# Recession Watch: risk of resurgent inflation

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Erik Britton

**Headlines**

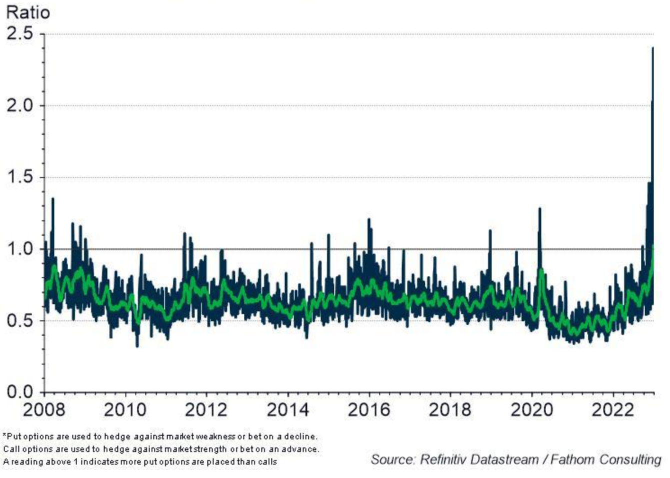
- The guarantee of ultra-low interest rates and quantitative easing – effectively a free put option provided to financial markets by the major central banks – has been removed and, as a result, market participants are having to pay for puts in a way we have not seen since the Great Financial Crisis
- The put/call ratio looks exceptionally bearish for equities, but it is driven at least in part by the removal of the Fed put
- In our central case, the worst news on inflation, growth and the rate cycle is in the past, and 2023 will not see a repeat of the carnage for long-only funds that we saw in 2022
- The main downside risk is if falling inflation (as the first-round effects wash out) intercepts a rising wave of second-round effects: this has happened before and could happen again

2023 kicks off with most of the developed world in or approaching recession. In most cases, this is a 'pause that refreshes' (the UK might be an exception here). The enormous monetary and fiscal stimulus of the COVID period secured the most rapid bounceback the world has ever seen, from the steepest recession it has ever seen. But that stimulus has driven aggregate demand above aggregate supply (still scarred by COVID) in many countries. High demand has provided the kindling for higher inflation, and Russia's pointless invasion of Ukraine has fuelled the inflationary fire.

Against this backdrop, the put/call ratio is, on the face of it, more bearish now than at any time since the Great Financial Crisis. Of course, the reversal has coincided with Powell's hawkish position on rates and QE, which was effectively a removal of the free put option that the Fed had issued to markets from the GFC onwards. With that removed, market participants now have to pay for the same option, and that is what they are doing. It is possible that they were just as bearish before, but felt protected by the Fed put. And the signal also reflects technical factors,[1] so it is not really as bearish as it might seem. It is prudent to take this signal into account when thinking about your asset allocation, but the outlook for equities is probably not as bad as this signal alone might suggest.

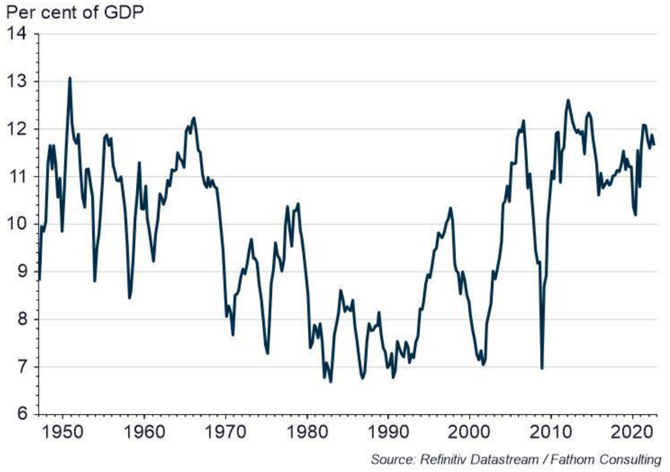
[1] Details available on request

**US CBOE equity put/call***

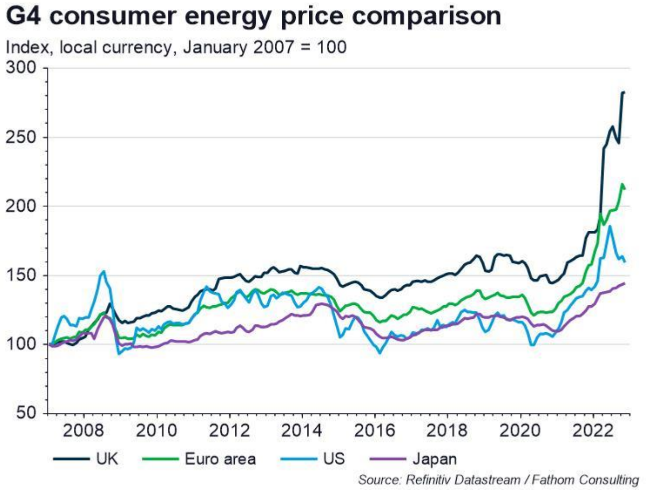



For a start, it turns out that the bearishness apparent in that ratio is not consistent with the news on corporate profits, which remain robust, especially as a share of GDP.

