

From one policy mistake to another

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Most central banks have committed to fighting inflation, but concerns are rising that these efforts will tip the global economy into a recession. In a recent testimony, US Federal Reserve Chairman Jerome Powell noted a recession is not the intended outcome but certainly a possibility. With the overriding near-term challenge to prevent the global economy shifting from a low- to a high-inflation regime, we may be witnessing a shift from one policy mistake of underestimating inflationary pressure to another of tightening too quickly.

Inflation in the US is now at a 40-year high and broad-based. Prices have ballooned at grocery stores and gas stations, directly impacting US consumer confidence, which has dropped to its lowest level in more than a year as inflation continues to dampen economic sentiments. In the Eurozone, oil prices are still roughly double the median of the past two decades, while natural gas prices are still running at five times their median. Meanwhile, the European Central Bank (ECB) has turned hawkish and started raising rates.

Employers have been bidding up wages to attract and retain talent, but overall, pay increases are still falling short of rapidly increasing prices. While central banks will welcome a cooling in wage pressures as they seek to tame high inflation, a marked decline in payroll earnings in an extremely high inflation environment would further curb consumers' ability to keep spending. The challenge is well defined; central banks are tightening into slowing growth and as long as inflation remains high, central banks will keep turning the screws.

Historical experience suggests that the long-term costs of allowing inflation to become entrenched outweighs the short-term pains of bringing it under control. Some pain is therefore inevitable. Central banks will probably be slow to ease policy with core inflation rates so far away from the average target of 2%. The risk of inflation becoming entrenched calls for a more vigorous response, but in doing so, policymakers will need to limit the costs to the economy as much as they can to safeguard financial stability. Consumers are now saving less as prices skyrocket, with the personal saving rate falling to levels not seen since the mid-2000s, which highlights the misery caused by rising inflation. As Americans grow increasingly nervous about the outlook of the economy, the headline measures of the labour market and incomes, which reflect consumers' six-month outlook, have dropped to the lowest in nearly a decade.

Global equity and fixed income markets are down materially, as asset prices remain under pressure. The surge in interest rates, a plunge in the stock market and the weakness of consumer confidence have fuelled fears of an impending recession, but the economic data is still mixed. While rising rates mean higher borrowing costs for corporates, eating into earnings growth and leading to pressure on profit margins, the strength of the job market is particularly hard to square with claims that a recession is imminent; particularly in the US as consumption may remain supported. Even though the latest Federal Reserve Bank stress tests concluded that US banks can sail through a 3.5% fall in GDP growth, a rise in the unemployment rate to 10%, a 40% decline in commercial real estate prices, and a 55% fall in equities, that does not mean that bank and non-bank financials will cope so well. Trouble has been brewing in Europe, with the Euro trading at two-decade lows against the dollar. The challenge is what amount of hiking the ECB will be able to pull off, given growing fears of a recession, compounded with problems from the war in Ukraine.



Economies across the globe quickly bounced back after COVID-19 in 2020, but central banks' withdrawal of pandemic stimulus measures this year has hit stocks and sparked renewed fears of a recession. Uncertainty has come to a head in the first half of the year, with all major stock indexes plunging into bear market territory, and the US economy unexpectedly shrinking 1.4% in the first quarter. Admittedly, with inflation rising, central banks will likely keep raising interest rates aggressively. With a broader global weakening economy, the likelihood of another policy mistake is increasing. Counter-cyclical inflation will depress margins. However, consensus earnings per share estimates are still at very elevated levels. We will likely start seeing downgrades in consensus earnings per share estimates. US earnings revisions have already turned negative and this trend may accelerate. If there is a recession, earnings are likely to decline rather than just grow more slowly, especially in real terms.

Risk assets have not yet reached capitulation. Until inflation is tamed, which would allow central banks to halt rate hikes, markets may have more downside. Investors should remain cautiously positioned in the second half of the year. This seems quite obvious but it is worth highlighting given recent price action – growth matters for equities. Equities tend to see significant gains when growth is above trend, struggle when it is below trend, and fall when it is negative. Additionally, markets are forward looking so the equity market tends to peak before the peak in the economy. A look at recessions since the 1970s shows that the S&P 500 has an average drawdown of -36%, implying a further -16% from the half year close. A classical more defensive positioning for a traditional portfolio would consider lowering weighting in equities, raising bonds, and keeping some dry powder in cash. Within equities, investors may consider the lower-beta markets where economies are relatively robust, while favouring defensive sectors such as consumer staples and healthcare. Within fixed income, investors may turn more defensive by lowering credit exposure, and favouring government bonds where yields are now high enough to represent a good recession hedge.

Luckily, any rallies in bonds and sell-off in commodities will strongly suggest a recession and not an inflation-driven market. Liquidity is fickle and is not likely to get appreciably better over the next half year. Investors should remain cautious into the second half year as volatility is likely to remain elevated along with a likelihood of a policy mistake from central banks, which may force the global economy into a recession.

Sources: The Overshoot & Bloomberg Economics

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