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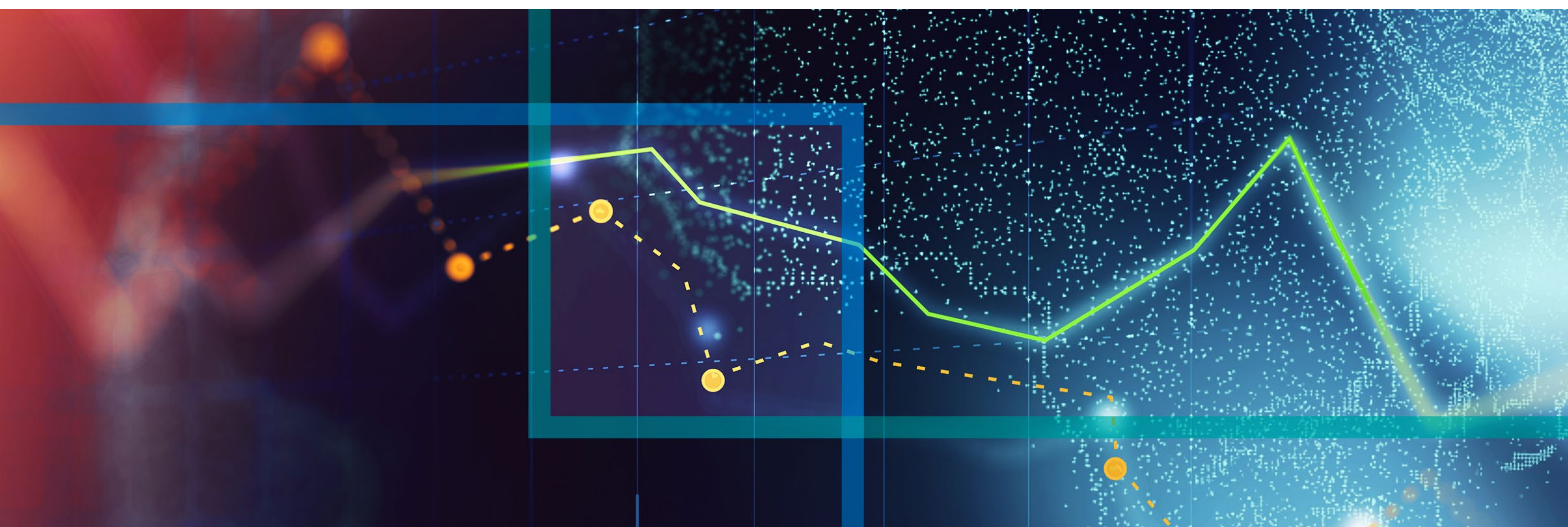

Recession watch: triggers, outlook and what next for central banks

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While recession risk is clearly elevated around the world, they are notoriously hard to predict with any accuracy, in terms of timing, duration or impact.

Rather than forecasting exactly when global markets might fall into recession this time, the following Q&A with economists Anne Vandenabeele and Stephen Green examines what is triggering current conditions, the outlook for inflation and interest rates and the role of China as the world economy slows.

Is the global economy entering a recession and what are the likely triggers?

Anne Vandenabeele: The short answer is yes. We think there is going to be a significant slowdown next year but keep in mind there are many factors at work, so there is uncertainty around exactly what recession might look like.

We expect this slowdown to be driven by recession in the US and Europe, caused by sticky inflation and higher interest rates, and a Chinese economy that remains weak. Japan will follow these three, so activity in the world's largest economies will be flat or contracting. The trigger for this is all about inflation and interest rate hikes in response to it. Inflation started post-pandemic with goods

prices leading to supply chain bottlenecks, then the commodity and energy shock caused by the war in Ukraine, and finally service price inflation rising fast, driven by strong wage growth, especially in the US.

In response, central banks have raised rates incredibly fast – 300 basis points (bps) in the US or a 12-fold increase in borrowing costs. That will clearly start to bite and the US housing market is already in recession. Mortgage rates have risen so fast that pending house sales have started to drop and houses are sitting on the market for a long time. That will start affecting company earnings, capex, employment spending and so on, particularly if the US Federal Reserve (Fed) pushes through another 150bps in rate rises over the coming months.

Could we actually be facing stagflation rather than inflation?

Anne: Stagflation as a term was used a lot in the 1970s and 80s when we had a combination of low growth and high inflation, and there is a lot that rhymes with that situation today. Whether we end up there again depends on a few things, such as whether inflation proves persistent and whether central banks can ultimately live with higher inflation to revive growth.

