Recession Watch: Goldilocks and the macroeconomic bears

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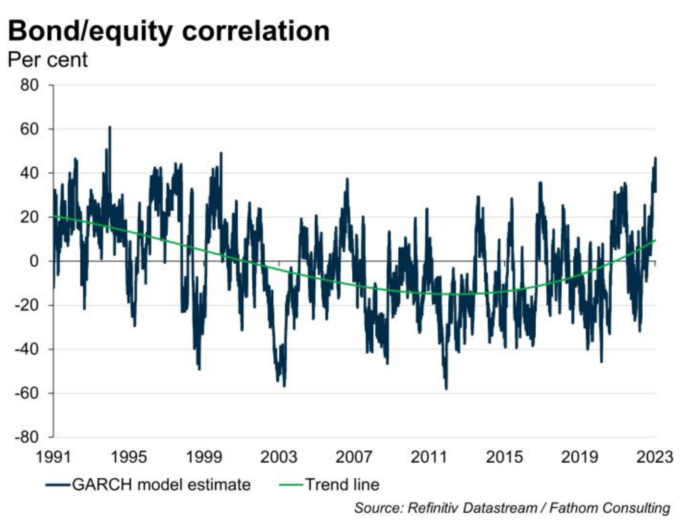
Headlines

- Markets are close to pricing in a Goldilocks environment, consistent with low inflation and stronger growth
- We remain of the opinion that this is premature, and we offer evidence of a deterioration in economic fundamentals consistent with a recession that is not yet reflected in asset prices
- In Fathom's opinion, the rebound in markets since summer 2022 is more of a victory parade for vanquishing inflation and for the potential end of the tightening monetary cycle than a true reflection of the macroeconomic picture
- We reiterate that it seems unlikely that we will escape a recession, and that central banks will deliver the expected interest rate path. Either of these two macroeconomic trends could end up disappointing increasingly bullish investors
- We maintain a cautious stance in our asset allocation, as signalled by the Fathom Risk-off Gauge

At the end of last year, the thesis we put forward to our clients was broadly one where the effect of rate hikes had mainly affected markets through the discount channel, but it had not been felt yet on the real economy. Last week's *Recession Watch* note laid out some evidence that data has been improving, feeding a market rebound, but that ultimately a recession is still on the cards. Even if a recession remains widely expected, the debate around it is increasingly turning towards its severity or whether it may even happen at all. In this week's note, we'll turn to markets for clues over this question.

In general, last year saw one of the most synchronised cross-asset sell offs in decades. According to our calculations, corrective actions from the Fed to fight inflation pushed the bond/equity correlation to the highest level since the late 90s, offering few places for investors to hide with both assets posting negative returns.



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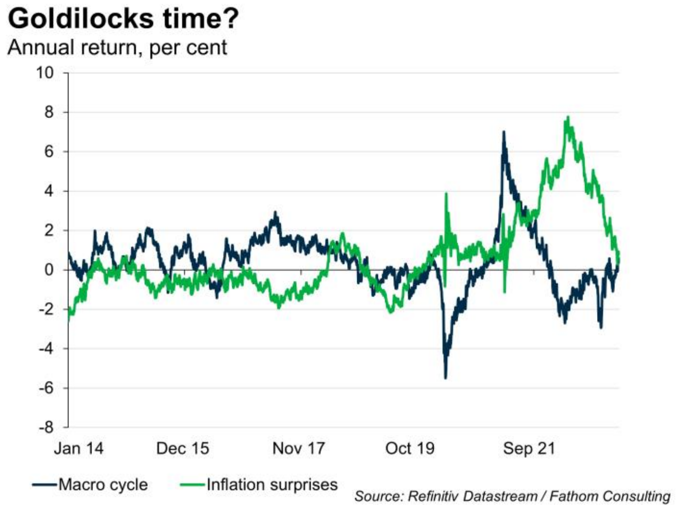
As a result, 2022 also provided strong evidence in support of our long-held view that creating portfolios resilient to different macroeconomic regimes could add more value than simply diversifying across a broad pool of assets. We built our allocation toolbox precisely to allow us to track how markets are adapting relative to the evolving macroeconomic landscape and to Fathom's own fundamental views about the global economy.