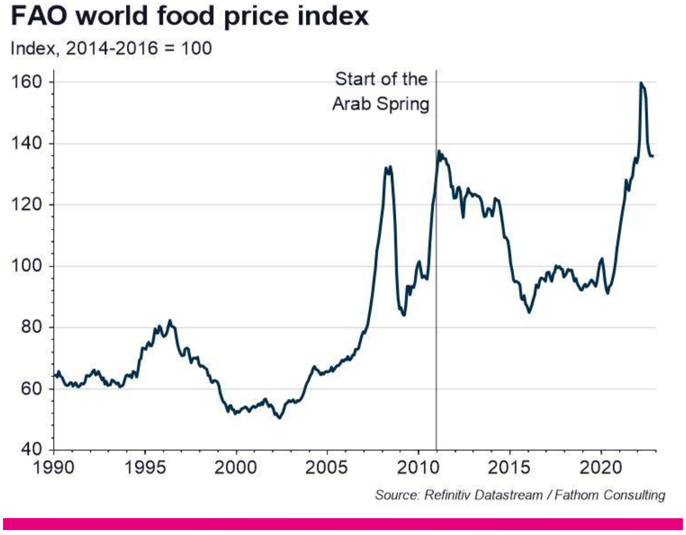
**US corporate profits**



Further, thinking about the US specifically, the worst of the news on energy prices (both wholesale prices and those paid by consumers) may already be in the past. The same is unfortunately not true in the euro area, the UK or Japan.




Looking further afield, food prices are still very high globally, though they have come off their peaks. This level of food prices, if maintained, is likely to create stresses in many developing or less-developed countries. Food prices are extremely important in less-developed economies, where they are a very good predictor of conflict and financial crisis, but less so in advanced economies like the US.



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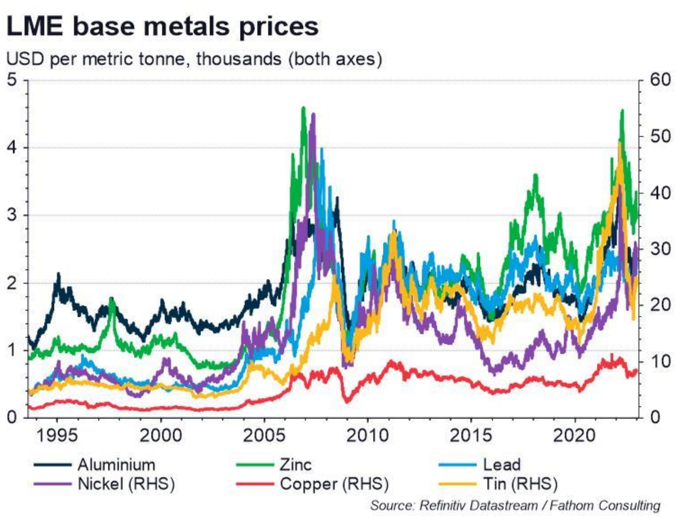
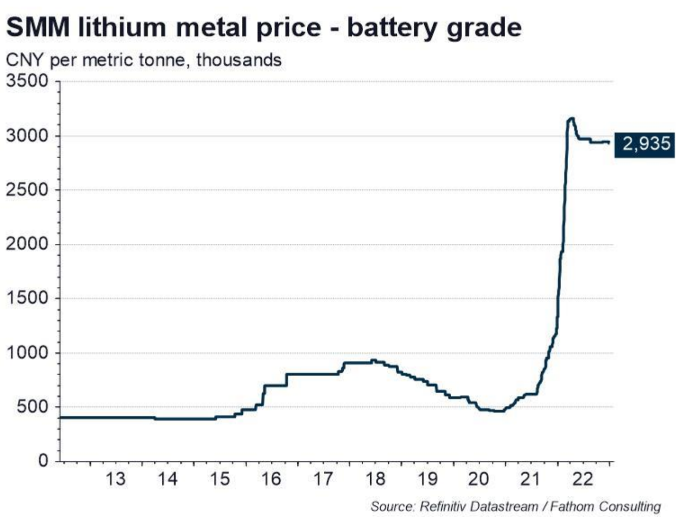
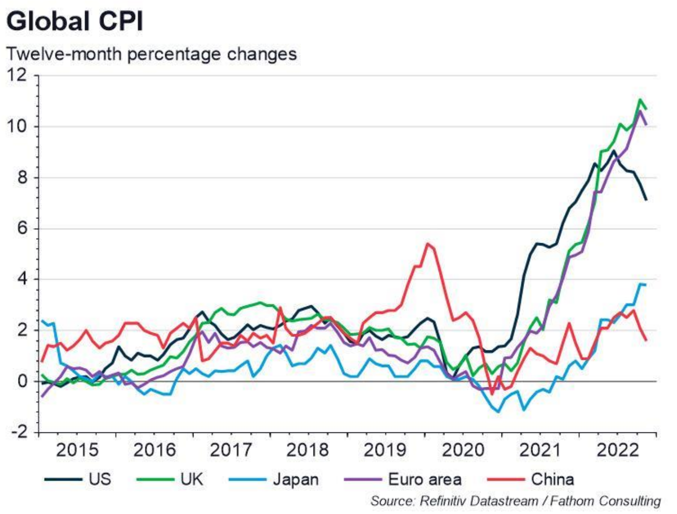
But other commodities such as base metals appear, on the whole, to have decisively passed their peak prices, at least for now. Much here hinges on the short-term outlook for China, which will be improved by the relaxation of COVID restrictions there.



