Perspectives

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Recession – risks and countermeasures

IHAG PRIVATBANK

“It’s always the economy”

Dear investor

“The economy, stupid” – this phrase, which was coined by one of Bill Clinton’s political strategists during the latter’s 1992 presidential election campaign, put the focus on the economy and was a key element in Clinton’s electoral success. In the midst of an economic slowdown and an emerging recession, the incumbent president George H. W. Bush was forced out of the White House after only one term of office.

The economic environment still dominates our lives today. Historically, economic cycles and activities, together with economic changes, have always had major political and social consequences. We may not like it, but the prevailing economic climate has a significant impact on everyday life for us all.

Economic cycles, in other words upswings and downturns in overall economic activity, have always been with us and are invariably the result of imbalances between supply and demand. These imbalances arise through a lack of information, and countermeasures by key economic agents usually follow only after a considerable delay.

The current excessive inflation figures reflect just such an imbalance: demand is too high compared with supply. In such an environment the central banks can tighten their monetary policy – in other words raise interest rates – to slow demand, thus bringing the economy as a whole back into equilibrium. This is particularly necessary at the moment because the disequilibrium largely stems from the supply side, which is considerably harder to influence directly.

However, experience shows that central banks usually intervene too strongly and too late. The result of this heavy-handed approach is a hard landing and we end up in a recession. This, too, is caused by a simple lack of information and adaptive problems on the part of the central banks.

So how hard will the landing be, and how deep the recession? These are the questions we shall be discussing below. As investors we also have a particular interest in the effects of economic developments on individual asset classes. The current cycle of rising interest rates – which are going up faster than at any time since the early 1980s – is an essentially new situation, potentially with far-reaching consequences.

Incidentally, another US president – Gerald Ford – also had direct experience of the relevance of the economic environment. While the economic downturn of the early 1990s cost George H. W. Bush his chance of re-election, Ford ran one of the more awkward political campaigns with his heavily marketed attempt to combat inflation in 1974: “Whip inflation now”, or WIN for short, suggested that citizens should grow their own vegetables, among other measures – and he failed to be re-elected, too.

We hope you enjoy reading this publication.

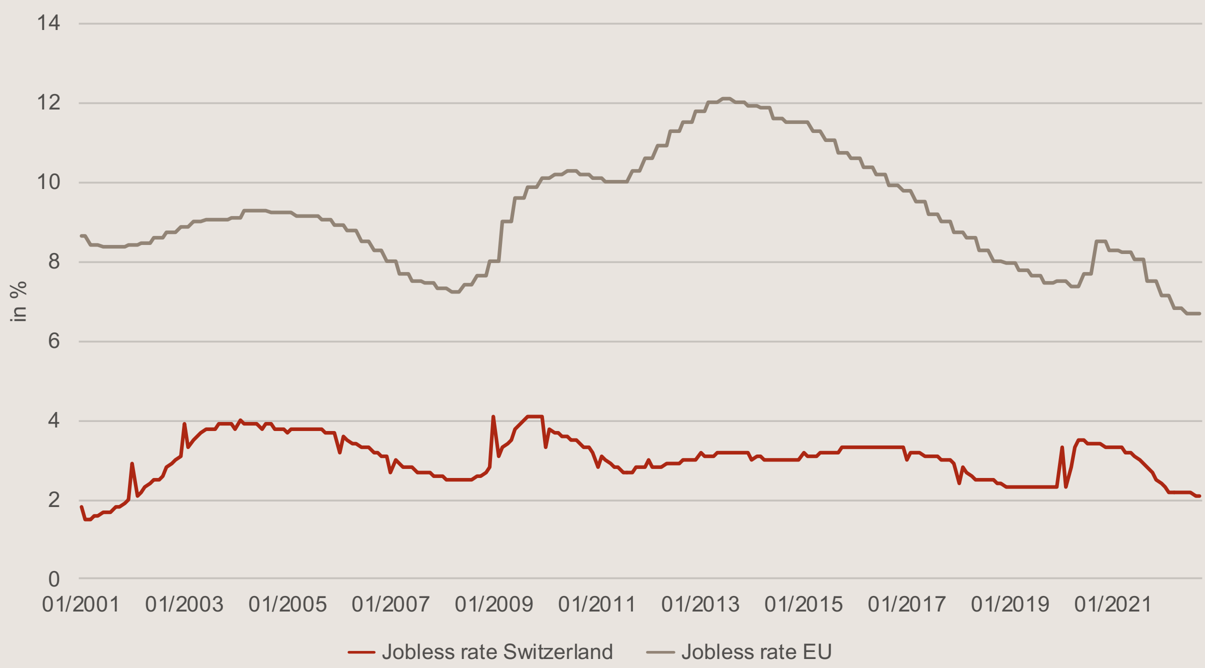
Christoph Boner
Chief Investment Officer

