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Six signs a recession is brewing: the perfect storm

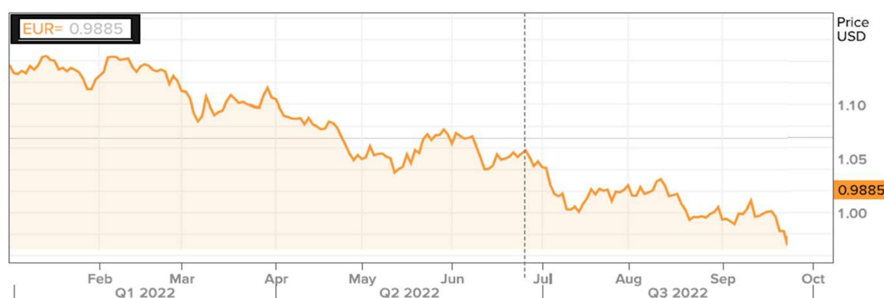
Overall, while the growth outlook remains challenging, many stocks are now already pricing in a relatively high probability of at least a moderate recession. The S&P 500 is down nearly 24% for the year. Government bonds are also pricing in a significant amount of further tightening. The US 10 Year note slid from 98% down to 92% at the end of September, pushing its Yields considerably up, from 1.60% to 3.65%. So, after a very difficult year so far for both stocks and fixed income, valuations now look overall more attractive. Around the world, markets are flashing warning signs that the global economy is teetering on a cliff's edge. The question of a recession is no longer if, but when. Over the past week, the pulse of those flashing red lights quickened as markets grappled with the reality — once speculative, now certain — that the Federal Reserve will press on with its most aggressive monetary tightening campaign in decades to tackle inflation in the US economy. Even if that means triggering a recession. And even if it comes at the expense of consumers and businesses far beyond US borders.

1.The strength of the US dollar

The US dollar plays an outsized role in the global economy and international finance. And right now, it is stronger than it's been in two decades. When the US central bank raises interest rates, as it has been doing since March, it makes the dollar more appealing to investors around the world.

In any economic climate, the dollar is seen as a safe place to park your money. In a tumultuous climate — like a global pandemic, or a war — investors have even more incentive to purchase dollars, usually in the form of US government bonds.

While a strong dollar is good news for Americans traveling abroad, it creates headaches for just about everyone else. The value of the UK pound, the euro, China's yuan and Japan's yen, among many others, has tumbled. That makes it more expensive for those nations to import essential items like food and fuel. In response, central banks that are already fighting pandemic-induced inflation wind up raising rates higher and faster to shore up the value of their own currencies. The dollar's strength also creates destabilizing effects for Wall Street, as many of the S&P 500 companies do business around the world. By one estimate from Morgan Stanley, each 1% rise in the dollar index has a negative 0.5% impact on S&P 500 earnings.



2.America’s economic engine stalls

The No. 1 driver of the world’s largest economy is shopping, and America’s shoppers are tired. After more than a year of rising prices on just about everything, with wages not keeping up, consumers have pulled back. The hardship caused by inflation means that consumers are dipping into their savings. The personal saving rate in August remained unchanged at only 3.5% — near its lowest rate since 2008, and well below its pre-Covid level of around 9%. Once again, the reason behind the pullback has a lot to do with the Fed. Interest rates have risen at a historic pace, pushing mortgage rates to their highest level in more than a decade and making it harder for businesses to grow. Eventually, the Fed’s rate hikes should broadly bring costs down. But in the meantime, consumers are getting hit with high borrowing rates and high prices, especially when it comes to necessities like food and housing.

Americans opened their wallets during the 2020 lockdowns, which powered the economy out of its brief-but-severe pandemic recession. Since then, government aid has evaporated and inflation has taken root, pushing prices up at their fastest rate in 40 years and sapping consumers’ spending power.

3.Corporate America tightening its belt

Business has been booming across industries for most of the pandemic era, even with historically high inflation eating into profits. We owe it to the tenacity of American shoppers, as businesses were largely able to pass on their higher costs to consumers to cushion profit margins.

In mid-September, one company whose fortunes serve as a kind of economic bellwether gave investors a shock. FedEx, which operates in more than 200 countries, unexpectedly revised its outlook, warning that demand was softening, and earnings were likely to plunge more than 40%.

FedEx isn’t alone. On September 27, Apple’s stock fell after Bloomberg reported the company was scrapping plans to increase iPhone 14 production after demand came in below expectations. It seems that companies are hanging back and waiting to see what conditions hold before hiring in preparation of the upcoming holiday (big spending) season. That is a significant warning for earnings as companies begin publishing data.

4.Bear territory

Wall Street has been hit hard, and stocks are now on track for their worst year since 2008.