For service companies, labour accounts for most of their costs so when wage growth is strong, service inflation follows and can stay elevated.

In the US, we think wage growth will stay high even as the Fed raises rates and unemployment goes up. The reason behind this is a huge shortage of workers, with at least four million people lost from the labour force due to various reasons, including long COVID, less immigration, early retirement or seeking a different work/life balance, so there are a lot of mismatches pushing prices up.

If wages continue to climb even as the unemployment rate rises, the question is what central banks do in that environment? Do they ease policy to contain recession and lower financial volatility, or keep raising rates like then Fed chair Paul Volker did in the 1980s to lower inflation?

Easier policy, whether monetary or fiscal stimulus as has been talked about in Europe, would, all things being equal, keep inflation high and that is also part of the equation.

My overall view is that inflation will be more persistent as a lot is coming from wage, which tends to be stickier. But I also think central banks will be quick to ease policy to limit any damage from recession or resulting volatility – that's what they have done in the last 20 years.

One last thing to stress: we will get through this; recessions end and we need to think about this when we plan our investments.

We cannot talk about global growth without discussing China, how far is that economy from recession?

Stephen Green: We are on the verge of contraction today, with China's economy hit by at least three big shocks. One is the housing market: over the last three years, the government has tried to contain the bubble and that is causing short-term pain for developers and households. Then you have the dynamic zero-COVID policy: the government is committed to eliminating COVID from the economy, which means rolling lockdowns of city districts and transport disruptions and a hit to consumption each time.

In addition, with the US/Europe having their own economic difficulties, China's export engine is beginning to sputter. We had a great 2020/2021 where China's export engine really took advantage of the COVID situation but are now on the brink of going into negative export growth.

These three shocks will continue to feed through in the next six to 12 months and, interestingly, there is no big stimulus from Beijing expected this time as they want these bubbles to wash out of the system.

Will we see central banks adopt a uniform response or are there likely to be differences across regions?

Anne: The European Central Bank (ECB) has perhaps the toughest job as it looks like fiscal policy will be eased at the same time as rates are rising; this can be inflationary, which is exactly what the ECB is trying to counteract.

Ultimately, if we continue to see episodes of financial market volatility (as we have over the last few weeks in the UK), and there is risk of contagion to Italy, for example, I think the ECB will relent and stop quantitative tightening, perhaps even reversing rate hikes depending on how significant recession is next year.

The Fed's job is a little less complicated as there is no fiscal stimulus in the US. The Fed has announced it will keep raising rates but, at some point early next year, things will start looking softer in the US economy. At that stage, especially if there is a lack of liquidity in some markets, policymakers will stop quantitative tightening (QT) and maybe even cut rates. This is the so-called central bank put, which is what they have done for the last 20 years.

Ultimately, we cannot read the minds of (respective ECB and US Fed chairs) Christine Lagarde or Jerome Powell so are trying to stay open minded as to what may happen.

As for the Bank of Japan (BOJ), they are facing a very different environment: Japan has much lower inflation than elsewhere and the recovery is very tepid. Things are improving but the BOJ is staying put with its loose policy and we do not anticipate near-term changes, even with the pressure on the yen. The yen will keep weakening as long as the Fed keeps raising rates and the BOJ keeps its own low.

Will volatility within fixed income this year continue into 2023 and where would you see the greatest relative value within FI sectors?

Anne: I do think we should prepare for ongoing volatility in fixed income and markets more broadly. We talk a lot about rate hikes but don't forget the Fed is also trying to shrink its balance sheet and letting US$100 billion of securities mature. This is reducing market liquidity and will have an impact on market functioning.

We saw a significant volatility episode in 2019 when they were further along in quantitative tightening and that is a definitive possibility again. Where do I see relative value? Corporate bond spreads and equities have seen some valuation adjustments but don't yet incorporate the fact earnings are likely to be under pressure in a significant recessionary slowdown. Spreads are not wide enough yet and offer less value versus inflation-linked debt for example. If inflation is more persistent and falls back to target slower than the market expects, inflation-linked bonds may be more attractive.

What are your expectations for growth in China next year and will sentiment continue to weaken?

Stephen: I have been analysing China's economy for 20 years and the two most important indicators for me are credit growth and housing sales.

With credit growth, it is slower than it has been for the last 10 to 20 years, running at around 10%, and on our forecasts, is not going to pick up that much. Contrast that with 2009 and 2017 when Beijing was in stimulus mode. Banks were lending more and there was more government bond issuance to drive

infrastructure spending. Mortgage loans were also higher as people were eager to buy a house. Right now, we are seeing far less of this activity.

