

Recession Watch: slowly, and then all at once

11 January 2023

Kevin Loane



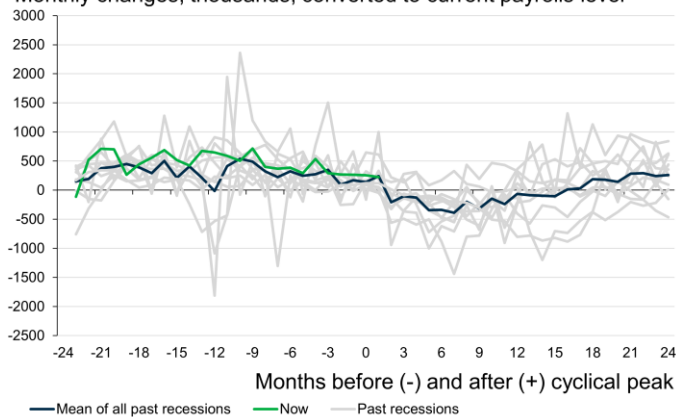
Headlines

- The US labour market remains strong, but is a lagging indicator
- December's services ISM offers the clearest signal yet of looming contraction
- We continue to see further downside to the S&P 500 as the recession bites
- European data surprise to the upside, leading to a resurgent euro

December's US payrolls figures highlighted ongoing gains in employment. Net nonfarm employment increased by 223,000, as its three-month moving average fell to 247,000, marking a big drop from the moving three-month average increase of 580,000 that was recorded at the beginning of 2022. As we highlighted in our *Global Outlook, Winter 2022*, however, strong payroll data are not inconsistent with a looming recession. How did the rich man go bankrupt? Slowly, and then all at once. That, too, is how recessions arrive. Employment tends to flip suddenly from positive to negative territory as the economy enters a downturn. And we expect this to happen in the first half of the year. Elsewhere, earnings data pointed to a softening in wage pressures, with increases in average hourly earnings coming in at an annual rate of 4.6%, which was below the consensus expectation for 5.0%. December's inflation report, which is due tomorrow, is likely to show a further softening in price pressures.

US nonfarm payrolls around cyclical peaks

Monthly changes, thousands, converted to current payrolls level



Source: Refinitiv Datastream / NBER / Fathom Consulting

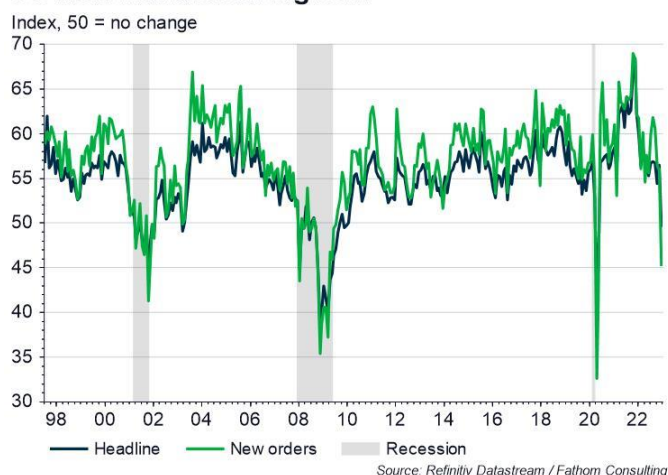
This week the ISM nonmanufacturing report for December offered perhaps the strongest evidence of an imminent recession, with signs of a potential rapid switch. The headline figure dropped 6.9 points to 49.6, well below the consensus economic forecast of 55, and falling below the 50 threshold that separates expansion from contraction for the first time since May 2020. So too did the sub-index that measures employment, down to 49.8 compared to 51.5 in November. Meanwhile, the new orders





subcomponent plummeted to 45.2, a 10.8-point drop compared to November, pointing to a rapid falling away in demand and consistent with further pain in January's numbers. We continue to expect a drop in GDP during the first half of the year, as households either run out of savings or start building up precautionary savings, and as the lagged impact of monetary tightening bites.