How central banks influence the economy

The global economy is currently marked by imbalances of historic proportions: while the supply side is plagued by armed conflicts, natural disasters, general supply chain problems and a trend towards deglobalisation, the demand side remains very strong. Reasons for this include an ongoing eagerness to consume following the end of Covid restrictions, the aftermath of the money glut of the past 15 years, and large-scale government investment projects.

The inflation that now predominates in many currency areas is the direct result of these imbalances: aggregate economic demand has risen further, while the supply side is experiencing significant constraints. Given that the demand side cannot be influenced directly – mainly owing to structural factors – it needs to be damped down in order to bring the overall economy back into equilibrium.

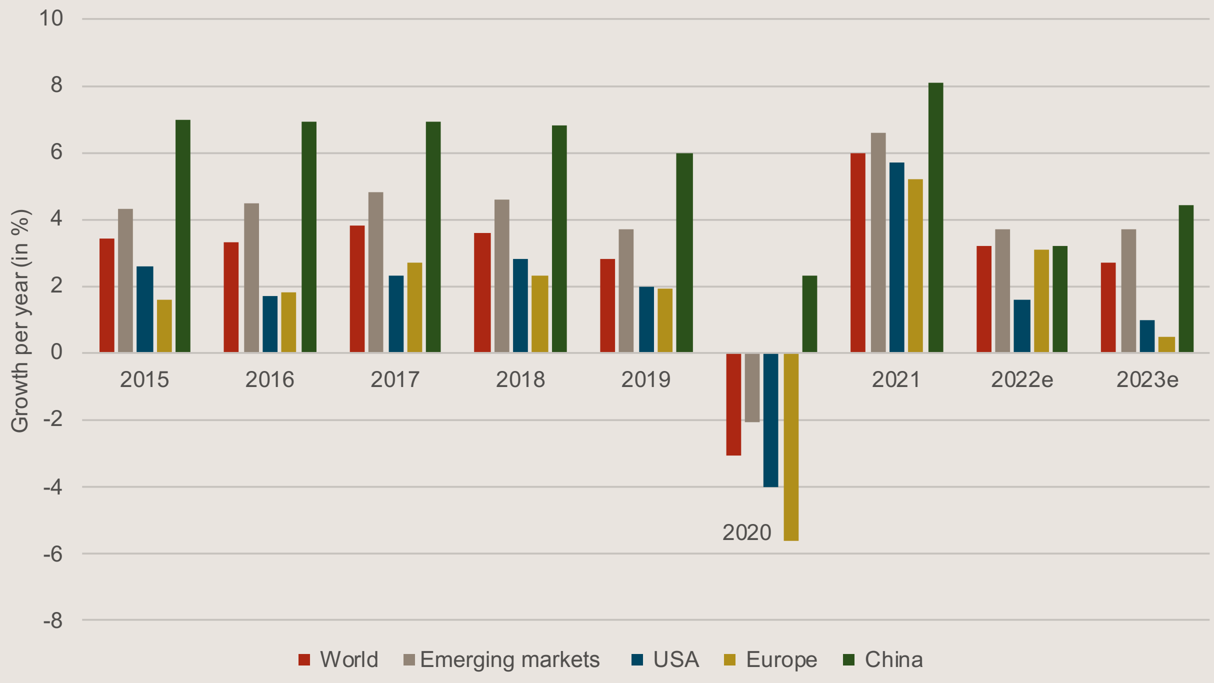
Labour market



This adjustment can take place via two routes. If inflation is deliberately kept above wage growth – thus causing a fall in real purchasing power – this leads directly to a drop in demand-side pressure. This is even more the case in western, developed economies where consumption accounts for well over half of aggregate demand. In any case, quite apart from its politically undesirable negative side effects, this route is not feasible given the current strength of the labour market. Employees are in a favourable position because of the tight market and the shortage of skilled labour: they can demand wages that keep up with inflation, thus wiping out the dampening effect on consumption. This in turn stokes inflation – since higher wage costs push up product prices – which then produces negative second-round effects, and in the medium term also destabilises inflation expectations, inexorably resulting in even higher wage demands. A dangerous wage-price spiral would then set in, potentially culminating in rampant inflation.

That leaves the second route: the economy is cooled down by a recession – in other words a slackening in overall demand. This is the route currently being taken: hiking key interest rates makes investing more attractive compared with consumption, real investments require higher marginal returns in order to be economically worthwhile, and the strengthening of the currency improves the external trade balance. Lastly, the government can also damp things down by reducing or postponing its investment plans.

Economic growth (GDP)



All these measures lead to a slowdown in economic growth. Whereas global economic growth for 2022 was still being estimated at 4.9% at the beginning of the year, the figure now stands at 3.2%. A further correction has been made for 2023, to 2.7% at present. The desired slowdown in economic activity can be observed, even though positive growth rates – in other words, no recession – are still expected at the moment.

We are left with the question of how far this deliberate cooling will succeed without plunging the global economy into a long-term recession – a contraction. History shows that central banks traditionally take action too late and then step on the brakes too hard and too long. Prices on the global asset markets clearly show that the investor community is preparing for a recession scenario. According to the signals from the asset markets, the central banks are set to bring the global economy to its knees through hiking interest rates too far and too late. The asset markets are simply pricing in these recessionary developments.

