# Recession Watch: the dog that didn't bark, yet

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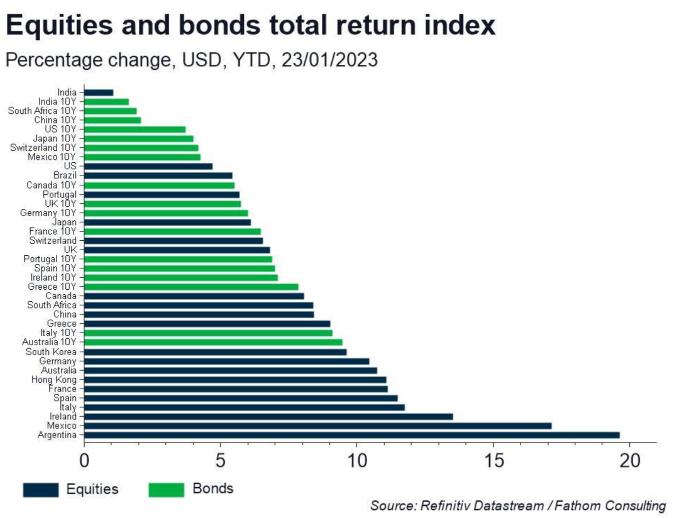
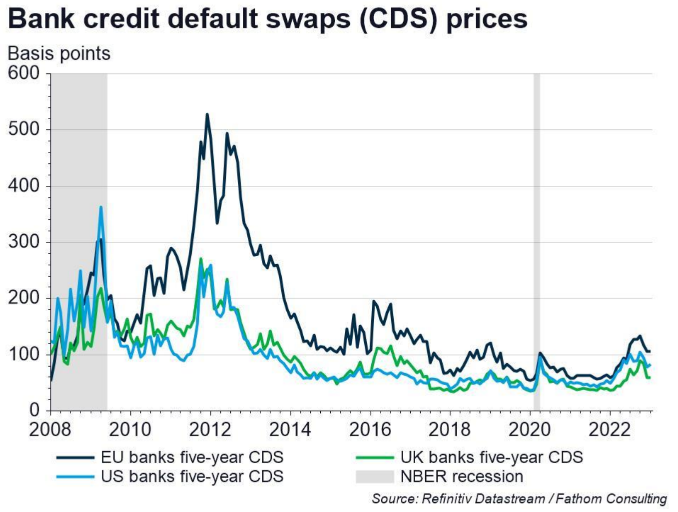
**Headlines**

- The worst of the news on growth and inflation is probably in the past
- Markets concur, with positive returns on bonds and equities, and lower market-implied risks of crises
- Nevertheless, in our central case a slight recession is still coming in most advanced economies, especially the UK – a ripple from the storm that was induced by COVID
- And a rising tide of second-round effects on inflation cannot yet be ruled out

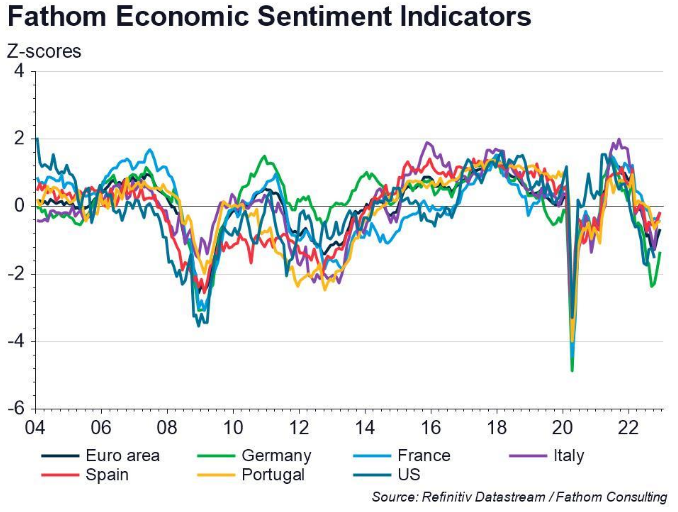
Long-only portfolios were hammered during 2022 but have recovered since then, based on expectations that the worst of the terrible growth/inflation trade-off induced by COVID and Russia's war on Ukraine is now in the past. The question is for how long that recovery can be maintained.




As the outlook has got better, albeit from a very low base, the risk of banking crisis has receded too. According to Fathom's Financial Vulnerability Indicator, the peak risk of banking crisis globally occurred in the third quarter of 2022. Credit default swap markets agree with that assessment.




Measures of economic sentiment have also nudged upwards, though they remain very low. Within that general picture, the euro area (EA) composite PMI surprised to the upside in yesterday's print, being above 50 for the first time since last June.




One of the risks that we have highlighted previously, that a large symmetric shock to the euro area could trigger a reassessment of the asymmetric exposures to sovereign default, in a re-run of the post-GFC experience, has peaked or abated too, without ever having reached the elevated levels we saw in 2012 and 2015 — at least in the estimation of government bond markets, as captured in the chart below.