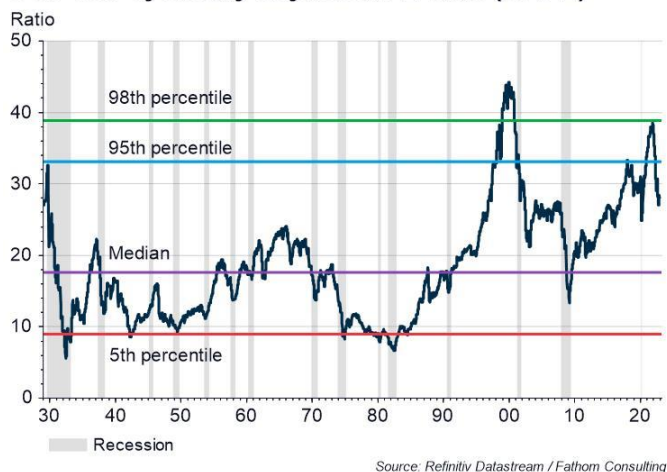
US non-manufacturing ISM



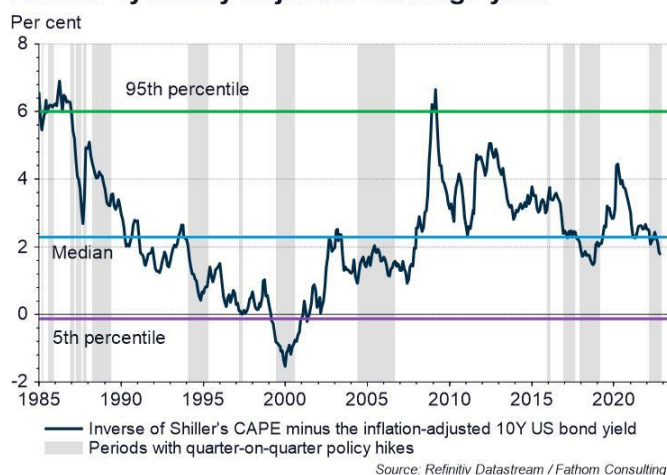
We stick with our view that investors remain complacent about recession risks, focusing too much on the outlook for Fed policy and not enough on company earnings. Since 1950, the median decline in S&P 500 earnings per share during an NBER-defined recession has been 9.9% with a mean drop of 16.2%. However, the mean analyst estimate on Refinitiv Eikon is for a very modest decline in EPS in 2023. This remains inconsistent with the narrative of a widely anticipated economic contraction, with risks to EPS estimates skewed to the downside as a result. Future Federal Reserve rate cuts are unlikely to save the day, as the impact on multiples is likely to be dominated by risk aversion. Despite a decline in multiples, earnings remain well above levels usually reached during previous economic contractions. We continue to believe that the S&P 500 will re-test its 2022 lows this year, staging only a modest recovery thereafter; and that a higher level of long-term interest rates than investors had become accustomed to is likely to prove a medium term headwind to equity returns.



S&P 500 cyclically-adjusted PE ratio (CAPE)



Excess cyclically-adjusted earnings yield



As has been widely discussed, the bout of inflation last year tore up the playbook for a traditional 60/40 equity and bond portfolio. Both assets declined in 2022 in, with bonds unable to offset the drop in equities given high levels of inflation and rapid monetary tightening. This positive correlation to equity and bond returns has remained so far in 2022. However, it could also flip suddenly if disinflationary and recessionary signs continue to intensify as we expect. In our view, bonds are much more likely than equities to offer positive returns this year.



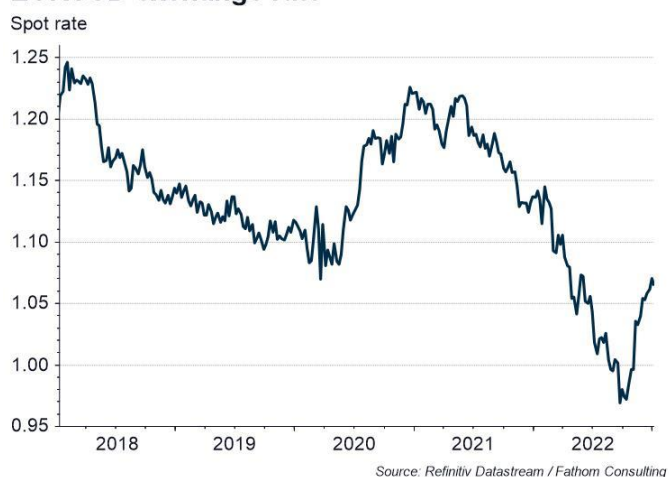


US equity/bond price correlation



Meanwhile, Europe's resilience in the face of its energy price shock has led to a rapid change in investors' perceptions about the continent. We have previously highlighted the impressive ability of euro area economies to reduce their natural gas consumption and pivot to non-Russian sources of energy. The continent has also benefited from relatively mild weather. All of this has helped to cap the increase in natural gas prices. We acknowledged this in our latest *Global Outlook*, upgrading our euro area GDP forecasts as a result. Incoming data have since validated this view, with the labour market remaining strong and German industrial production continuing to expand in November. This positive backdrop has resulted in a sudden change in fortunes for the euro, with the common currency heading to 1.10 against the US dollar after having fallen through parity in Q3 of last year.

EURUSD exchange rate





Further reading

[Global Outlook, Winter 2022](#)

[Recession Watch: risk of resurgent inflation](#)

[Recession Watch: savings only temporary respite for US](#)



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



Contact information
kevin.loane@fathom-consulting.com
www.fathom-consulting.com

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