Just now, our toolbox suggests that investors may not only have shrugged off recessionary fears, but they could also be on the verge of embracing a Goldilocks scenario, consistent with low inflation and stronger growth. For example, the inflation surprise Fathom Macro Portfolio (FMP) is showing that assets tracking inflation surprises have fully reversed the significant gains accumulated over the course of 2021 and 2022. At the same time, a positive trend in our macro cycle FMP — a portfolio of assets tracking global economic activity — has become discernible since around the end of 2021. The combination of disappearing inflationary concerns and improving macroeconomic conditions would suggest that not only have investors started to become less worried about a recession or higher rates, but also that a Goldilocks environment may be within reach.



Further market evidence supporting this view is not hard to come by. For example, consumer staples stocks — an equity investor staple (pun intended) during uncertain times — appear clearly out of favour. So far in 2023 consumer staple stocks are down 12% relative to consumer cyclical stocks, which are generally preferred by investors in times of plenty. Also, notoriously macro-sensitive stocks such as copper miners gained about 40% more than the broader S&P500 index between the start of September 2022 and the present, including a 10% relative rise in 2023 alone.

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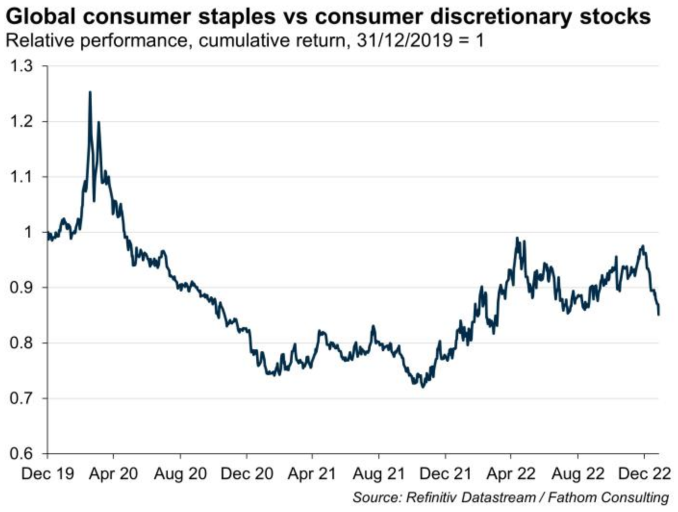
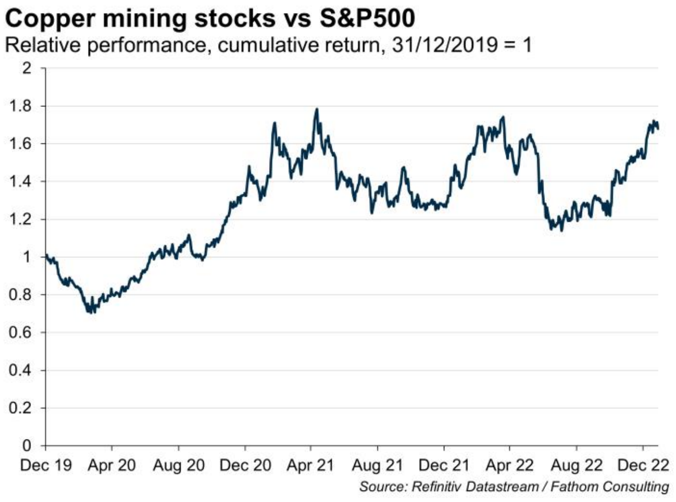
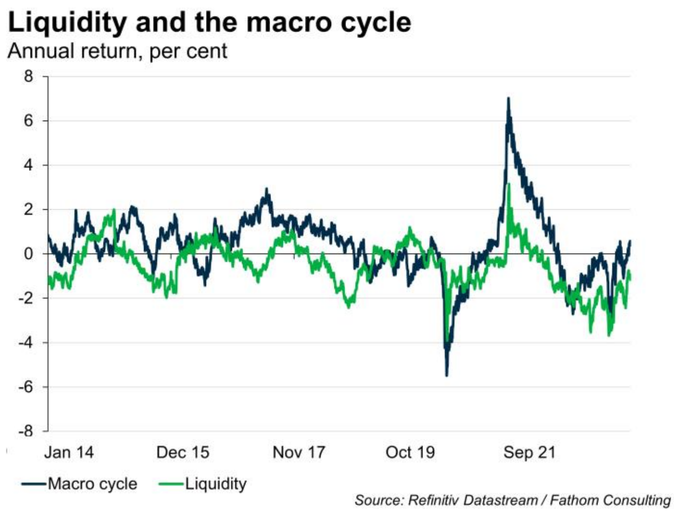




All this could suggest that the market also believes that the worst of the macro news may be behind us. However, we also find sufficient evidence to argue that the market upswing since last summer may have been driven less by hard data over the state of the economy and more by hopes over a Fed pivot. For example, we noted in our *Global Outlook, Winter 2022* that since 2020 the evolution in the macro cycle FMP has been highly correlated to that of our liquidity FMP. This is not a common occurrence, and would support the view that it is primarily discounting effects that are driving assets, rather than tangible improvements in economic fundamentals.



