

# Recession Watch: markets two steps ahead of the data

Andrea Zazzarelli



14 December 2022

Andrew Harris



## Headlines

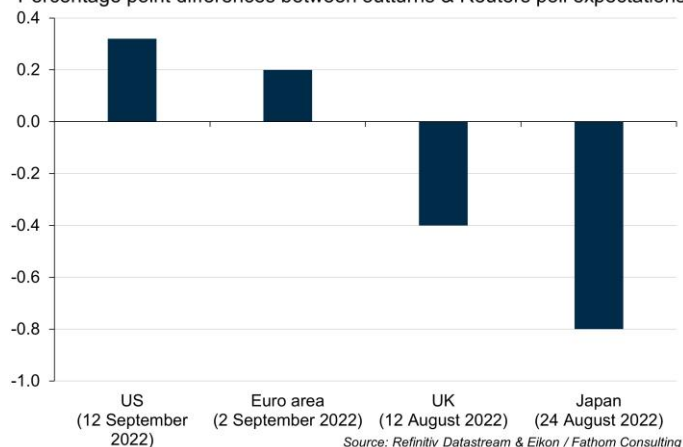
- This week's *Recession Watch* note discusses whether a recession remains a relevant risk to investors
- We have had positive news, if with caveats, in the euro area and US — upside GDP surprises, downside inflation surprises and impressive energy substitution in Europe — but a global recession remains our central forecast
- According to the Fathom Macro Portfolios, investors seem to be two steps ahead of the data, not only looking beyond a recession before it even decisively shows up, but also in increasingly pricing in a pivot from central banks
- The risk of complacency is high; sticky inflation could trigger a sobering reassessment of rates, growth and market returns

Uncertain times make for uncertain forecasts. We have recently finished putting together our [Global Outlook, Winter 2022](#) for Fathom clients with a special focus on recession risks. Although we do not rule out the risk of avoiding recession completely (at 30% probability, the US is the most likely to avoid one), our take is that it is less about 'if' and more about 'when' recession materialises. Without wanting to steal our forecast's thunder [please get [in touch](#) should you wish to receive a one-off demo], its main premise is that the UK and euro area are probably already in a recession, with the US likely to join them early next year. There is an element of uncertainty, however, due to the leads and lags in the publication of economic data and in the propagation mechanism of shocks across the economy.

This week's *Recession Watch* provides some more colour to this picture: not only on the odds of a recession, but also on the extent to which one is already priced in and how material it might prove for financial markets.

## G4 quarterly GDP growth surprises, 2022 Q3

Percentage point differences between outturns & Reuters poll expectations



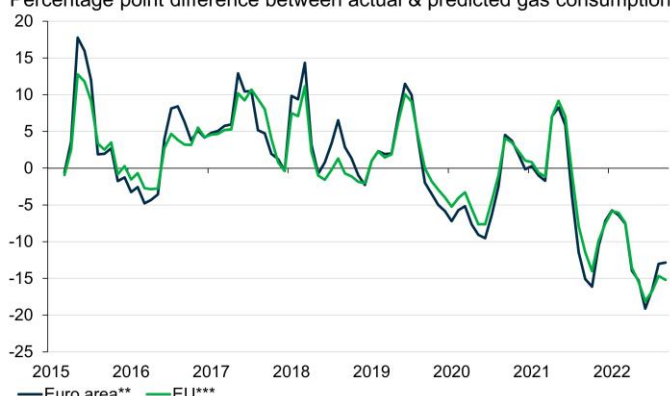


On the face of it, the economic news between the publication of our autumn outlook (on 12 September) and our winter outlook (on 5 December) has been net positive. As the chart above shows, GDP surprised to the upside in Q3 in both the euro area and US, with the latter avoiding a third consecutive contraction in output. In both cases, this is despite the headwinds from higher interest rates and lofty commodity prices.

In [Europe](#), the positive surprises to growth have gone together with a faster-than-expected substitution away from Russian gas. Earlier in the year, many had expected that such a substitution would necessarily imply much weaker growth and even sizeable economic contractions. So far, that has not proven to be the case, thanks to an accelerated substitution towards other suppliers (most notably American LNG), as well as a reduction in overall gas demand resulting from a relatively mild autumn. As the chart below shows, not all the reduction in demand can be attributed to the weather.

