Recession Watch: realistic optimism

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Andrea Zazzarelli

Headlines

- Most economies have avoided recession, despite the higher cost of living and energy price shock following COVID-19
- Higher interest rates pose a risk of slowing down the macroeconomic cycle, but the economy remains resilient for now
- US house prices, which remain resilient to higher mortgage rates, corroborate this and have even picked up in 2023 thanks to lower supply (i.e., construction) that is helping homebuilders' stocks post strong gains
- Investment growth has also remained strong and corporate issuance has held up well, with both variables strongly procyclical and lagging in response to higher interest rates
- The Fathom Liquidity Indicator (FLiq) — a broad measure of market liquidity incorporating both public (i.e., central bank) and private (i.e., investors and markets) sources of liquidity — is currently signalling a rebound and underpinning the positive performance in markets year to date

In Fathom's recently released *Global Outlook Summer 2023* we discussed how most economies may have avoided a recession, brought about by the post-COVID higher cost of living and energy price shock. Despite a sharp fall in real wages across most major economies, household spending has continued to grow, supported by fiscal transfers, excess savings and net migration. As a result only a few countries and regions, such as Germany and the euro area, have experienced a technical recession, while others have maintained positive growth rates. One bullet has been dodged.

However, this does not mean that the dangers of a downturn have passed. Analysing and disentangling the macroeconomic forces at play has arguably become even more important in order to decipher how policy action, such as higher rates, can translate into economic outcomes. As we have argued for a while now, higher interest rates have a habit of breaking things and this time is unlikely to be different. Yet, each economic and hiking cycle comes with its own characteristics. This one appears to be increasingly defined by a much greater uncertainty over how quickly and by how much the economy will respond to the higher rates already implemented.

This is the first of two risks that we explored in Fathom's *Global Outlook Summer 2023* (the second relates to the persistence of inflation around current levels). Recent data suggest that, on balance, the global economy remains resilient to higher rates, while the direction of travel seems consistent with a steady slowdown in the macroeconomic cycle, albeit without encountering a global recession that many, including Fathom, expected — at least not this year.

Take real estate for example, US house prices fell over the course of the second half of 2022, but they have posted monthly gains in 2023. Part of the recovery in prices is likely to be motivated by a slowdown in supply, as highlighted by the sharp drop in residential construction spending in 2022.

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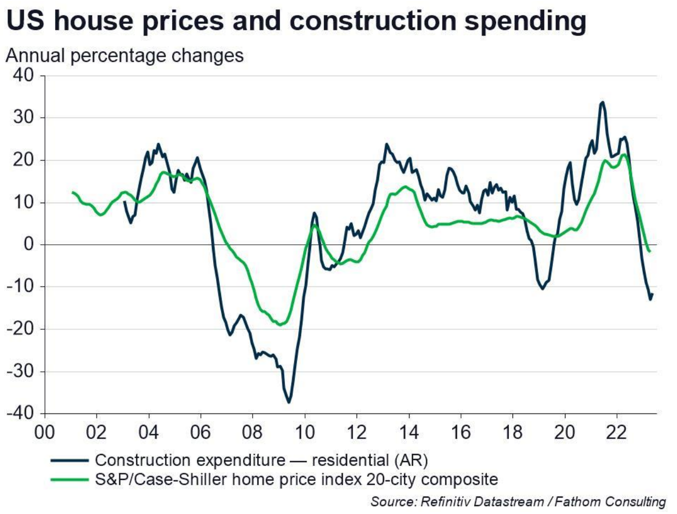
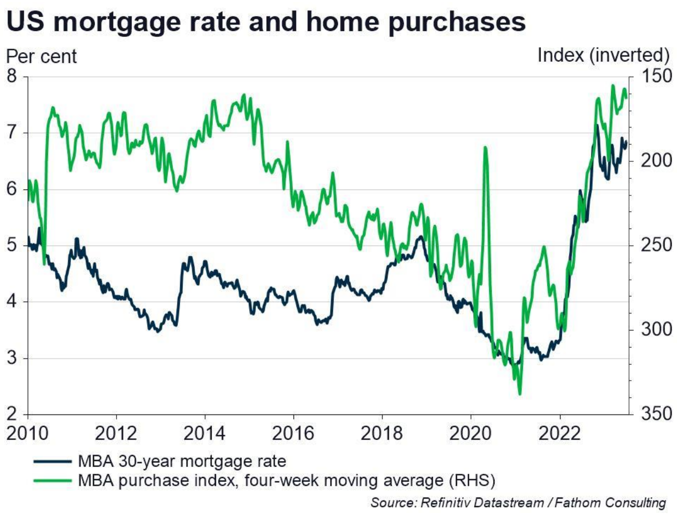


Low levels of new mortgage activity suggests that demand for housing remains weak, as mortgage rates remain high.



