ECONOSIGHTS

with Diana Mousina

AMP

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Recession risks

Key points

- Predictions of an approaching recession have become a consensus forecast. However, global growth has mostly surprised to the *upside* in early 2023, especially in the US and Eurozone, which reflects the plunge in energy prices, the turn-up in real wages and some one-off tax refunds for US households. The reopening of the Chinese economy has also been positive.
- Many traditional recession indicators are pointing to a high risk of a downturn. But, sharemarkets have not fully priced in a recession because earnings so far are holding up more than they would in a recessionary-like environment. The magnitude and timing of a recession is important for sharemarkets because the largest equity market declines tend to be associated with deep and long recessions. However, markets can rally before a recession occurs so it is important to keep watching the recession signals.
- Recent issues with banks in the US and Europe show the risks from higher interest rates. Policymakers are trying to control the issues through securing deposits and providing funding for banks (like in the US) or brokering bail-outs (in the case of Europe's Credit Suisse bank) which is positive in avoiding further financial contagion for now or a near-term recession. The tightening in financial conditions may lead to a faster slowing in the pace of rate hikes which could *reduce* the odds of a recession in 2023.
- We don't see a deep recession occurring across the major economies in 2023 because we think inflation will decline faster than expected this year. However, if inflation proves to be sticky at 5-6% per annum throughout 2023, then central banks will be forced to hike rates more through the year which will risk a recession occurring in 2024.

Introduction

Forecasts of a looming recession in 2023 or early 2024 in major economies have become consensus, reflecting the environment of sharp and fast interest rate rises as central banks attempt to get inflation down. History tells us that there is a good chance that the end of central bank's tightening cycle will result in some sort of crisis or downturn. Recent problems in US and European banks are an example of the risks associated with aggressive rate hikes.

But this stands in contrast to the flow of economic data since the start of 2023, which has surprised to the *upside* in many of the major advanced economies. The reopening of the Chinese economy in late 2022 has also benefitted global growth lately.

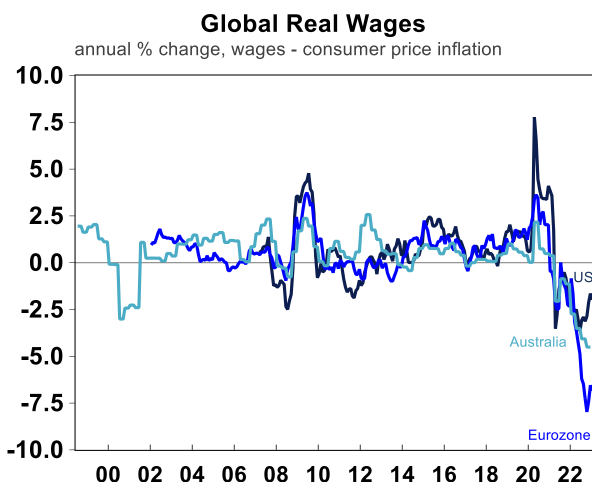
So, does stronger growth in 2023 mean that high recession odds look overdone? Or is the turn up in economic data just a reflection of economic data running hot and cold and the risks of recession are unchanged? Perhaps the risk of a near-term recession look even higher now given the financial contagion risks due to the problems in the banking sector recently. We look at these issues in this *Econosights.*

The global economy in early 2023

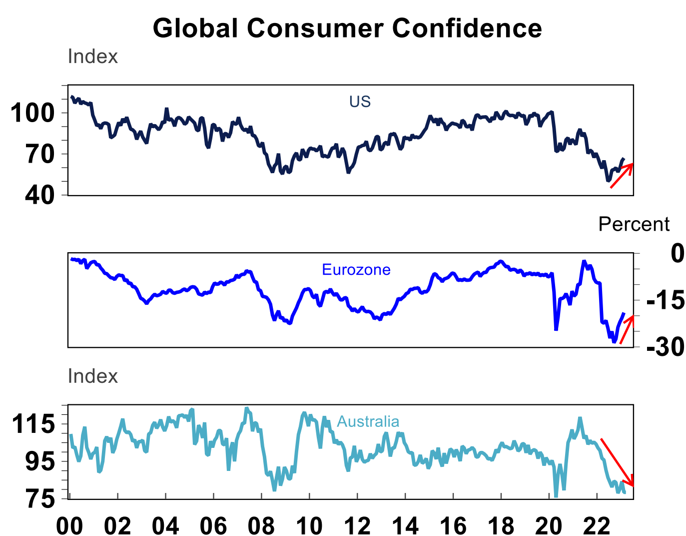
Economic data across the major economies has held up better than expected in early 2023. US employment growth remains very strong, job openings are still close to record highs and the unemployment rate is low at 3.6%. US and Eurozone inflation is also proving sticker, especially in the services sector, despite the fastest and sharpest hiking cycles in the post inflation-targeting history (the US Fed has hiked by 450 basis points in just over a year and 350 basis points by the European Central Bank in under a year). Clearly there has been more resilience in the advanced economies than expected, reflecting the very strong starting positions after the V-shaped post-pandemic bounce back and the accumulation in savings built by consumers since 2020 which are helping to cushion the impacts of rate rises and high inflation. This also means that the "neutral rate of interest" may be higher than previously expected.