## Gas consumption

Percentage point difference between actual & predicted gas consumption\*



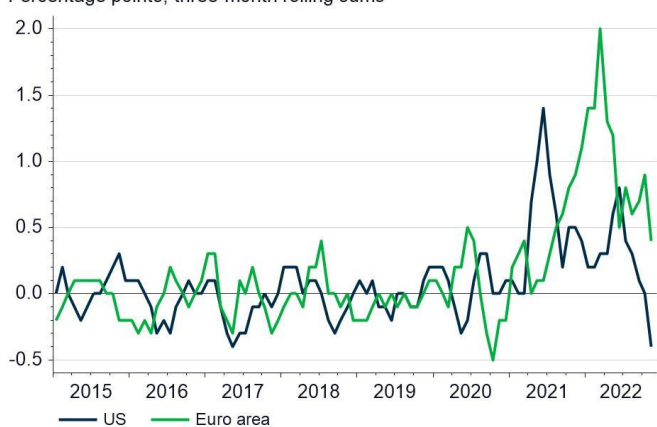
\* Based upon a model that uses annual temperature changes to explain annual changes in gas consumption  
 \*\* Euro area excludes Cyprus due to data availability  
 \*\*\* EU excludes Cyprus & Sweden due to data availability

Source: Fathom Consulting

While upside inflation surprises are fading, the latest labour market earnings data from the US rose by more than expected in November. If the strength in earnings data persists, it raises the risk that a stronger labour market could fuel so-called second-round effects, and generate a more persistent inflation overshoot.

## US and euro area CPI surprises

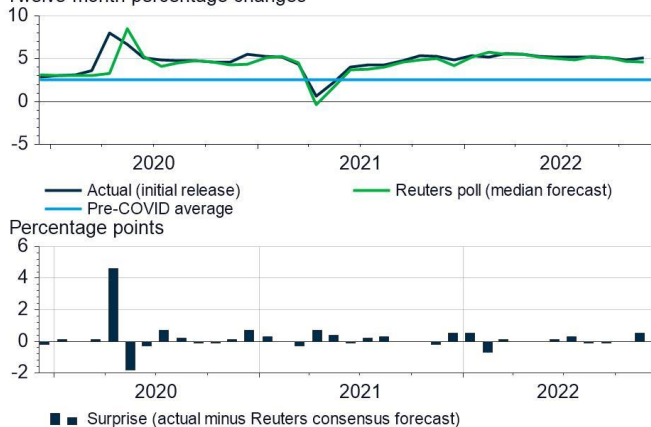
Percentage points, three-month rolling sums



Source: Refinitiv Datastream / Fathom Consulting

## US average earnings

Twelve-month percentage changes



Source: Refinitiv Datastream / Fathom Consulting

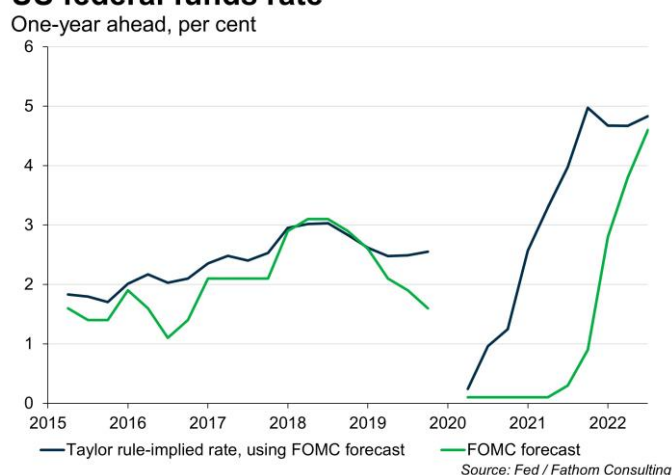


Ultimately, avoiding a recession will probably require a recovery in liquidity followed by a rebound in consumer confidence. (Recall that, in the past 50 years, neither the US nor euro area has previously avoided a recession when confidence has fallen as low as this year.) In this respect, an end to central bank tightening, triggered by a clear sign that inflation is moving in the right direction, is likely a prerequisite. There are some signs that the US could be approaching this point — the gap has now closed between the FOMC's expected year-ahead policy rate and what a simple Taylor rule applied to their own macroeconomic forecasts would suggest is appropriate. If correct, this would suggest a terminal fed funds rate of 4.5–5.0%, with the Fed likely to hit the lower bound of this later today.

## US consumer confidence



## US federal funds rate



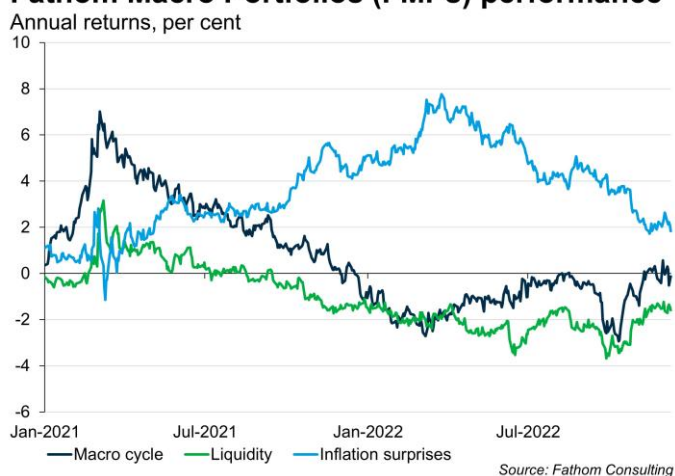
That said, it is hard to see where a confidence rebound will come from. It remains Fathom's view that the tightening seen to date is likely to tip both the US and euro area into recession, especially given the 'long and variable' lags with which monetary policy typically works. It has traditionally been assumed that it takes around 18 months for the full effect of monetary policy on inflation to be seen — the Fed's first hike was in March, nine months ago.