24%

was the average amount lost by the major equity markets in the past nine months

-28%

was the average amount lost by the stock markets in the 15 most recent negative phases (since 1937)

Cooling with the potential for a new equilibrium

Given the supply-side challenges, the current slowdown in global economic activity as a result of suppressed demand is intentional. Interest rate hikes are the easiest and most direct way of achieving this goal – although the impact of monetary policy is anything but direct. Central banks are suffering from a two-fold adaptation problem: on the one hand, the mechanism by which interest rate changes act on demand is anything but clear and unequivocal; on the other, there is a significant time lag before they take effect.

Historically, it is evident that central banks attempting to cool the economy have generally reacted too late and hiked interest rates too far. This worry, combined with uncompromising communications from the central banks, pushed the global equity markets to new lows in the third quarter of this year. The markets are expecting not only a slowdown in growth, but also a recession – i.e. negative growth. There is also increased uncertainty about the overall economic trend. Both concerns are putting pressure on the prices of higher-risk investments.

The market trends of recent months are pricing in a recession while simultaneously reflecting greater uncertainty with regard to both economic performance and future central bank policy. In contrast to this development, we are still seeing solid fundamentals at corporate and consumer level, as shown by positive growth forecasts for the economy as a whole. The markets could therefore be said to be overreacting, and a counter-movement can still be expected in the coming weeks. However, against the backdrop of the above-mentioned risk factors and the scenario of further escalation at global trouble spots such as Russia and China, the mood remains sombre at present.

An assessment of the current situation highlights three points in particular:

The uncompromising stance of the central banks

The current environment of relatively high inflation is forcing the central banks to focus resolutely on combating inflation, even when – as is the case with the US Federal Reserve – they have a duty to give consideration to the overall economic trend. It is more important to retain credibility as regards combating inflation: that is the only way to dampen second-round effects via the labour market and prevent a wage-price spiral setting in. Even though the Fed has explicitly refused to predict when the turning point in central bank policy will occur, it is evident that the current market expectation (a peak of 4.4% in February/ March 2023) is close to the equilibrium interest rate for the US economy. The question remains of how far the Fed will then overshoot the target. This uncertainty is currently weighing on the markets significantly.

