Recession Watch: markets two steps ahead of the data

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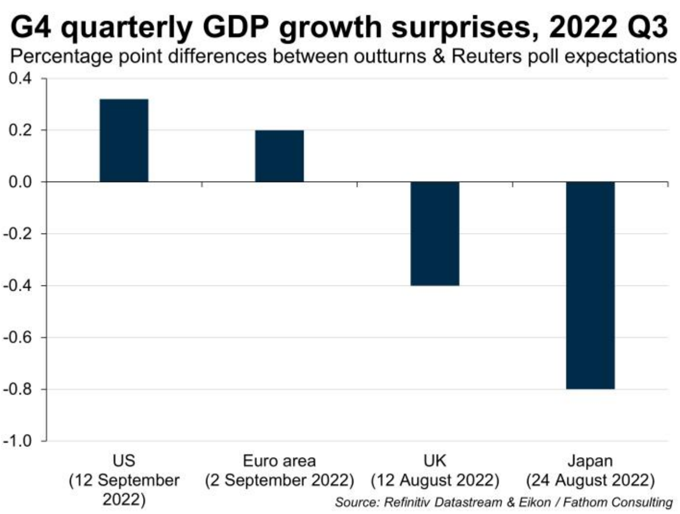
Headlines

- 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

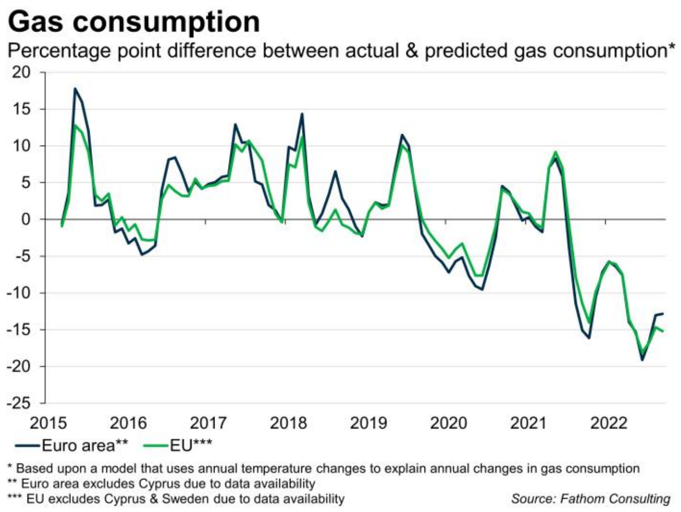
Uncertain times make for uncertain forecasts. We have recently finished putting together tour Global Outlook, Winter 2022 for Fathom clients with a special focus on recession risks. Although we do not rule out the risk of avoiding recession completely (at 30% probability, the US is the most likely to 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.

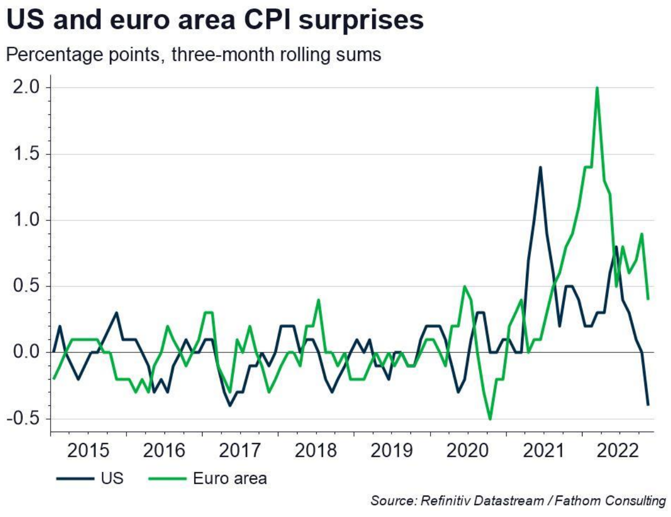


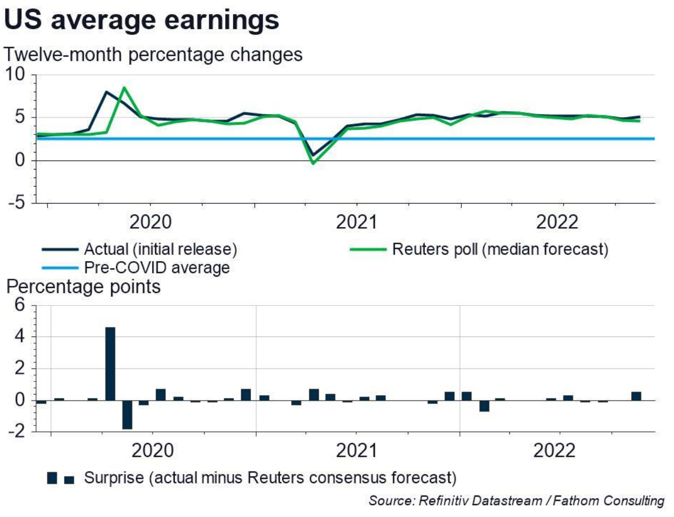
On the face of it, the economic news between the publication of our autumn outlook (on 12 September) and our winter outlook (on 5 December) has been net positive. As the chart above shows, GDP surprised to the upside in Q3 in both the euro area and US, with the latter avoiding a third consecutive contraction 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.