Investors, however, seem to be taking an overall more benign view. The Fathom Macro Portfolios (FMP) — our proprietary set of indicators which replicate key economic series through liquid financial assets — allow us to track investors' perceptions of key macroeconomic trends daily. Since the beginning of the year, the following developments are clearly visible:

- Inflation surprises have steadily pulled back, reaching levels closer to normality
- Assets closely connected to the macro cycle have posted losses as they would during a recession, but now show signs of a rebound
- Liquidity has notably tightened since mid-2021 and, while it remains tight, there are some tentative signs of a trough

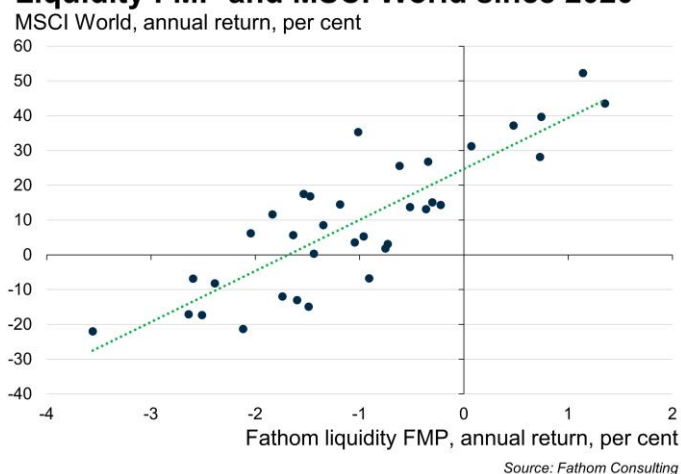


## Fathom Macro Portfolios (FMPs) performance

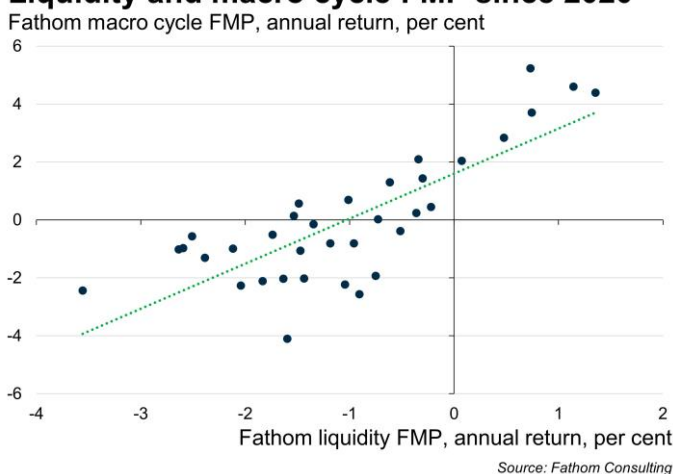


Taken together, these trends tell us that investors have grown progressively less worried about inflation since central banks started tightening monetary conditions. The FMPs also confirm a clear sequence in the macro narrative where tighter monetary policy has led to weaker liquidity, lower growth and lower asset prices. The extent to which liquidity has been driving market prices and macro conditions can be more clearly seen in the two scatter plots below. Since 2020, there has been a tight relationship between liquidity and equity prices, but also between liquidity and macro conditions. (Note that neither relationship is clearly observable over longer horizons, and that this is a recent phenomenon).

## Liquidity FMP and MSCI World since 2020



## Liquidity and macro cycle FMP since 2020



The inescapable conclusion is that liquidity appears to be all that currently matters to investors. The key question for market participants is therefore: will there be a pivot? Investors seem to think so, with recent moves in the FMPs suggesting that an expected recovery in liquidity will support economic activity. However, we would caution that investors appear two steps ahead of the data: not only looking beyond a recession before it even decisively shows up, but also in increasingly pricing more abundant liquidity to be just around the corner. The joint probability of both outcomes occurring is small, in our view, and conditional on a very benign outlook for inflation.