Seemingly, homebuilders have somewhat shrugged off these concerns for now, with homebuilder stocks posting returns twice as high (+30%) as the broader S&P500 index (+15%) in 2023 to date.

Outside of the US, we remain more concerned about growth prospects in Europe and the UK. However, even in these two areas economic sentiment notably rebounded in late 2022 and 2023. Even though the euro area did enter a technical recession at the end of 2022, better economic sentiment was one of the signposts that we were on the lookout for as a signal that consumers had put the winter energy price shock behind them, another tick-mark in favour of a resilient economy .

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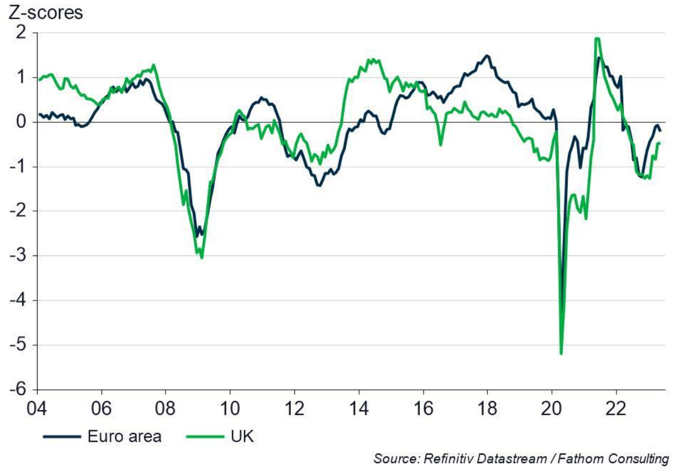
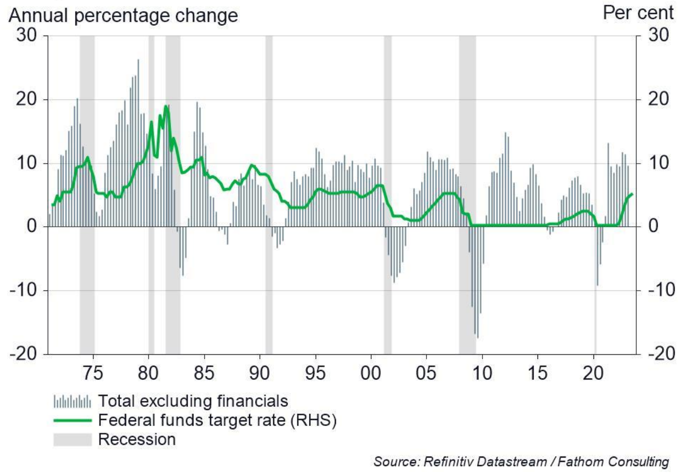
Fathom Economic Sentiment Indicators



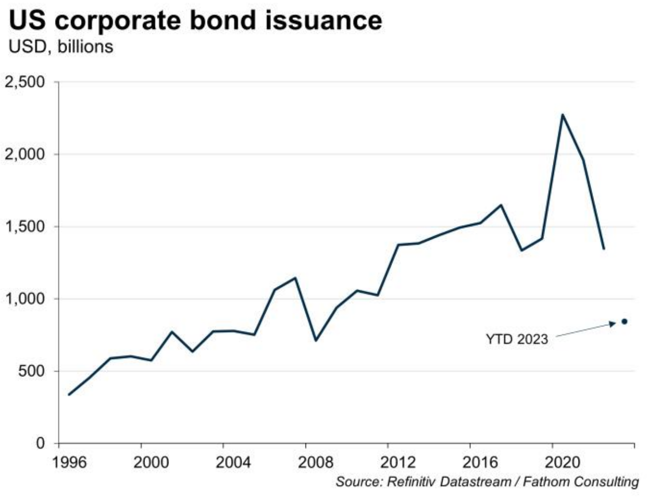
In the *Global Outlook Summer 2023* we argued that credit is another sector that ought to provide clues over how quickly higher rates are affecting the real economy. For example, basic textbook economics states that higher rates should discourage new investment by raising the cost of capital for firms, leading to negative ripple effects for employment and consumption.