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.





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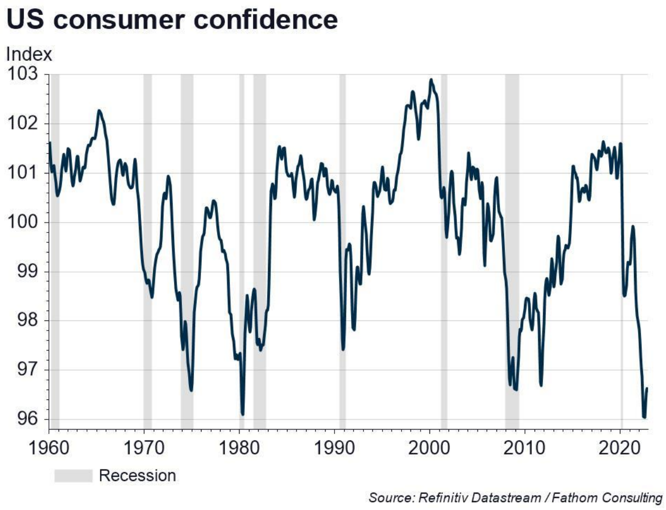
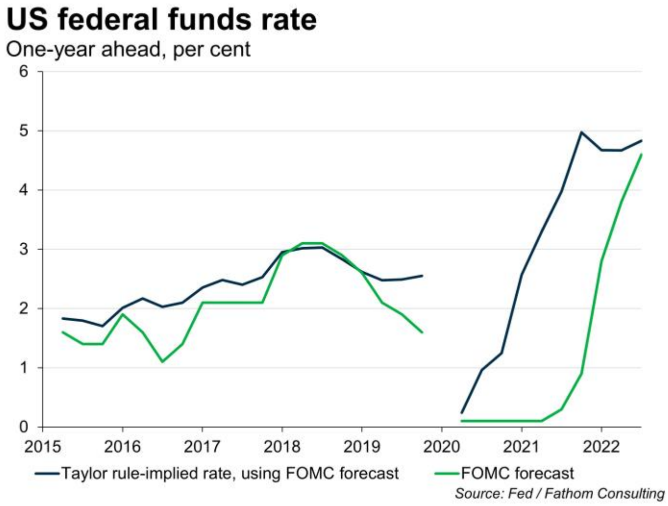
Ultimately, avoiding a recession will probably require a recovery in liquidity followed by a rebound in consumer confidence. (Recall that, in the past 50 years, neither the US nor euro area has previously avoided a recession when confidence has fallen as low as this year.) In this respect, an end to 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.





