases in Germany and Austria but drops in France and to a lesser extent in the Netherlands and Portugal. Measures such as Germany's planned 200 billion euro energy subsidy could therefore be useful, if not to address global energy prices, to at least deter consumers from saving too much, thus keeping demand afloat — with broader benefits for the rest of Europe.



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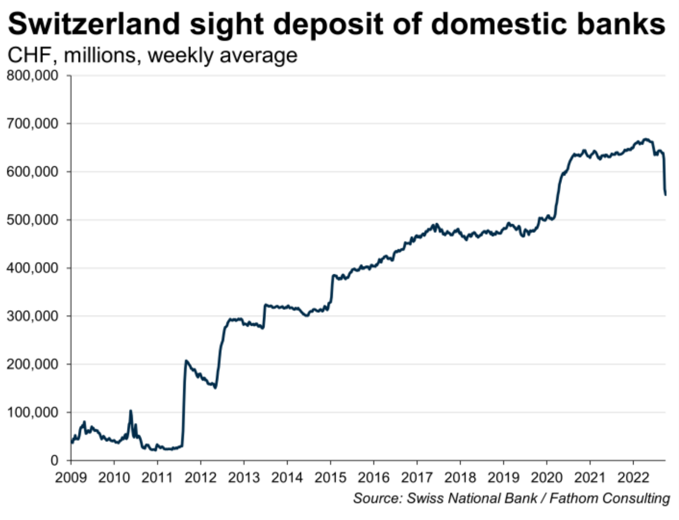
Overall, a sharp European recession coupled with ongoing geopolitical risks is the type of systemic shock that could exacerbate Europe's pre-existing vulnerabilities and potentially trigger one or more crises. Moreover, Europe is a potential hotbed for more isolated, less obvious shocks that have a habit of morphing into more systemic risks.

The worsening economic situation in the UK has the potential to be one such event. We covered this in some detail in a separate note to clients. Crises can become self-fulfilling when financial market confidence gets shattered and policymakers are seen as too reactive, slow or outright dismissive of problems.

Another localised European red flag that warrants closer scrutiny is the situation with the Swiss bank, Credit Suisse, which was discussed in last week's *Recession Watch* note. Some investors have latched onto the saga, as risks around a systematically important bank have brought back memories of 2008. Something is obviously going wrong there. The combination of surging CDS prices, a sharp drop in the sight deposit of domestic banks, unusually large dollar liquidity provisions ($9.4bn in just two weeks) from the Fed to the SNB through swap facilities, a large dollar denominated maturity wall of over $2bn over the remainder of the year, and the recent investment bank CEO resignation, is more than a set of unfortunate coincidences and has raised questions about solvency.



Our take is that policymakers are being proactive in taking the risks seriously. Quietly building large reservoirs of liquidity seems a sensible and conservative approach, to project confidence that whatever is brewing can be managed. However, these provisions are mostly buying time, and more clarity needs to emerge soon if the uncertainty is to be resolved harmlessly.