US private non-residential fixed investment



In absolute terms, there is little evidence for this as investment growth is markedly procyclical: it is strong during booms, and it slows as a recession hits and interest rates fall. It can take a while for investment to slow, even as interest rates peak. Take the 1990s for example: it took the best part of ten years before we saw a significant drop in investment growth. The parallels with the 'roaring '90s' are not too farfetched either, as they marked years of rapid technological improvement and geopolitical shifts.

The resilience in investment growth has a parallel with that of consumption, where excess savings accumulated during the pandemic have helped cushion consumers from the higher cost of living that has subsequently ensued. In 2020 and 2021, US corporates boosted their coffers bringing forward borrowing intentions, as highlighted by a large spike in corporate bond issuance. The current issuance levels are likely weaker than the trend, though not by much and the UK in Q1 2023 posted the strongest quarter in corporate issuance since the pandemic. This suggests, again, that the economy remains resilient and it is still going through a process of unwinding some of the pandemic dynamics.



Healthy levels of investment and issuance, often overlooked, are also important indicators of market liquidity as signals of credit expansion and willingness to take risks. Investors tend to overly focus on shifts in central bank balance sheets and rate decisions, while forgetting about changes in these private sources of liquidity. If central bank actions were all that mattered liquidity would be a countercyclical indicator. However, liquidity as gauged by the Fathom liquidity indicator (FLiq) is, like investment, strongly procyclical and currently signalling a rebound.

A pause from the Fed in the pace of monetary tightening is likely supporting this trend, even as other central banks remain behind the curve. More support for liquidity trends may come from China, as authorities could step in with fiscal measures aimed at boosting growth, as the post-Covid rebound starts to fizz out.

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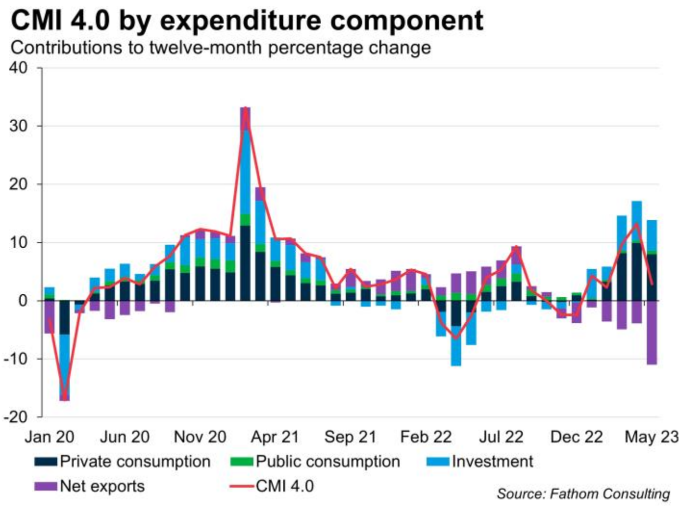

Liquidity is a key component of our asset allocation models and it is consistent with a better short-term outlook for risky assets. We cannot say for certain how long the renewed market optimism will persist. It is important to embrace this better outlook, even if only relative to, perhaps, too bearish expectations. Equally, it is paramount to remain realistic and be prepared for worse times ahead.

We remain most concerned about the UK economy, as the immediate risk of a global recession subsides. However, over the course of the coming 18 months a recession might be hard to avoid, as higher rates have set the wheels in motion. This risk is increasingly well understood. In our judgment, the true risk to investors in the current cycle is the path to a recession, a journey likely littered with false dawns and over-hyped doom. To navigate these uncertain times, accurately reading and interpreting macroeconomic trends will be paramount. For more insights keep reading Recession Watch, and do get in touch to know more about our services and track record in helping clients identify key economic signposts and dynamics.

Further reading

Recession Watch: is the Fed tightening going to plan?

Which came first — credit crunch or recession?

Global Outlook, Spring 2023: the Good, the Bad and the Ugly

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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

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