Recession Watch – delaying the inevitable?

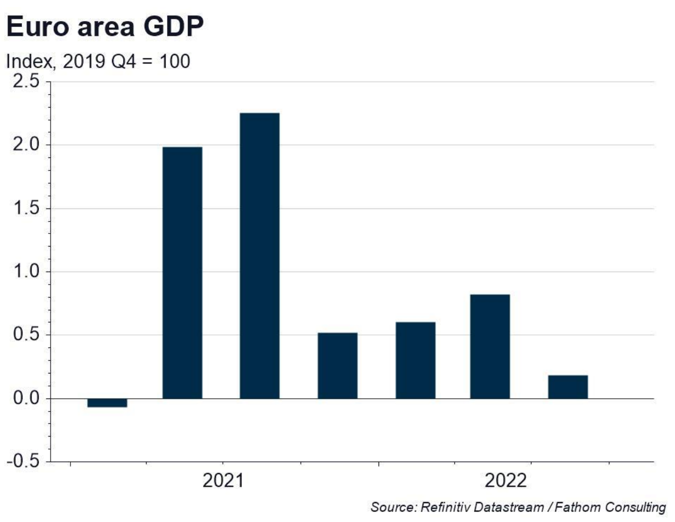
2 November 2022

Kevin Loane

Headlines

- The euro area avoided contraction in the third quarter; with mounting headwinds, this looks to be delaying an inevitable recession
- Policymakers in some advanced economy central banks seem to be weighing the sluggish outlook for demand over still-high price pressures, raising the spectre of a DM central bank 'pivot'
- Were that pivot to transpire, it would lead to a further decoupling with the US, where two-year real rates of interest are firmly in positive territory
- This combination of well above-target inflation and weak output offers a tricky landscape for investors: we will provide a more detailed assessment in our upcoming *Global Outlook, Winter 2022*

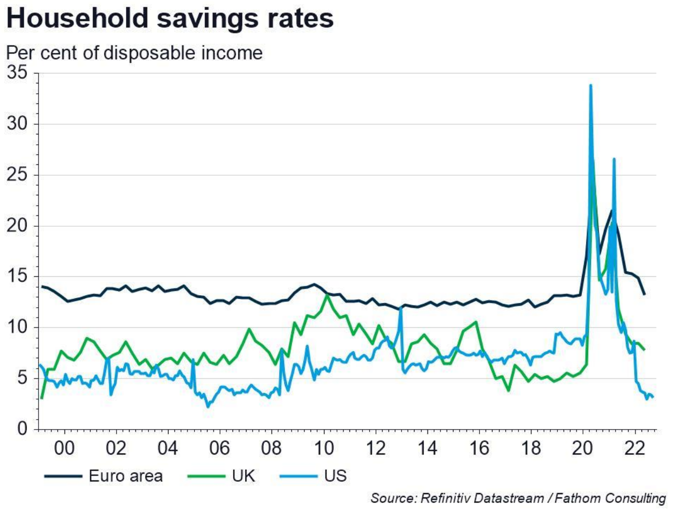
Euro area GDP expanded by 0.2% in the third quarter, confounding our expectations that the currency bloc was already in recession. Strong household consumption in Germany helped to boost activity, but with 11.7% inflation in October, this appears to be an unsustainable source of growth. Indeed, momentum has clearly eased across the bloc, from a 0.7% quarterly average in the first half of the year. Our view that the euro area was in recession may have discounted the strength in services spending, including tourism, following two years of heavy restrictions. It's also possible that an historically higher savings rate will offer euro area households a greater degree of resilience than we expect to price shocks. Of course, with data revisions typically pro-cyclical, it's always possible the Q3 data will at some point be revised to show a contraction.



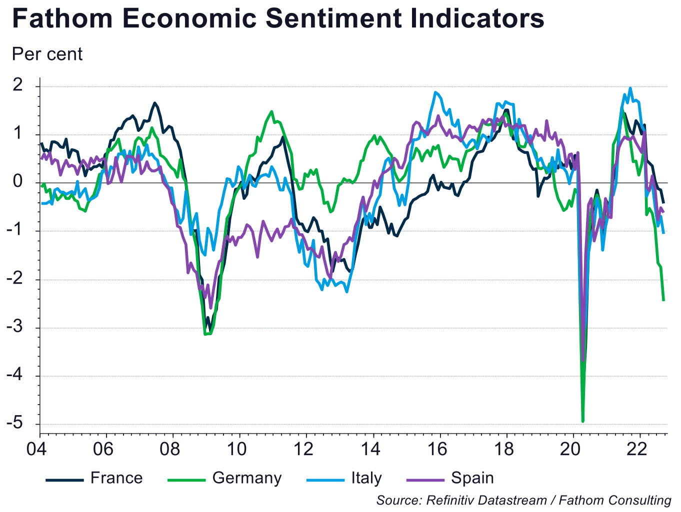
Less positive were the Inflation data, which showed that prices in the euro area increased at a 10.7% annual rate in October. The ECB expects compensation per employee to increase by 4% in 2022, implying a 6%+ decline in real wages – a more

