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AN IMMINENT RECESSION… OR A DREAM?

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The impressive equity markets' rally posted so far this year in most developed countries has wrong footed many investors. The battle against uncomfortably rising inflation has forced central banks to massively tighten financial conditions, with notably the Fed embarking on its most aggressive hiking cycle in decades. With economic uncertainty rising and liquidity shrinking, bearish sentiment has markedly increased, with a potential recession being probably the most anticipated in US history.

This is not the message conveyed by markets, however, with risky assets leading the way in terms of performance since the beginning of the year in the US: equities are up about 10 % (essentially driven by the tech sector), followed by high yield bonds (+3.6 %), investment grade bonds (+2.8 %), sovereign bonds (+2.4 %) and finally cash at +2 %. Clearly the reverse order of what would be typical of a recessionary environment. Only commodities, with a drop of more than 10 %, have signalled a prospective downturn in economic prospects, with prices now below the level that prevailed before the Ukraine war.

MIXED MESSAGES CHALLENGE PREDICTIONS

So where do we stand? Is this largely predicted economic (hard-)landing coming or is it just an illusion? Economic indicators are sending mixed signals, with firstly a divergence between hard data (actual statistical measures like GDP unemployment rate…, which typically tend to be retrospective) that remain firm, and soft data (business surveys, consumer confidence etc.) that suggests economic weakness and are more forward looking.

Looking at the latter, amongst the many leading indicators that are commonly used to assess the direction of the economic cycle, the Purchasing Manager Indices (PMIs) are probably the most accurate. As a reminder, these are monthly surveys of purchasing and supply executives of hundreds of firms across sectors, who answer questions related to different sub-categories (production/business activity, price paid etc.) that translate into diffusion indices where 50 is the threshold above which business conditions are improving, and similarly below which they are contracting.

Ironically, a mild recession would probably be the best outcome, as the most effective way to rebalance the job market, consumption, and inflation, but this will require more tightening, likely ending, as it has in the past, with a policy mistake.

Published figures include a composite measure, as well two distinct manufacturing and service components (and sub-components). Regarding data published by either the ISM institute or S&P Global, here again, we notice a marked divergence between the manufacturing gauge, which has contracted sharply to levels that imply a forthcoming recession, compared to the service one, that remains in expansion territory. Such a divergence is the widest in 2 years, and actually the widest since 2009 if we look at their European counterparts.

This clearly questions the sustainability of current growth. Indeed, looking at past downturns, the service PMI can lag manufacturing, and remain resilient for longer, sustained by the strength of consumption, but eventually contracts as well. As Services is the largest contributor to US GDP (about 77 % according to the World Bank), this weakness is needed to finally trigger a recession.

WILL THIS TIME BE DIFFERENT?

We are doubtful but it is a close call; cyclical, temporary factors may also explain this divergence, notably the increased service consumption (rather than manufactured goods) underpinned by the continuation of the post-Covid reopening (including of course in China). Furthermore, structural factors such as the increasing digitalisation of economies can be cited.

What is the adjustment variable of the equation? Obviously, the job market, which is super tight, with unemployment at historical lows and strong job openings for a shrinking labour force… this inevitably creates sustained wage inflation, which boosts household purchasing power and consumption, feeding the vicious spiral of inflation.

So, who will be the arbitrator of this difficult game? As always, all eyes are on the US central bank, which is trapped in its (impossible?) mission to slow down growth, without risking financial stability. Cracks have already started to appear in the regional banks' sector…. Fed members seem divided on the future monetary policy path, and have made diverging comments; will they risk a pause in June or rather frontload more rate hikes? Their determination to curb inflationto their 2 % target will be key here, and clearly, we are not there yet, with also possibly a mini cyclical rebound being at play now.

FINAL WORDS

Ironically, a mild recession would probably be the best outcome, as the most effective way to rebalance the job market, consumption, and inflation, but this will require more tightening, likely ending, as it has in the past, with a policy mistake. Remember, seven of the last eight Fed hiking cycles have resulted in a recession. This is also the message sent by the yield curve, which is the most inverted in 42 years. So dream on!

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