Recession Watch: flipflopping

8 March 2023

Andrea Zazzarelli

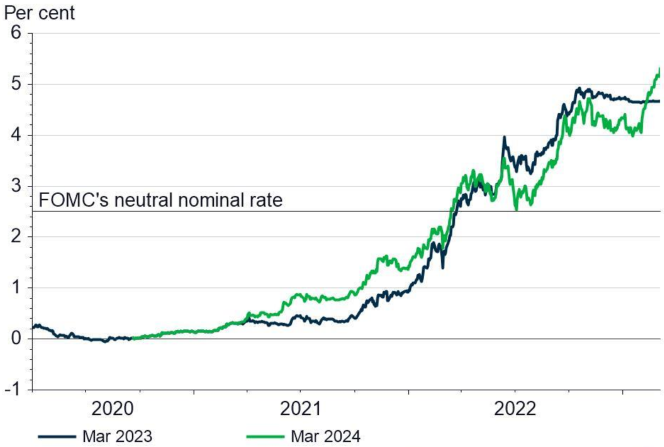
Headlines

- As economic data continue to surprise on the upside, markets flipflop again from worrying about a recession to fretting about higher rates
- A recession is probably delayed, but is still on the cards as the rebound in post-lockdown China has peaked
- The real estate sector holds the key to tracking the long and variable lags of the impact of tighter rates on the real economy
- Drops in real prices in key real estate markets and weaker housing demand in the US present clear fault lines that should be taken seriously

In our *Recession Watch* of 1 February, we argued that investors could not have their cake and eat it. We warned that the receding probability of a recession might be superceded by the risk of higher rates, and that moving to such a scenario would not improve the outlook for markets. The two outcomes were also not mutually exclusive — the chances of suffering both were always a matter of timing.

This is almost exactly what has happened over the past month. The chart below shows how investors have backtracked on expectations of rate cuts, and priced in further rate hikes over the next twelve months. As in February, inflation expectations remain the key variable determining which scenario might prevail, and when. The received wisdom in economics says that a stronger-than-expected outturn in growth should lift inflation expectations, and force a still more hawkish stance from monetary policymakers who are already grappling with the post-pandemic acceleration in prices.