Manageable credit risks

While the present imbalance is primarily being driven by the supply side, both corporate balance sheets and the financial situation in the private sector are healthy. Unlike at the time of the financial crisis, there is no credit crunch looming at the moment, although high levels of debt are causing increased vulnerability to rising interest rates. Public debt levels are in fact reducing the scope for future fiscal stimulus packages. Market sentiment continues to be affected by investors' awareness of this lack of scope and the impracticality of the type of monetary stimulus packages that have repeatedly been used to prop up the markets since the financial crisis.

Economic slowdown anticipated

Equity markets, and to an even greater extent interest rate markets, are anticipating a slowdown. The current central bank policy of hiking key interest rates has led to higher interest rates and lower prices for higher-risk investments. Combined with the additional uncertainty regarding forecasts, this has resulted in significant losses.

Chances of economic recovery are intact

Christoph Boner
Chief Investment Officer

Why do economic cycles occur?
If supply and demand remain in step in an economic system, there will be equilibrium and stable prices; unemployment will remain steady at a basic level.

Economic cycles occur because economic operators face adaptation problems on both the supply side and the demand side: on the one hand, an imbalance does not become obvious immediately and on the other, there is always a time lag between an agent's decision to act and the eventual impact of this action.

The lack of information and the delayed impact mean that when economic operators react to imbalances the correction process takes some time, so the agents are almost always playing catch-up. In a slowdown, the movement therefore goes too far and ends in a recession, while an upturn often results in overheating.

How can downturns be avoided?
In the simplest scenarios, downturns occur because the outlook is becoming gloomier on the demand side; alternatively, problems on the supply side may have a constraining effect. Agents on the supply side then reduce their economic activity – voluntarily in the case of depressed demand, or involuntarily in the case of supply-side constraints. For the reasons cited, this happens too forcefully and too late, possibly culminating in a recession. Technically, a recession is understood to mean at least two consecutive quarters of negative economic growth.

In principle, two instruments can be used to prevent or moderate a downturn. On the fiscal policy side, demand can be supported by cutting taxes or expanding government consumption and government investment. On the monetary policy side, demand can be stimulated by increasing the money supply through interest rate cuts and purchase programmes by the central banks. In the first of these, government debt could present problems, while in the second, excessive monetary policy measures will jeopardise price stability.

In contrast to using fiscal or monetary policy measures to prop up demand, directly controlling the supply side is considerably harder because it is primarily influenced by structural factors and by the prevailing framework conditions.

What are the boundaries of fiscal and monetary interventions?
Since the main causes of the present downturn are to be found on the supply side rather than the demand side, demand needs to be damped down; this can be achieved by curbing government consumption and government investment. However, monetary policy has a more immediate effect. Since one of its main objectives is to maintain price

stability, it is tasked with reining in economic growth in the interests of monetary stability. In order to combat the dangerous second-round effects already mentioned, it is also forced to act uncompromisingly in order to protect its credibility.

What is the right thing to do in the current scenario?
Re-establishing economic equilibrium is imperative in the interests of price stability, too. While supply-side measures only take effect after a considerable time lag, monetary policy is the sole relatively direct means of stabilising prices. An economic slowdown or even a recession would then be an unavoidable, if logical, development.

What does this mean for economic growth in the future?
Some of the factors acting upon the supply side are long-term in nature: in the technological field, declining marginal benefits can be expected, especially from networking, while the emerging trend towards deglobalisation is likely to persist and the fuelling of economic growth by two decades of falling commodity prices seems set to come to an end. The supply-side challenges are forcing a partial slowing of demand, which will have a restraining effect on overall economic growth. All these elements, combined with a higher level of political and social uncertainty, are already being reflected in asset prices. Market losses have been correspondingly high in recent months. Provided that current growth expectations actually materialise and investor uncertainty simultaneously diminishes, a market recovery is to be expected in the medium term.

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