Housing sales are declining: they are contracting around 30% YoY and that has been going on for around the last 15 months[1]. Housing in China is very important: housing sales are around 14% of GDP but when you include all the associated activities, such as roads, pipes, utilities, leasing services, management services and so on, you get to around 25% of GDP[2].

A quarter of the economy contracting at these levels year on year is a huge downdraft and will continue to feed into commodities and consumer sentiment. We are already seeing several developers defaulting on their debt obligations and going bankrupt. That could mean unpaid bills for construction equipment, materials, and workers' wages.

Right now, the government is trying to support the housing market cautiously, allowing cities to lower mortgage rates, but such measures are not as effective when people are cautious. Sentiment could improve if we see housing sales pick up, but everyone is waiting to see if prices correct downwards and more developers go under, so we could be in for another six to 12 months of a fragile housing market.

We have seen US dollar strengthening with multiple rounds of rate hikes, what are your views on this?

Anne: US dollar strength has gone hand in hand with the rate hikes the Fed has enacted. For some currencies, especially the Japanese yen, this has been very relevant as the real rate differential between Japan/US has done nothing but widen and that is very highly correlated with movements in dollar/yen. As long as the BOJ keeps rates low and the Fed continues raising, then the dollar continues to strengthen versus the yen in particular.

It works for other currencies too, although the correlation is not as high, but the rate path for the Fed is key to get dollar strength across the board. As we go into next year and see the slowdown, and markets start anticipating an end to rate hiking, sentiment around the dollar will change and that is when the dollar bull market may be over.

Are Asian and other emerging market economies facing the same concerns regarding inflation and rate hikes?

Stephen: Across emerging markets (EM), we are seeing quite a lot of inflation so there are some similarities but also significant differences. Across Asia, headline inflation rates in countries like Korea, Thailand and Indonesia are around 6-8% with core inflation running at 4-5%. These numbers are fairly high but EMs are used to fairly high when it comes to inflation, so this is not unusual, particularly in the context of the US where levels are unusually high at present.

EM central banks are raising rates but not as aggressively: as outlined, the US Fed has hiked by 300bps over the last year whereas most EMs across Asia have increased by 100-200bps.

Asia wants to contain inflation but is not dealing with the same circumstances as the US; we are not seeing rapidly rising wages, for example, which means inflation will probably not be as long lasting. At the same time, everyone is looking at the US and Europe heading into recession so if you are an Asian central bank, you don't want to overtighten going into that.

[1] http://www.stats.gov.cn/english/PressRelease/202210/t20221025_1889676.html
[2] https://www.nber.org/system/files/working_papers/w27697/w27697.pdf

That's where we are at present in Asia and EM: somewhat higher inflation and some rate hikes, but not facing the same challenges as the Fed.

What is the outlook for EM currencies versus the US dollar?

Stephen: Key to this is what's happening with the US and, as a team, we don't think that will change much for another six to eight months into the middle of 2023. The dollar looks overvalued on our models, with the country running an ever-bigger current account deficit, but everything is being driven by rate expectations and US yields have moved up aggressively. That's what is moving everything right now in terms of dollar versus euro/yen and versus EM currencies generally.

EMs have also not been experiencing strong productivity growth over the last few years and, over the long term, that is what drives your real effective exchange rate. Weaker productivity growth across Asia and other emerging markets, China in particular, means there is no fundamental economic reason for exchange rates to appreciate.

By the middle of next year, maybe the story will have changed if inflation starts to come down. If the Fed can end the hiking cycle or even reverse some of the rises, that would be the key reason for the dollar to start to fall. In that environment, assuming EMs are not hit too badly by recession in Europe and the US, we would expect to see those currencies start to recover.

Anne Vandenabeele *is an economist at Capital Group, covering the US and Japan. She has 21 years of investment industry experience, all with Capital Group. She holds a master's degree with honors in economics from the University of Edinburgh and a master of philosophy in economics from the University of Oxford. She is also a member of the National Association for Business Economics. Anne is based in Washington, D.C.*

Stephen Green *is an economist at Capital Group, responsible for covering Asia. He has 17 years of investment industry experience and has been with Capital Group for seven years. Prior to joining Capital, he was head of economic research for Greater China at Standard Chartered Bank. Before that, he ran the Asia Programme at Chatham House, the UK think tank. He holds a PhD in government from the London School of Economics and a first-class honours degree in social and political sciences from Cambridge University. Stephen is based in Hong Kong.*

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