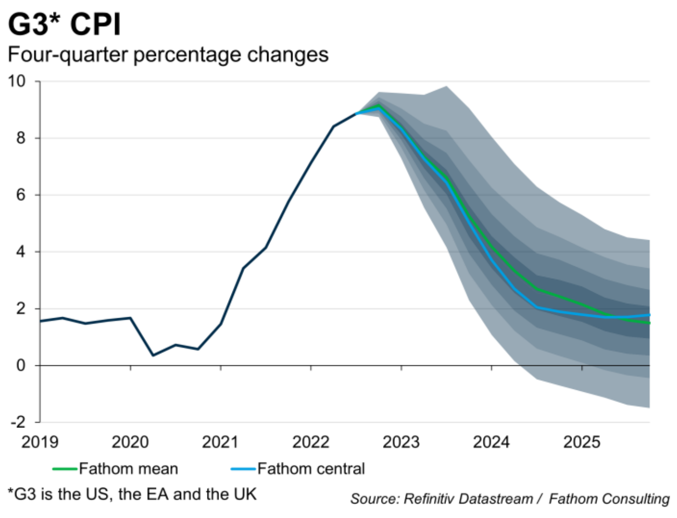

In certain key commodities, though, the story is different – lithium prices, for example, have rocketed in line with demand for electric vehicles, and they remain exceptionally high.



In the US and China, inflationary pressure in the round appears to be waning, but it is still on the increase in the euro area, the UK and Japan.




The UK stands out to us as most vulnerable to an extended period of high or even rising inflation. The outlook for inflation in the US, EA and UK is summarised in the fanchart below.



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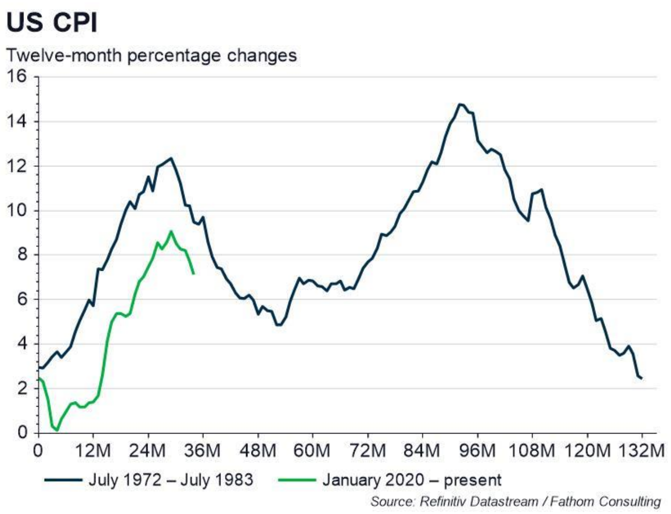
Our central forecast has inflation drifting slowly back down towards the target over the coming two or three years. But that is by no means a certainty, especially in the EA and the UK. And, as the chart below shows, the risk of resurgent inflation cannot be written off even in the US.




The experience of the 1970s showed that the flames of the first-round effects of higher energy prices can start to fade, only to be stoked again by second-round effects through wages and other costs — aggravated in the 1970s by another energy price shock at the end of the decade. The inflationary fire was only finally put out by the Volcker period, and by the recession induced by the monetary tightening he oversaw. It is too soon to be sure that Powell has yet doused the flames in the way that Volcker did. Watch this space.

**Further reading**

[Recession Watch: savings only temporary respite for US]

[Recession Watch: markets two steps ahead of the data]

[Recession Watch: what if Japan releases the brakes?]


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

Contact information
erik.britton@fathom-consulting.com
www.fathom-consulting.com