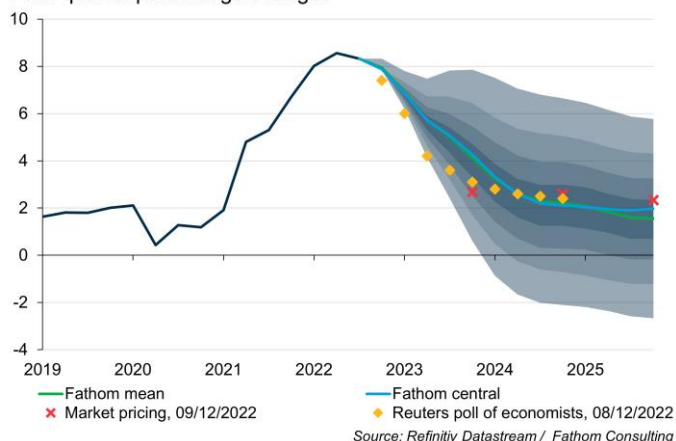




The risk of complacency is high in this respect. Inflation may finally be coming down, but we are not out of the woods yet. Looking beyond base effects, we see inflation easing more slowly than consensus. Moreover, our inflation fan charts are unusually wide, and we see a material risk (15% in the US and euro area, and 30% in the UK) of a continued loss of central bank credibility leading to spiralling second-round effects. In that world, a (much) higher path for rates and weaker economic growth could cause a significant reassessment of valuation, and an abrupt end to the market rally.

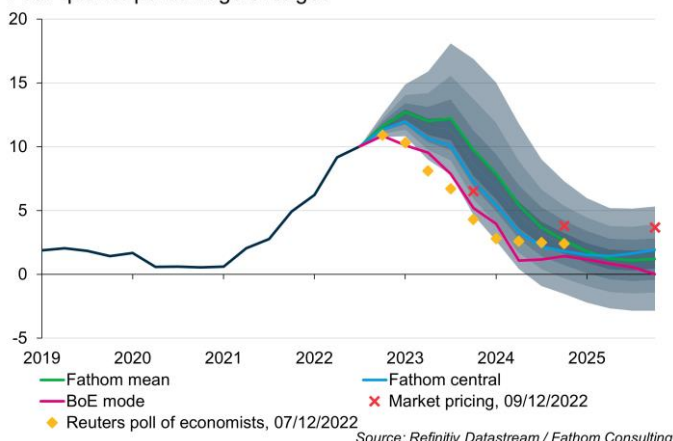
## US CPI

Four-quarter percentage changes



## UK CPI

Four-quarter percentage changes



## Further reading

[Global Outlook, Winter 2022: Blinded by the pivot?](#)

[Energy crisis fuels EU sovereign risks](#)

[Recession Watch: identifying recessions with uncertain data](#)



**Fathom Consulting**  
47 Beveden Street  
London  
N1 6BH  
Tel: +44 (0)20 7796 9561



Contact information  
andrea.zazzarelli@fathom-consulting.com  
www.fathom-consulting.com

This newsletter is a confidential, copyright protected communication intended only for the person to whom it was originally sent. If received in error, please notify the sender and delete immediately. Its intended recipients may not make copies of this newsletter, or distribute it to third parties, without the written consent of Fathom Consulting.

Fathom Consulting is a trading name of Fathom Financial Consulting Limited, a company registered in England & Wales under the Companies Act, company number 04942817, © 2022

### Regulatory Disclaimer

FFC LIMITED and all of its affiliates (henceforth FFC) do not conduct "investment research" as defined in the FCA Conduct of Business Sourcebook (COBS) section 12 nor do they provide "advice about securities" as defined in the Regulation of Investment Advisors by the U.S. SEC. FFC is not regulated by the SEC or by the FCA or by any other regulatory body.

This research report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Nonetheless, FFC has an internal policy that prohibits "front-running" and that is designed to minimize the risk of receiving or misusing confidential or potentially material non-public information.

The views and conclusions expressed here may be changed without notice. FFC, its partners and employees make no representation about the completeness or accuracy of the data, calculations, information or opinions contained in this report. This report may not be copied, redistributed or reproduced in part or whole without FFC's express permission.

Information contained in this report or relied upon in its construction may previously have been disclosed under a consulting agreement with one or more clients. The prices of securities referred to in the report may rise or fall and past performance and forecasts should not be treated as a reliable indicator of future performance or results. This report is not directed to you if FFC is barred from doing business in your jurisdiction. Nor is it an offer or solicitation to buy or sell securities.

### Analyst Certification

I Andrea Zazzarelli, the lead analyst, certify that the views expressed herein are mine and are clear, fair and not misleading at the time of publication. They have not been influenced by any relationship, either a personal relationship of mine or a relationship of the firm, to any entity described or referred to herein nor to any client of FFC nor has any inducement been received in relation to those views.

I further certify that in the preparation and publication of this report I have at all times followed all relevant FFC compliance protocols including those reasonably seeking to prevent the receipt or misuse of material non-public information.