Continued

negative number than we see in the UK or US. That squeeze is exacerbated by a lower level of excess savings from the pandemic than in the UK or US. A historically high savings rate more generally suggests that euro area households could smooth consumption if they desired. However, they have shown little appetite to accept lower savings rates previously.



Timelier business surveys add data to the theoretical case for a euro area downturn. The 'flash' euro area composite PMI was 47.1 in October, marking the fourth straight month below 50, the level that separates contraction from expansion. Fathom's own Economic Sentiment Indicators, that weigh together a slew of business and household surveys, are sharply falling and are in line with previous downturns such as the GFC and euro area debt crisis, albeit higher than the COVID trough. So despite a surprisingly resilient Q3, we continue to see a euro area recession as close to inevitable in the coming quarters, as falling real wages, slumping business confidence and rising interest rates all weigh on activity.



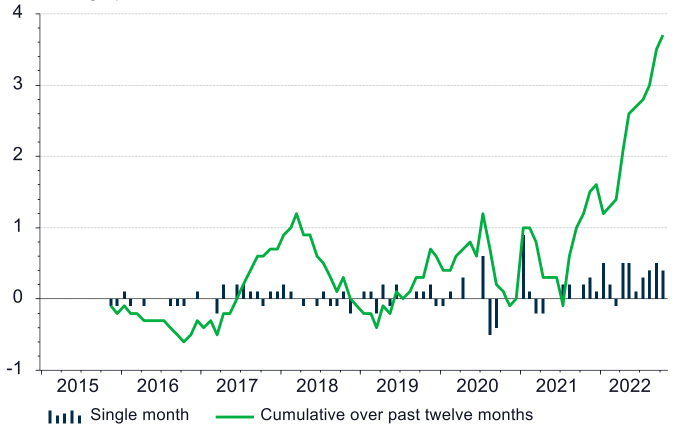
This bleak outlook for economic activity may explain why some on the ECB wish to 'pivot'. The Governing Council voted to hike rates by 75 basis points last week for the second month in a row. However, it also adjusted language in the accompanying statement, in an apparent desire to push back against market pricing of future hikes. In our *Global Outlook, Autumn 2022*, we

Continued

argued that markets were too bullish on future ECB rate hikes, given little sign of excess demand and a particularly weak outlook for economic activity. However, core inflation has consistently surprised to the upside over the past twelve months, and that raises the question whether a modest hiking cycle will lead to meaningful disinflation, even with slumping output. Answering that will be critical to policymakers beyond the continent. Policymakers at central banks in Australia, Canada and the UK have all mooted pivots towards less aggressive hiking in recent weeks. Assessing whether they will be able to get away with this will be a key part of our upcoming *Global Outlook, Winter 2022*.

