

## Recession Forecast Capitulation

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Whether the US economy falls into recession is not the only thing that matters for financial markets, but it is close. The simplest explanation for why equity markets have been so buoyant this year is that the widely forecast recession in the US has failed to materialise.

In January, the consensus forecast was that the US economy would grow by 0.30% this year. This was as close as could be expected to a recession being the base case scenario given Wall Street's inherent predisposition towards optimism. Furthermore, the Federal Reserve's forecasts for the unemployment rate also implicitly forecast a US recession.

The Conference Board's Leading Economic Index suggested that a recession was approaching and models run by Bloomberg Economics and research consultancy Capital Economics put the chances of a US recession at 100% and 90% respectively.

While the consensus was that any recession would be mild, there were more bearish voices. Bridgewater suggested that "2023 will likely be the year of a very significant global recession". This is not to be critical of Bridgewater, their investment research is amongst the best in the industry, however it is instructive to consider why US recession forecasts have so far been wide of the mark.

The word "recession" gets widely used but the definition is not always clear. Two consecutive quarters of negative GDP growth is sometimes considered a recession, but that definition is weak. The best way to think about recessions in the US is through the labour market.

In prosperous times, economies are powered by a virtuous circle of positive economic growth which creates more employment, more income and therefore more demand. However, in recessions this sequence reverses into a vicious circle. Negative growth leads to falling employment, falling incomes, falling demand and financial dislocations. This dynamic then puts pressure on corporate profits, pricing power, future growth expectations and credit fundamentals.

In recent weeks, we have seen a range of respected institutions and commentators reverse their call for an imminent US recession. In a research note titled "The end is not near", JP Morgan explained that they no longer expect a recession this calendar year. They also helped to explain why so many models have been wrong: "recessions are nonlinear events, and most economic models are linear."

The research provides two further explanations of why growth has been resilient. Firstly, that adjusting for the unusual accounting treatment of student loans, fiscal expansion has amounted to over 3% of GDP this year. Secondly, that "recessions take hold when optimistic expectations meet less upbeat realisations". Counterintuitively, businesses preparing for recession in advance might have actually helped the economy avoid one.



Economists at Bank of America have also reversed their recession call. In a recent interview, CEO Brian Moynihan said “people are employed, they have money, they are spending money... it looks like we are reaching a pretty good equilibrium”.

Turning to the Federal Reserve, at the July press conference, Chair Powell explained, "so the staff now has a noticeable slowdown in growth starting later this year in the forecast, but given the resilience of the economy recently, they are no longer forecasting a recession".

Obama’s key economic advisor, Jason Furman, has also stepped away from his recession forecast. Explaining in recent posts: “Every year there is a 1 in 6 chance. Like rolling a die, get a 1 you have a recession, 2-6 you don't... (one) can raise/lower that probability a little bit based on circumstances. But we don't know enough to change it very much... Last year my recession probabilities went way above 1 in 6 (although lower and later than many others--and with much less conviction than my inflation views). Was a mistake.”

The capitulation of recession forecasts is also evident in financial markets. Equities have been outperforming bonds, cyclical stocks outperforming defensives, credit spreads have tightened and the yield curve has shown nascent signs of bear steepening (long dated yields rising more than short dated yields).

Conditions outside of the US have been more challenging. China’s reopening has been disappointing and credit stress is rising. Weak global manufacturing has also been a challenge for Germany’s economy. The UK was considered one of the most vulnerable economies coming into the year but has so far avoided recession.

While some high-profile analysts are no longer in the recession camp, many others still are and have just moved their call from this year to next. In Bloomberg’s July survey of economists, forecasters still say there’s a 60% chance the US will fall into recession in the next 12 months.

There is a risk that this good news comes with a sting in the tail. Resilient growth could lead to stickier inflation, which could mean bond yields moving higher. While the current US outlook is rosier, the challenge for investors is to assess how much of the good news has already been priced in. The US is a relatively closed economy but markets are far more international, so the US economy is not quite the only things that matters for investors.

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