In Australia, momentum in economic growth has slowed. December quarter GDP growth disappointed, retail spending is slowing, wages growth has risen slower than expected and the pace of jobs growth is lower compared to 2022 levels. In our view, this is a sign that monetary policy is more potent in Australia (despite the RBA's assessment that the impacts of monetary policy are felt equally in Australia relative to our global peers) because of the higher sensitivity of households to rate changes.

We see a few reasons behind the pick-up in US and Eurozone activity. The Northern hemisphere winter was warmer than usual which may have led to more spending, real wages growth is rising again as inflation comes down (see the chart below) whereas in Australia it is still falling, energy prices are down nearly 90% on their highs and US tax refunds were higher than usual in early 2023.



This is also reflected in an improvement in consumer confidence in the US and Eurozone (see the chart below), while Australian consumer confidence is still tracking around its lows.



Source: Macrobond, AMP

The turn-up in US and European data in early 2023 reduces the risk of recession in the first half of the year, even with the recent issues in the financial sector which policymakers are trying to control (and you could also argue that central banks are now likely to pause hiking sooner given the financial stability risks which reduces the risk of a recession). However, the banking sector troubles are also a warning sign around the future risks associated with central banks pushing hard to slow the economy through rate hikes. So, future risks of a recession are still elevated, which is line with recession indicators.

What do the recession indicators show?

A large number of indicators show a high risk of recession in the next 12-18 months (see the table below).

Indicator	Recession Yes/No
Yield curve	Yes
Leading Indicator	Yes
Inflation > target	Yes
Fed Funds rate v Nom. growth	No
Cyclical spending share of GDP	Maybe
Housing Starts & Permits	Yes
PMIs	No
ISM New Orders	Yes
Consumer Confidence	Yes
Lending Standards	Yes
Jobless claims	No
Corp profits	No

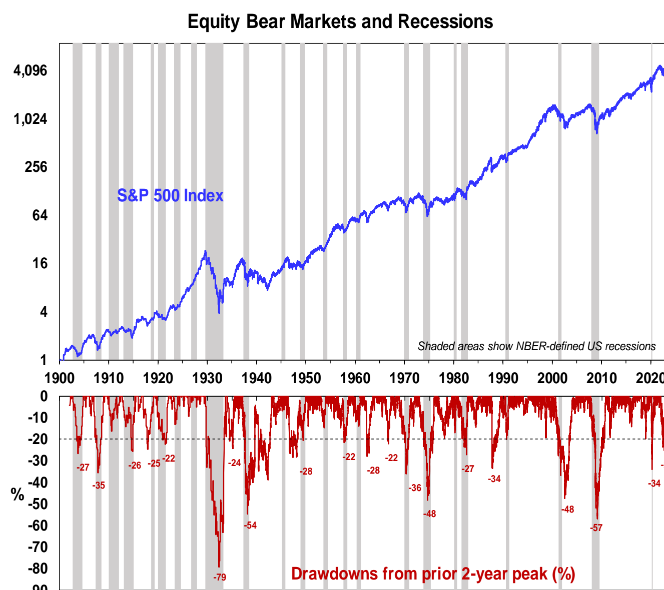
Source: AMP

The yield curve remains inverted on most measures (looking at the gap between 10 and 2 year yields and 10 year yields and the Fed Funds rate) which reflects *markets* expectations of central bank interest rates and has tended to lead recessions by around 12-18 months. Economic indicators, like the collapse in the leading economic indicator and consumer confidence, fall in housing starts and decline in new orders are all at levels typically associated with a recession, cyclical spending as share of GDP is slightly above its long-run average (a sign of excesses built up) and lending standards have tightened (and will likely tighten even more with the recent banking issues). Corporate profits are signalling poor growth, around -5% year on year, but this is nowhere near recession-like (usually corporate profits would decline by 20-30% in recession periods), although you could argue that the tech sector is experiencing its own recession as corporate profits have fallen by around 20%. Although sometimes profits can be a lagging indicator of the economy. In positive news, the jobs market is still holding up well with low initial and continuing jobless claims (which are a leading indicator of employment).

Clearly the risk of a recession or significant downturn still remains high, at around 50% in the US in the next 1-2 years. Risks of a recession are lower in Australia, at around 40% in the next 1-2 years, because we believe the RBA will not take the cash rate much higher from here given the easing in growth indicators, global financial stability risks and no signs of wages breakout.

How do sharemarkets perform during recessions?

The high risk of a recession will keep market volatility high for now. But, the timing and severity of a recession is important for sharemarkets. The most severe equity market downturns usually coincide with deep and long recessions (see the table below). However, the difficulty is in predicting the timing, as equity markets can still rally before the recession, so if you are constantly predicting a recession, you may miss out on significant price gains before it occurs.



Source: AMP

Conclusion

Recession indicators show that a risk of a recession or downturn remains high and recent issues with US regional banks and Europe's Credit Suisse show the risks associated with sharp rises in interest rates. Despite the recession concerns, the global economy turned up in early 2023, with economic activity looking better in the US and Europe. We don't see a deep recession occurring in 2023 across the major economies because we think inflation will decline faster than expected this year. However, if inflation proves to be sticky at 5-6% per annum throughout 2023, then central banks will be forced to hike rates more through the year which will then risk a recession in 2024. The difficulty in predicting the precise timing of downturns means that investors need to watch for changes in the recession signals.

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