Fed funds futures

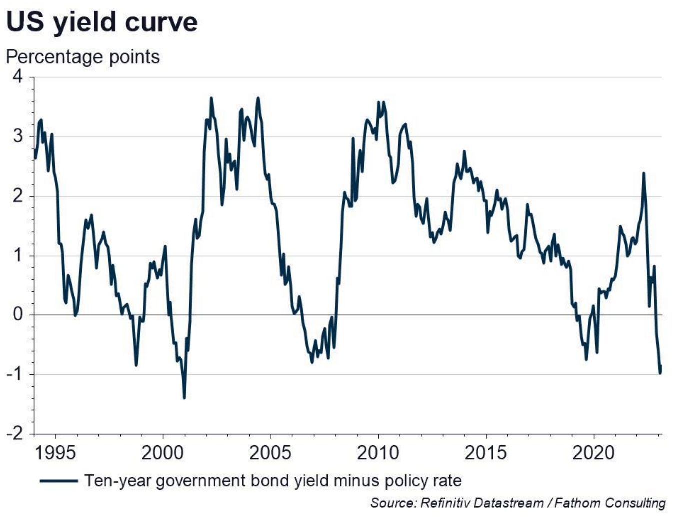


Source: Refinitiv Datastream / Fathom Consulting

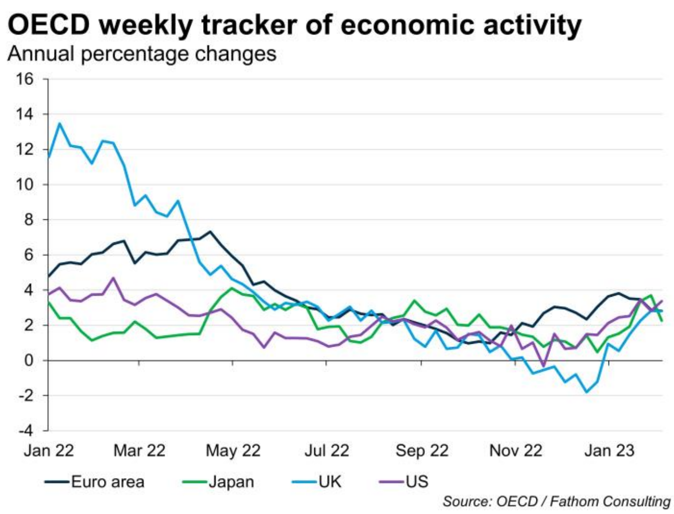
Continued

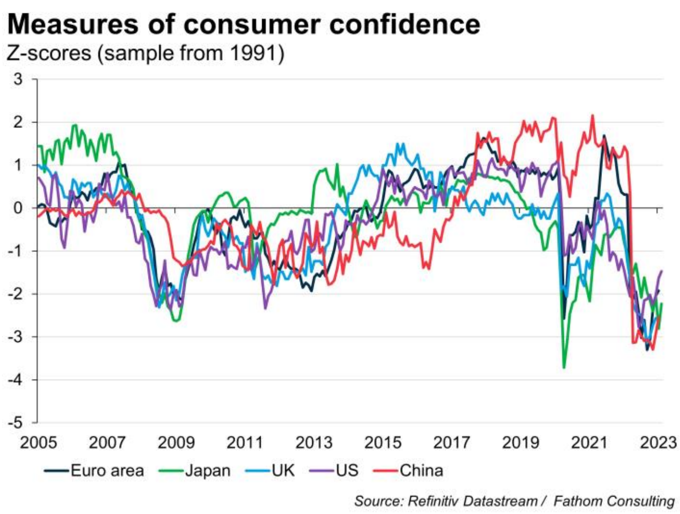
Investors flipflopping between recession and higher rates via inflation expectations are an important, if not the most important, source of market volatility; and this is the type of environment where Fathom can add a lot of value. In our just-released *Global Outlook, Spring 2023*, we explain why we still expect a recession to materialise, even as the economic outlook seems to have brightened up. The main thrust of our argument is that different data points provide different signals about the timing of a recession. In particular, macroeconomic data are generally better at telling you if you are in a recession right now, while market data, such as the yield curve, are better at explaining a slowdown six to twelve months out.

Over the past weeks, the US yield curve has inverted even more, signalling that the risks of a recession are very much alive.



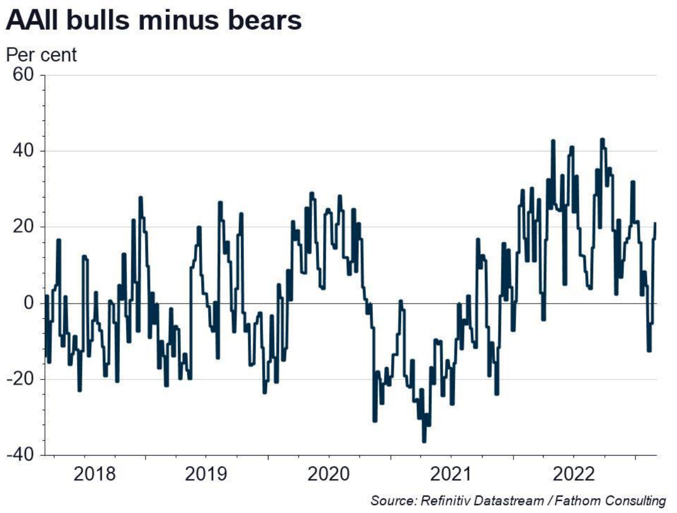
However, investors have also reacted to the better macroeconomic data, effectively shunting recession risks further down the line. As a result, recent [polls from YouGov] shows that 51% of US consumers still expect a recession, but this figure is down from 60% in November and the share of consumers reporting an improvement in the economy has risen from 9.3% in early July 2022 to 16.9% at the end of February 2023. The [Atlanta GDP tracker] estimate for 2023 Q1 rose significantly ahead of the Blue Chip consensus in February. Also, the OECD GDP tracker has picked up since the latter end of 2022 Q4 across some key developed markets, as has consumer confidence, as the charts below show.