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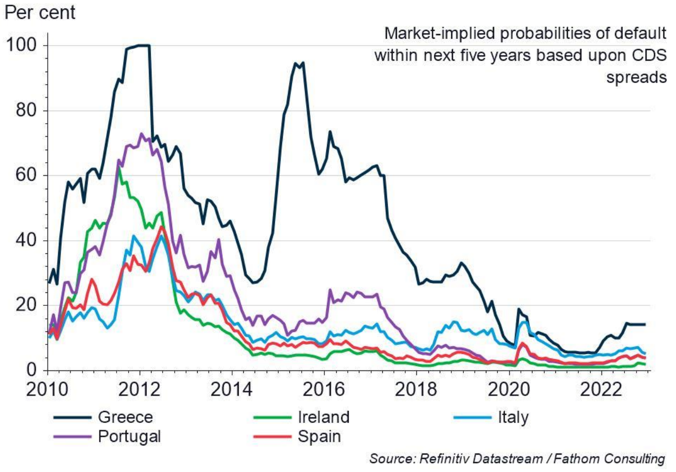
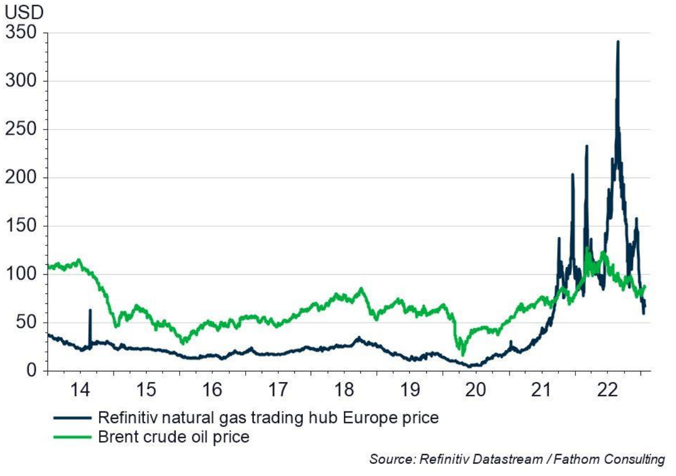
## Euro area probabilities of default




All of this better news springs from easing energy prices, for both oil and natural gas, including for European consumers. Gas prices are still high but are a long way off their peak. As long as the stocks of natural gas in Europe hold (which is our central case), the worst of the first-round effects should be in the past.

## Commodity prices




You need sharp eyes to see the improvement in CPI inflation across the OECD as a whole – both headline and core measures remain very high. But our central forecast has both headline and core measures of inflation slowing from here on.

## OECD inflation

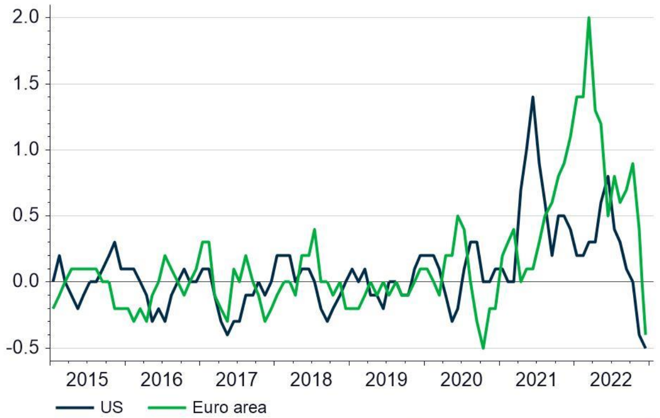
Twelve-month percentage changes


*Source: Refinitiv Datastream / Fathom Consulting*

Unpicking the data on inflation for the US and the EA reveals that the pattern of 'surprises' reinforces that benign view: inflation has surprised on the downside, compared to the Reuters poll of professional forecasters' expectations, for the last few months.

## US and euro area CPI surprises

Percentage points, three-month rolling sums




*Source: Refinitiv Datastream / Fathom Consulting*

But while headline CPI inflation has surprised on the downside, the same is not true for core CPI inflation in the euro area, where upside surprises have continued, with no sign of waning yet. This points to the risk of second-round effects coming through to a greater extent than most forecasters anticipated, particularly in the EA.



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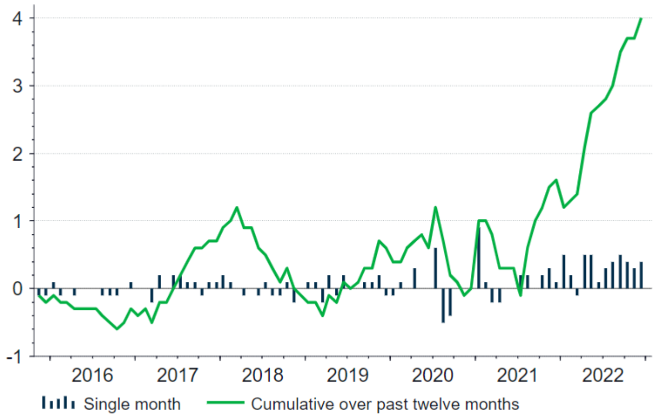
## EA core CPI surprises

Percentage points




All told, the worst news is probably in the past (presuming there are no further negative shocks like Russia's invasion of Ukraine). But that does not mean we have avoided recession. It is more a question of how bad the recessions might be, across countries. Monetary policy, famously, operates with long and variable lags, and some of the impacts of higher rates (such as on house prices and, via wealth effects in general, on economic activity) have yet to be felt in full. In our central case, the UK and the EA will see a recession within the coming two quarters,[1] while the US will enter recession later in the year. The downturn will not be anything like as bad as the pandemic experience and, for most countries, is correctly thought of as a ripple from that storm: a pause that refreshes, so to speak. The case is worse in the UK than elsewhere, though even here the news over the last month or so has been less bad than we feared towards the end of 2022.

And, before we all get carried away, there remains a pronounced risk that declining first-round effects on inflation will intercept rising second-round effects through wages, profits and other nominal quantities. This risk is particularly pronounced in the EA and the UK, and is a key theme in our forthcoming global outlook.

**Further reading**

[Recession Watch: tightening with both hands]

[Recession Watch: slowly, and then all at once]

[Recession Watch: risk of resurgent inflation]

1. UK GDP is likely to have ended 2022 lower than it was in July of that year, even if, so far, it has avoided a 'technical' recession in the sense of two consecutive quarters of negative q/q growth.



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