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

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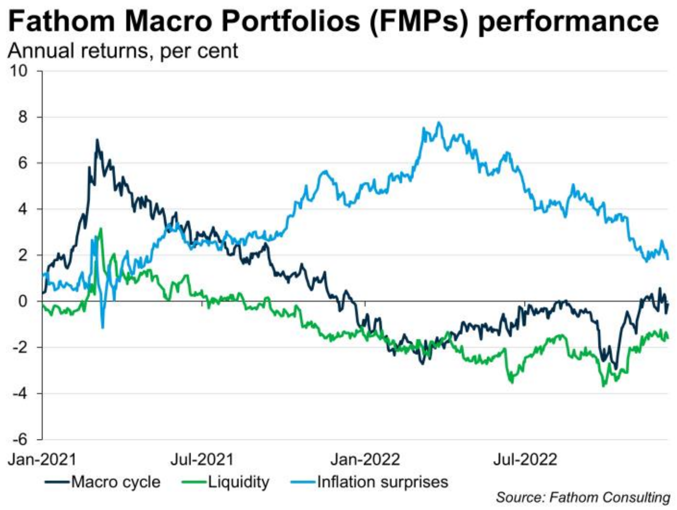
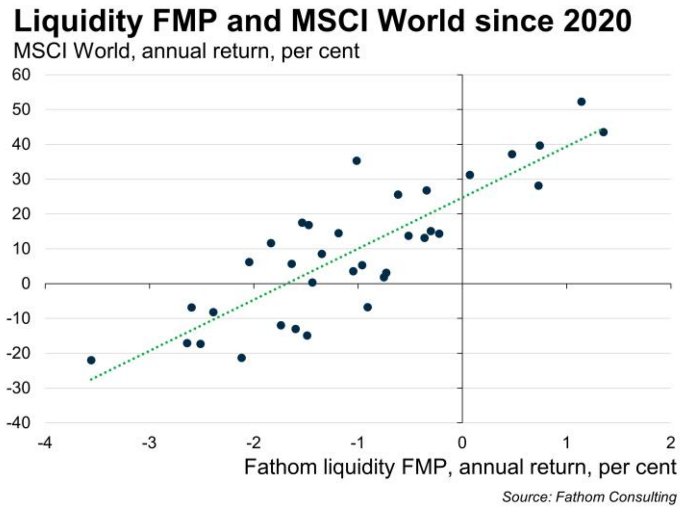
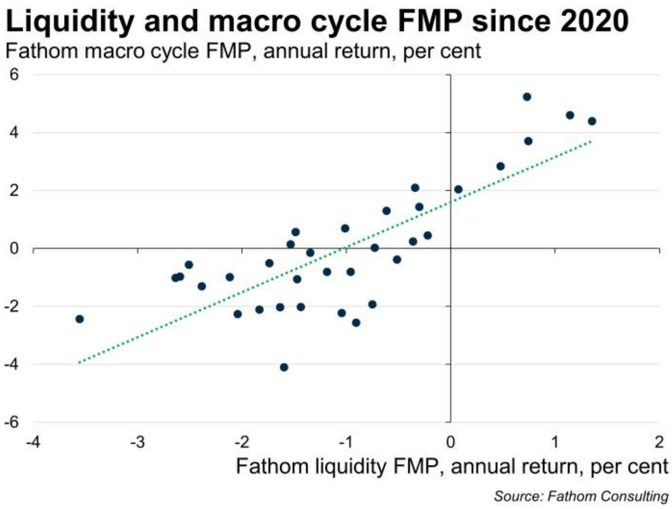


Taken together, these trends tell us that investors have grown progressively less worried about inflation since central banks started tightening monetary conditions. The FMPs also confirm a clear sequence in the macro narrative where tighter monetary policy has led to weaker liquidity, lower growth and 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).





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.

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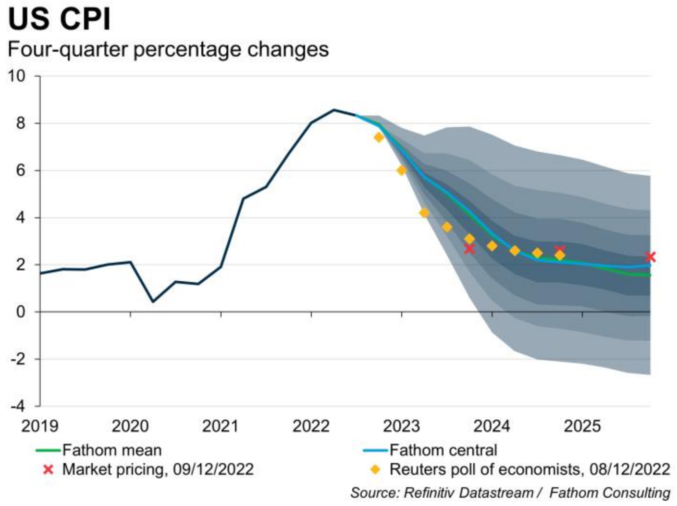
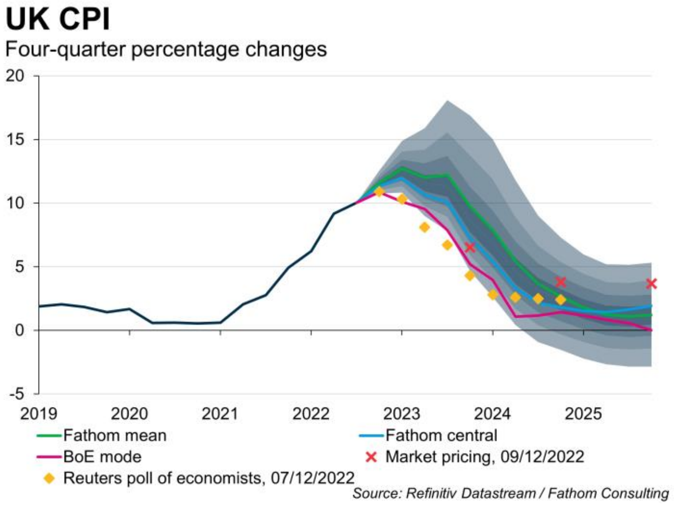
The risk of complacency is high in this respect. Inflation may finally be coming down, but we are not out of the woods yet. Looking beyond base effects, we see inflation easing more slowly than consensus. Moreover, our inflation fan charts are unusually wide, and we see a material risk (15% in the US 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.





Further reading

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

[Energy crisis fuels EU sovereign risks]

[Recession Watch: identifying recessions with uncertain data]

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