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Independent Thinking

February round-up: macroeconomic strategy

9 March 2023

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Last month Fathom's economists focused their attention on the highly uncertain global macroeconomic picture and whether an economic downturn was looming. We explored why there are fewer recessions these days, why the jobless rate is a poor leading indicator of recession, whether current US market pricings are too optimistic, and whether an upward creep in EA inflation swap rates will herald more aggressive ECB tightening. Read on for a round-up of some of the economic insights Fathom sent to clients in February.

Where have all the recessions gone?

Unemployment and recession

US outlook that markets are pricing in

EA inflation expectations on the rise

Where have all the recessions gone? (8 February 2023)

- January's strong payrolls data led many to push back the expected date when a widely anticipated US recession will start
- Taking a longer view, US recessions (using the National Bureau of Economic Research definition) have become less frequent over the past century, occurring 22% of the time from 1900 to 2022, but just 9% of the time from 1990 onwards
- Historically, many recessions were caused by high inflation and the subsequent monetary tightening required to bring price pressures back down
- It is possible that the era of inflation targeting has helped to anchor inflation expectations, and has reduced the need for aggressive monetary tightening, until now at least; and that this in turn has reduced the volatility of output
- While having fewer recessions is something we should celebrate, it is also worth noting that the recent period with fewer recessions has been accompanied by historically poor productivity growth and a huge financial crisis — there is no free lunch

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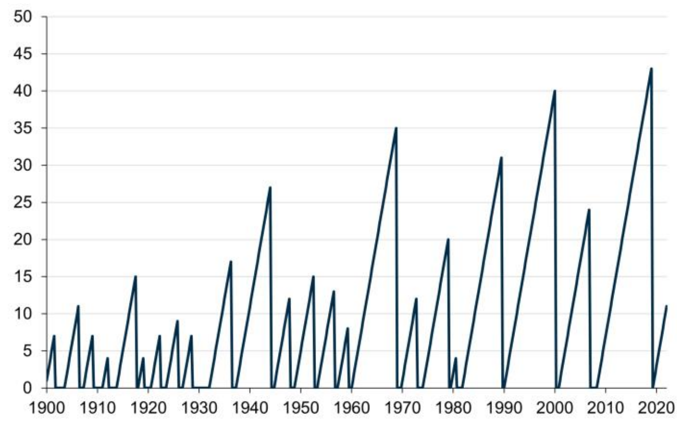

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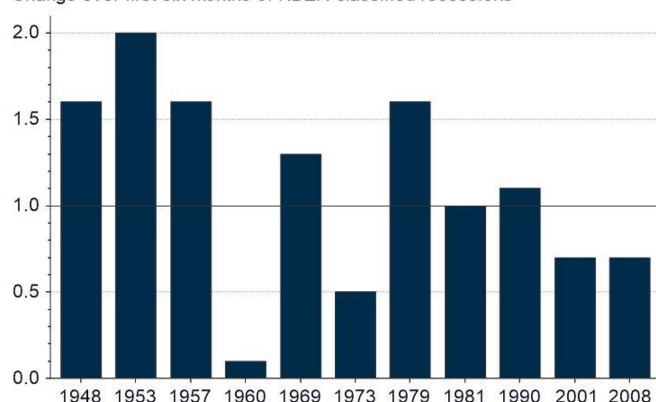
Unemployment and recession (15 February 2023)

- Treasury Secretary Janet Yellen recently suggested the current strength of the US jobs market makes an imminent US recession less likely. The US unemployment rate is at 3.4% and over 500,000 jobs were added in January
- But the unemployment rate is not always a very timely indicator of recession. Jobless totals rose by more than a percentage point in the first six months of only six of the last eleven US recessions
- And unemployment may be particularly slow to increase during the next recession due to the wounds of the pandemic. Many employers found it costly to re-hire after lockdown, meaning businesses may be more reluctant to make redundancies should demand reduce in the coming months
- There is no official definition of a recession, but the most commonly used rule of thumb (also known as a 'technical recession') is that it constitutes at least two consecutive quarters of negative real GDP growth. In the United States, the National Bureau of Economic Research (NBER) maintains a track record of US business cycles and defines a recession more broadly as "a significant decline in economic activity that is spread across the economy and that lasts more than a few months"
- Recessions are non-linear events, which are often triggered by a sudden change in behaviour. We tend to know them when we see them, and a range of factors should be assessed in making that judgment