EA core CPI surprises

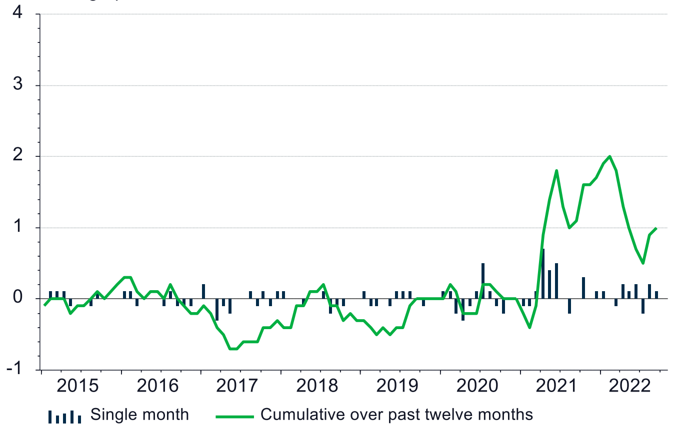
Percentage points



Source: Refinitiv Datastream / Fathom Consulting

US core CPI surprises

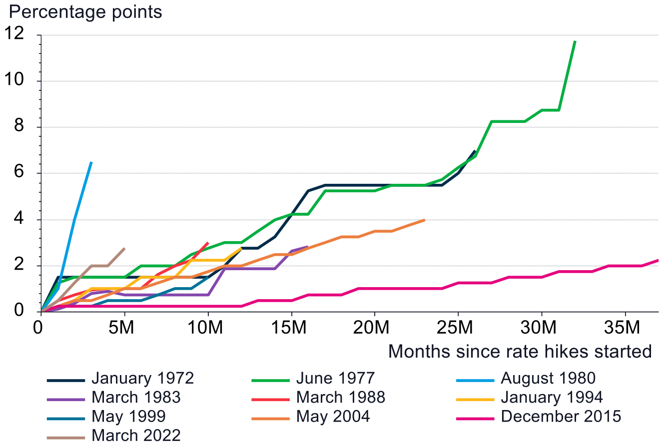
Percentage points



Source: Refinitiv Datastream / Fathom Consulting

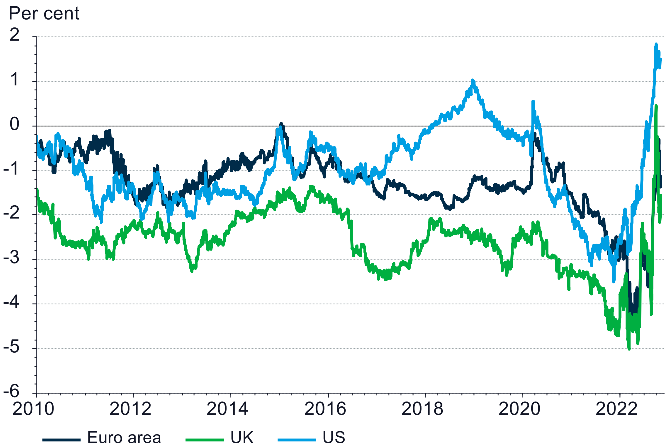
In contrast to some other developed market central banks, the Federal Reserve has shown itself willing to move policy into meaningfully restrictive territory. In nominal terms, the current hiking cycle is the second steepest since the 1970s. This contrasts significantly with the Bank of England, which is moving at a historically slow pace despite 10.1% inflation. Meanwhile, US two-year real rates, implied by market pricing, have increased by over 400 basis points over the past twelve months and are trading at 1.5%. This contrasts with equivalent measures for the euro area and UK, which imply persistently negative real rates of interest over the next couple of years.

The speed of Fed hiking cycles



Source: Refinitiv Datastream / Fathom Consulting

Two-year real interest rates, implied by markets



Source: Refinitiv Datastream / Fathom Consulting

With that in mind, we anticipate another 75bps hike by the Fed later today, and another 50bps in December. Given the steep pace of hikes, a deteriorating economic outlook and the general consensus among Federal Open Market Committee (FOMC) participants that policy will be firmly above neutral by then, it seems reasonable that the FOMC will then take a breather to assess the economic outlook more carefully through 2023. Indeed, with a recession probable in the coming quarters, the outlook for future moves will become increasingly balanced. While the focus now is on where the terminal rate will peak, we judge there to be a good chance of rate cuts by the end of next year, which, on the surface, would offer a more constructive backdrop for risk assets, helping to explain their recent bounce higher. Whether that trend can continue will depend in large part on earnings and the ability for companies to weather the expected downturn. Expect the macroeconomic outlook to become an increasing focus of interest.

We will be assessing the prospects for UK monetary policy in greater detail at an *Emergency Monetary Policy Forum*, held on Friday 4 November, 2022, at Chatham House. Click here to register.

Interesting reading

- The BIS highlights the US dollar's enduring role as dominant world reserve currency, amid signs of momentum at low levels from the renminbi: *https://www.bis.org/statistics/rpfx22.htm*
- The BIS highlights the impact of a strong dollar, raising the possibility of 'global co-ordination' by other central banks they don't 'overtighten monetary policy from a global standpoint': *https://www.bis.org/publ/bisbull62.pdf*
- The Biden-Harris National Security Strategy, which was released a few weeks ago, highlights the importance the administration places in countering China: *https://www.whitehouse.gov/wp-content/uploads/2022/10/Biden-Harris-Administrations-National-Security-Strategy-10.2022.pdf*
- With the US midterms less than a week away, Nate Silver sees the race for the Senate in a dead heat, with Republicans expected to retake the House: *https://fivethirtyeight.com/*

Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
kevin.loane@fathom-consulting.com
www.fathom-consulting.com