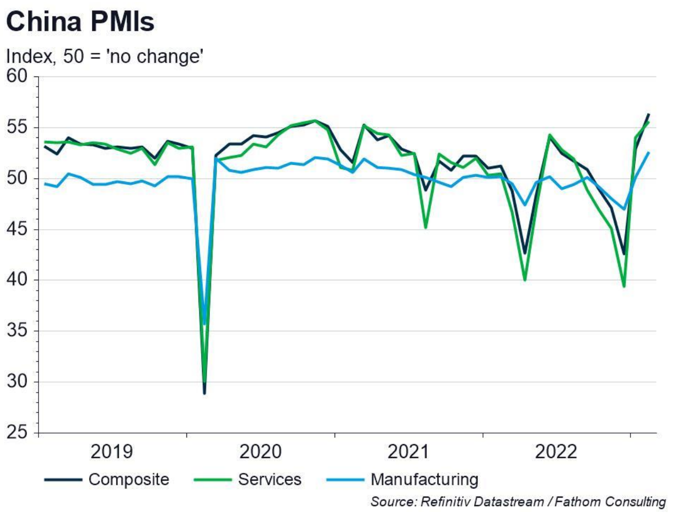


Continued

Even more tellingly, the AAII bull-to-bear ratio — a market sentiment indicator frequently used as a contrarian signal — flipped from pointing at bearish to bullish conditions in the space of three weeks.

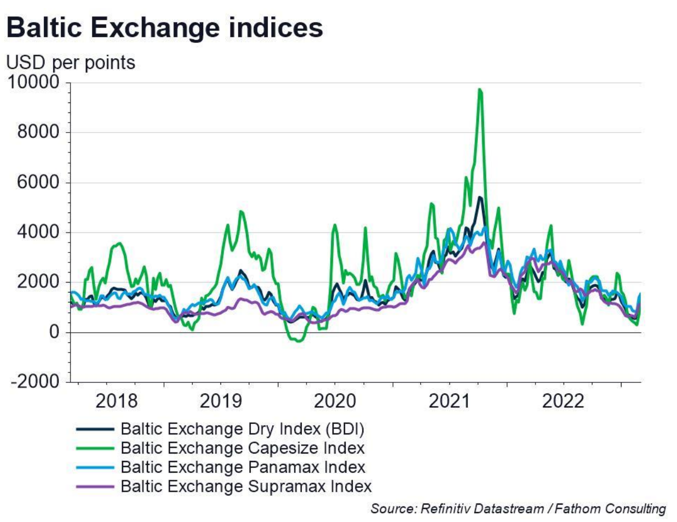


Some of the recent improvements in the macro data can be attributed to China's reopening after abandoning its zero-COVID policy. Chinese manufacturing and services PMI rose again last week, reaching their highest level since the pandemic.



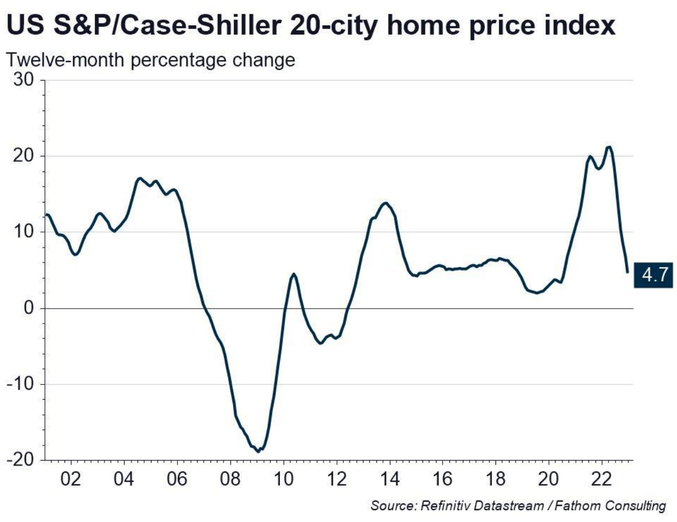
However, the positive boost to the global economy from China's reopening may have already peaked, as our *Global Outlook, Spring 2023* points out. The steady decline in freight rates lends credibility to this view, indicating a drop in demand for manufactured goods that is too sharp to have been solely the result of the ongoing reshaping of supply chains. Data from the [Association of American Railroads] report lower traffic loads in 2023 than at a similar point in 2021 and 2022, adding to the evidence that weakening US demand may be contributing negatively to an oversupply of shipping services.