More evidence on this comes from other assets too. The performance of gold mining stocks, for example, showed little variation relative to copper mining stocks in 2022, in spite of their much lower sensitivity to macro conditions. In other words, copper mining stocks ought to have significantly outperformed gold ones if improving fundamentals had been the main driver of their recent strong performance. Instead, the comparable recent trends in gold and copper mining stocks can be primarily explained by waning inflation surprises and improving liquidity conditions, two macro forces that affect both assets in a broadly equal fashion, according to our calculations.

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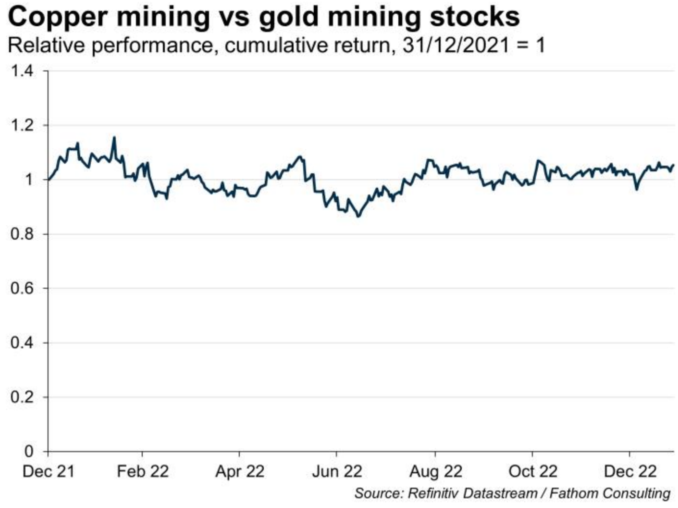
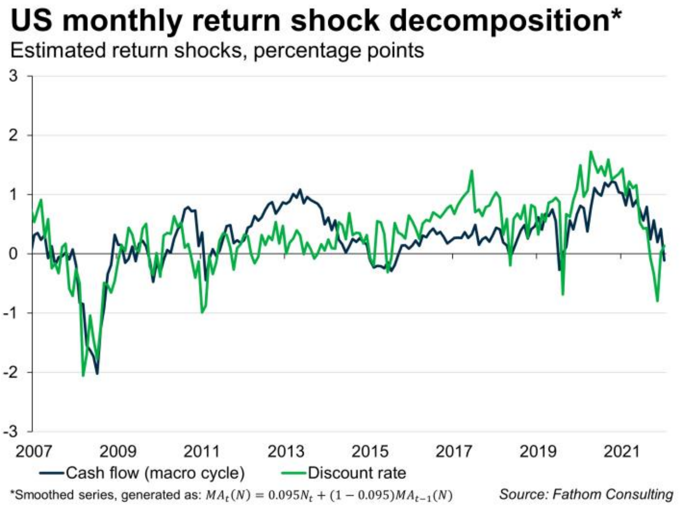


More direct evidence from company earnings is also not particularly supportive of the idea that investors have priced in weaker fundamentals. Decomposing US equity returns between cash flow (i.e., the fundamental part) and discounting effects (i.e., the rate-sensitive part) highlights how the latter has shown signs of a rebound while the former has not.



With the US earning season in full swing, earning expectations continue to be revised lower by analysts. Expectations for 2022 Q4 earning growth have turned negative, as have those for the first two quarters of this year, but the full 2023 earnings growth estimate remains positive at 3.1% (even if down from 9.8% last April).