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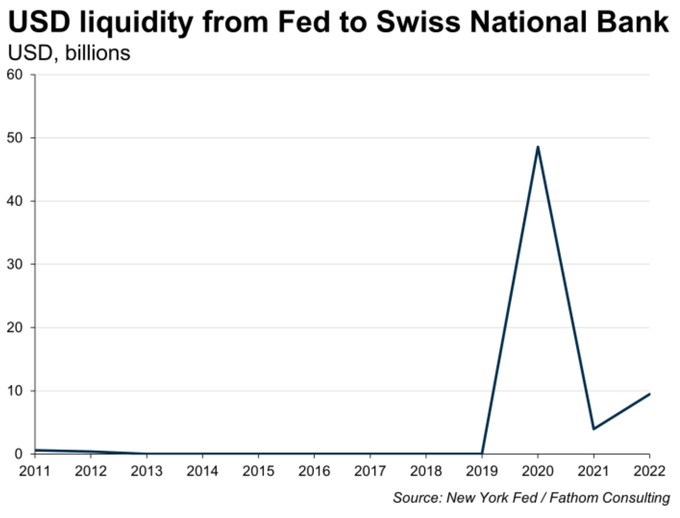
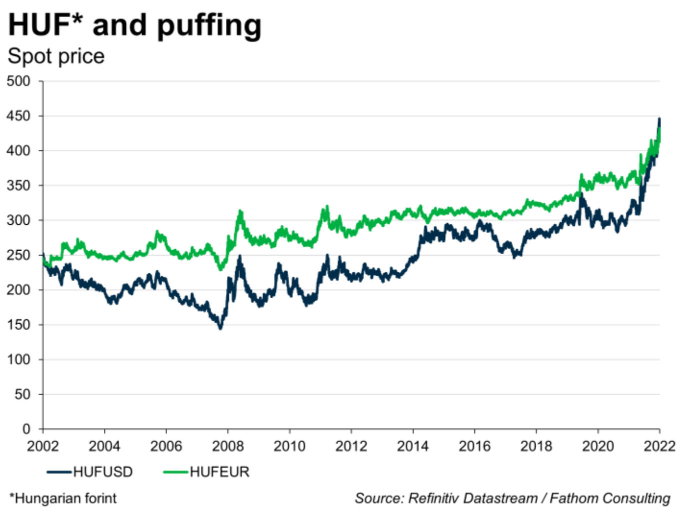


Last week it was Hungary's turn to claim the spotlight. The forint (HUF) plunged to record lows, prompting the central bank to intervene and hike its collateralised lending rate to 25% to stem the depreciation. While the HUF is no stranger to bouts of volatility, some of the challenges facing Hungary are particularly severe. Not only is the country facing high inflation, higher rates and a weaker currency, but it also remains very exposed to geopolitical tensions further east of its border, while its government is still at loggerheads with the European Union about unlocking a large share of funding worth almost 14 billion euros. Summarising the ongoing risks faced by Hungary, the FVI estimates that the probability of a sovereign crisis in Hungary is set to peak at 42% in the second quarter of next year.

This is just Europe over the past few weeks; and we are just at the beginning. Hang on tight, like riders on a storm, and keep reading Fathom's weekly *Recession Watch*.



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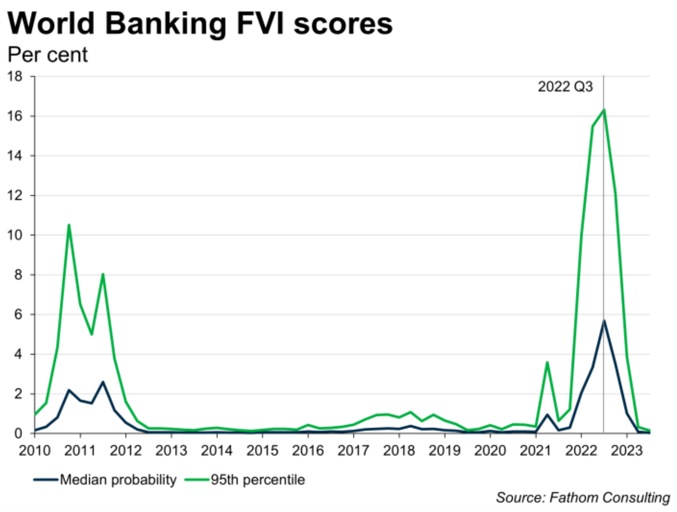

Further reading

- [Another high level resignation at Credit Suisse – Reuters (reuters.com)]
- [The Hungarian Forint holds a debatable accolade – Daily News Hungary (dailynewshungary.com)]
- [Recession Watch: here we go again – Fathom Consulting (fathom-consulting.com)]
- [How countries should respond to the strong dollar – International Monetary Fund (imf.org)]

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