Continued



All told, if back in February investors seemed to be premature in cheering the defeat of inflation, then perhaps now they are dismissing the risks of a recession too quickly. We think monitoring changes in the property sector will be key in tracking how far and how quickly tighter monetary policy impacts the real economy – the so-called long and variable lags.

Recent work, again outlined in our *Global Outlook, Spring 2023*, identifies house prices in Sweden, France, Canada, Spain, Denmark and the UK as bellwether markets. Real house prices in these markets were already down -2.3% on average as early as 2022 Q3 compared to other developed markets, which were broadly flat. A flurry of recent data from the US confirms a stuttering housing market there too. With 30-year fixed mortgage rates reaching 7% last week, demand for housing is getting hit. The Mortgage Bankers Association reported a drop in mortgage applications of -5.7% YoY last week, and purchase applications sat at the lowest level since the mid-90s. Sagging demand has led to a slowdown in house prices, but they still remain 4.7% above the level recorded a year ago, according to the Case-Shiller Index released last week.



Continued

However, the weaker demand for housing is already having knock-on effects on other sectors. For example, lumber prices have dropped sharply and remain close to their pre-pandemic lows, while US private residential construction spending fell 3.9% YoY in January, according to the Census Bureau.

Further rate hikes and weaker demand are not the only risks potentially affecting real estate markets. So far, lower inventories have probably cushioned the slowdown in house prices, but this may change, and we remain particularly watchful of large, leveraged, buy-to-let investors downsizing their portfolios and potentially flooding the market with significant new supply. On the bright side, household balance sheets appear in better shape than prior to 2008, and may be more resilient to a real-estate shock. The same, however, cannot be said about non-financial corporate balance sheets, but perhaps this is a topic better left for a more in-depth analysis in a future edition of *Recession Watch*.

Further reading

Recession Watch: Goldilocks and the macro bears

Global Outlook, Spring 2023: Markets risk repeating mistakes of the past (non-subscribers can request to read)

Recession Watch: no landing… for now

Recession Watch: the pause for breath

Continued

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

Contact information
andrea.zazzarelli@fathom-consulting.com
www.fathom-consulting.com

Regulatory Disclaimer

FFC LIMITED and all of its affiliates (henceforth FFC) do not conduct "investment research" as defined in the FCA Conduct of Business Sourcebook (COBS) section 12 nor do they provide "advice about securities" as defined in the Regulation of Investment Advisors by the U.S. SEC. FFC is not regulated by the SEC or by the FCA or by any other regulatory body.

This research report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Nonetheless, FFC has an internal policy that prohibits "front-running" and that is designed to minimize the risk of receiving or misusing confidential or potentially material non-public information.

The views and conclusions expressed here may be changed without notice. FFC, its partners and employees make no representation about the completeness or accuracy of the data, calculations, information or opinions contained in this report. This report may not be copied, redistributed or reproduced in part or whole without FFC's express permission.

Information contained in this report or relied upon in its construction may previously have been disclosed under a consulting agreement with one or more clients. The prices of securities referred to in the report may rise or fall and past performance and forecasts should not be treated as a reliable indicator of future performance or results. This report is not directed to you if FFC is barred from doing business in your jurisdiction. Nor is it an offer or solicitation to buy or sell securities.

Analyst Certification

I Andrea Zazzarelli, the lead analyst, certify that the views expressed herein are mine and are clear, fair and not misleading at the time of publication. They have not been influenced by any relationship, either a personal relationship of mine or a relationship of the firm, to any entity described or referred to herein nor to any client of FFC nor has any inducement been received in relation to those views.

I further certify that in the preparation and publication of this report I have at all times followed all relevant FFC compliance protocols including those reasonably seeking to prevent the receipt or misuse of material non-public information.