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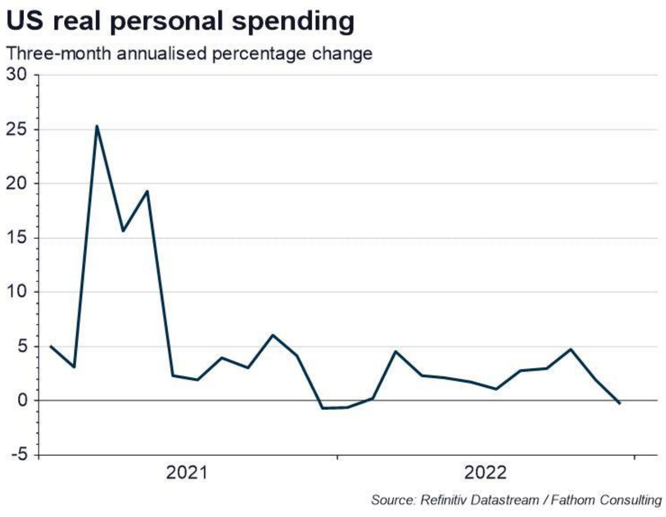
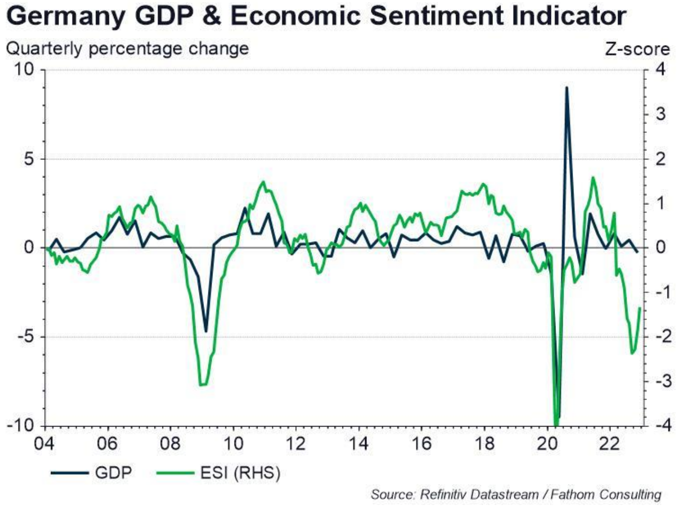
S&P500 bottom up analysts' estimates, growth rates								
	22Q4	23Q1	23Q2	23Q3	23Q4	24Q1	24Q2	24Q3
Revenue	4.2%	2.2%	-0.1%	1.0%	4.1%	4.8%	4.9%	5.4%
Net income	-6.1%	-3.0%	-3.8%	1.6%	9.3%	8.4%	8.8%	8.6%
Earnings	-2.7%	-0.9%	-1.8%	4.1%	9.8%	10.7%	10.5%	11.0%

Source: I/B/E/S / Refinitiv

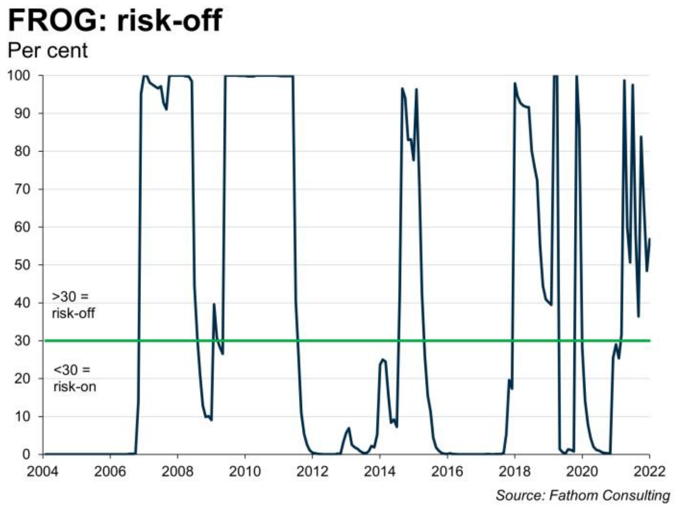
Perhaps, the clearest indications that a recession is still on the cards despite the more recent buoyant market performances have come from the hard economic data. Last week, the US reported a drop in real spending driven by higher saving, as flagged before in past *Recession Watch* notes.



To take another example, this week German GDP was reported to have unexpectedly contracted by -0.2%, against expectations for a flat outturn.



This week will also see the Fed delivering its latest rate decision, and with markets on the edge of a Goldilocks scenario, the risks for disappointment seem particularly elevated. If the US swerves a recession, or this proves to be a mild one, then a negative surprise for investors may well end up materialising again from rates rather than from weaker economic activity. In either case, we continue to advocate a more cautious stance .Our Fathom Risk-Off Gauge (FROG) remains in risk-off territory, a signal that has stood us in good stead over the course of a tricky 2022.



Further reading

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

[Recession Watch: tightening with both hands]

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

[Fathom's Top 10 reads for 2022 Q4]

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