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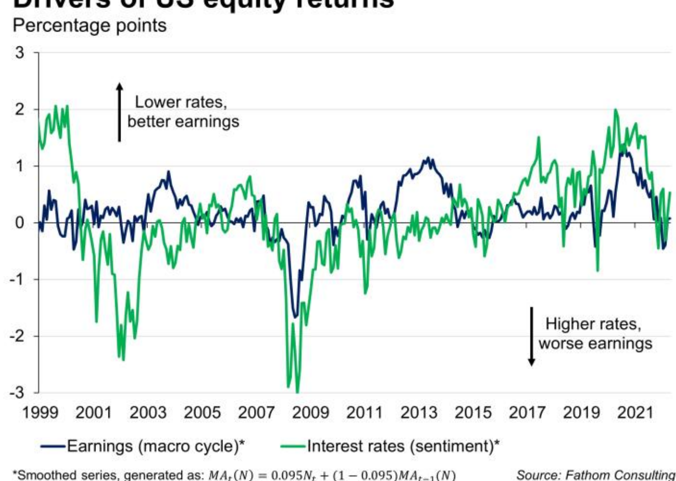
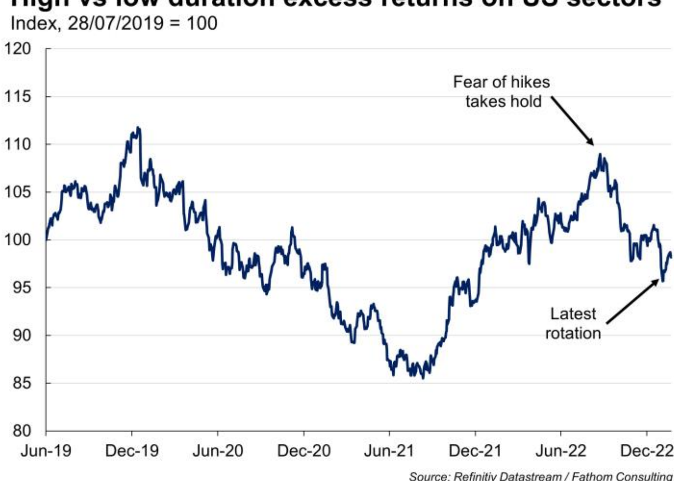
US outlook that markets are pricing in (22 February 2023)

- Clues as to the current assumptions of the markets can be gleaned from the movements of interest rates and the earnings components of US returns
- Recent positive news on inflation and the US jobs market has set the scene for a drastic easing of the interest rate component (for further details, see Fathom Chief Economist Andrew Brigden's latest *Recession Watch* note)
- Equity returns suffered in the period from June 2022 when markets were pricing in higher policy rates, but since the start of 2023 this phase has been replaced by a recovery that feeds on optimism about an imminent Fed pivot (even though the Fed has remained hawkish in all communications)
- Markets are no longer pricing in recession trauma to the same extent as before, highlighting a belief that the US economy is resilient and thus any shock is unlikely to have the negative impact that was previously assumed
- Equity sectors which traditionally have long equity duration (e.g., tech, computer services, real estate, biotech and, travel),[1] and are therefore more affected by interest rate shocks, saw their equity prices tumble in 2022 H2; but as the pricing of rates has eased, so have the price pressures on long duration stocks
- Overall, the market has rotated to reflect expectations of better potential US outcomes; but the rebound those expectations have brought may prove short-lived if the additional conditions for a Fed pivot are not met, and if the US indeed experiences a recession — a plausible outcome that Fathom will explore in its forthcoming *Global Outlook, Spring 2023*





1. Like bonds, shares have a measure of duration that reflects the average time to maturity of cash flows — i.e., how long an investor has to wait to pocket all future benefits. The concept was developed by Dechow et al (2004), who came up with a measure that resembles the Macaulay duration of bonds.

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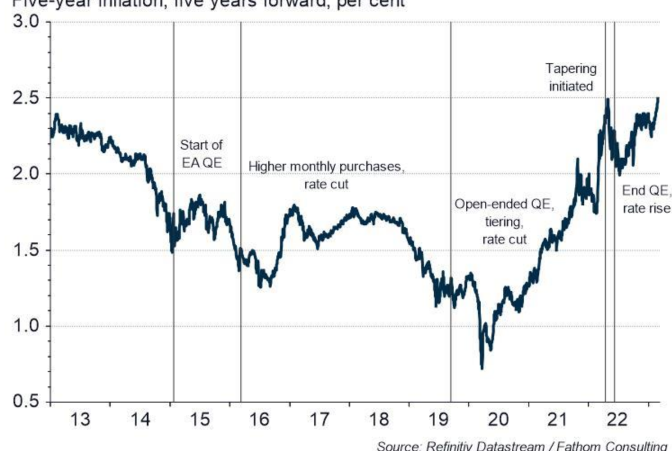
EA inflation expectations on the rise (2 March 2023)

- Market-based measures of euro area inflation expectations are rising and, if history is anything to go by, the European Central Bank (ECB) may tighten even more aggressively as a result. Fathom's *Global Outlook, Spring 2023* will present our view on further euro area policy rate hikes
- A pattern has developed over the past decade where large movements in five-year, five-year forward inflation-linked swap rates[2] have tended to be followed by significant ECB policy changes
- The ECB announced the start of euro area QE less than six months after former ECB President Mario Draghi's speech at Jackson Hole, in 2014, drew attention to declines in the 5Y5Y-forward measure of inflation expectations
- Inflation expectations also declined in the run-up to new announcements on asset purchases in 2016 and 2019
- Medium-term inflation expectations are now well above target, with the 5Y5Y-forward rate at close to 2.5%. While de-anchoring on the downside was arguably more concerning for the ECB, given proximity to the lower bound for interest rates, policymakers will also be reluctant to allow higher expectations to cause second-round effects
- Central bankers view medium-term inflation expectations as crucial determinants of inflation. Jim Bullard, the St Louis Fed President, last week argued that for the US "inflation expectations may play a large role in the coming disinflation, as opposed to the size of the output gap or the level of unemployment"



2. This is the average inflation rate over a five-year period starting in five years' time, as implied by inflation-linked swap rates.

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Chart authors: Kevin Loane, William Hynes, Dimos Andronoudis

Further reading:

Recession Watch: no landing… for now

Introducing *Welcome to the machine*

Global Outlook, Winter 2022: Preview

In case you missed it, here's last month's round-up:

January round-up: China economics

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