Last year -should we venture into making a comparison- was a very different story. Equity markets thrived with the S&P 500 soaring 27%, thanks to huge amounts of cash pumped in by the Federal Reserve, which unleashed an impressive monetary-easing policy in the spring of 2020 to keep financial markets from crumbling. Happy times lasted until early 2022. But as inflation set in, the Fed began raising interest rates and unwinding its bond-buying mechanism that had propped up the market.

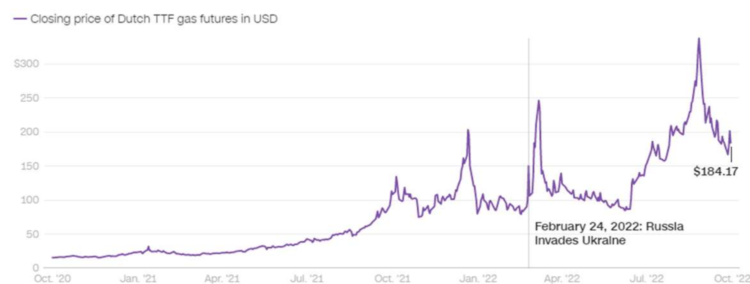
The wake-up has been brutal. The S&P 500, the broadest measure of Wall Street — is down nearly 24% for the year. And it's not alone. All three major US indexes are in bear markets — down at least 20% from their most recent highs. In an unfortunate twist, bond markets, typically a safe haven for investors when stocks and other assets decline, are also in a tailspin. Once again, blame the Fed.

Inflation, along with the steep rise in interest rates by the central bank, has pushed bond prices down, which causes bond yields to go up. By the end of September, the yield on the 10-year US Treasury briefly surpassed 4%, hitting its highest level in 14 years. That surge was followed by a steep drop in response to the Bank of England's intervention in its own spiraling bond market — amounting to earthquake like moves in the usually uneventful bond market. European bond yields are also spiking as central banks follow the Fed's lead in raising rates to shore up their own currencies.

Bottom line: There are few safe places for investors to put their money right now, and that's unlikely to change until global inflation gets under control and central banks loosen their grips.

5.War, soaring prices and radical policies

Nowhere is the collision of economic, financial, and political calamities more painfully visible than in the United Kingdom. Like the rest of the world, the UK has struggled with surging prices that are largely attributable to the colossal shock of Covid-19, followed by the trade disruptions created by Russia's invasion of Ukraine. As the West cut off imports of Russian natural gas, energy prices have soared, and supplies have dwindled. Ultimately, OPEC latest decision to cut production threatens gas prices.



But then, during the last week of September, the freshly installed government of Prime Minister Liz Truss announced a sweeping tax-cut plan that had to be recalled shortly thereafter. That decision set off a panic in financial markets and put Downing Street in a standoff with its independent central bank, the Bank of England. The ripple effects of the "Trussonomics" turmoil are spreading far beyond the offices of bond traders. Britons, who are already in a cost-of-living crisis, with inflation at 10% — the highest of any G7 economy — are now panicking over higher borrowing costs that could force millions of homeowners' monthly mortgage payments to go up by hundreds or even thousands of pounds.

The other major instability factor is the war (or special operation if we want to please someone). Seven months after the first Russian soldier crossed into the Ukraine, the conflict has added geopolitical issues, especially in the wake of the referendums staged in the breakaway provinces. Is Putin trying to lure NATO into this mess as if saying "if I go down (likely), you'll go down with me"? That causes immediate concerns about the possibility of using nuclear weapons, likely to cause a panic across the board, and not limited to energy prices.

6.China: a telltale of global economic slowdown

The Chinese economy was confronted with several headwinds this past quarter, such as the country's zero Covid policy, weather-related disruptions, and lingering weakness in the housing market.

However, while at the start of the third quarter most economic data remained weak, some started to improve throughout the quarter on the back of policy measures which supported fixed asset investment and industrial production. However, China's economy remains fragile, as illustrated by weak credit demand. Weak domestic demand implies that China is not facing the inflation pressures faced by most other countries. Both CPI and PPI (consumer and producer price index) inflation came in below expectations in August, dropping to 2.5% and 2.3% year on year, respectively.

What next?

While the consensus is that a global recession is likely sometime in 2023 (a 98% chance according to research firm Ned Davis), it's impossible to predict how severe it will be or how long it will last. Not every recession is as painful as the 2007-09 Great Recession, but every recession is, of course, painful. Some economies, particularly the United States, with its strong labor market and resilient consumers, will be able to withstand the blow better than others.

As we entered the fourth quarter, the global economy should continue to slow while some economies could enter recession. The magnitude of this event will partly depend on the effectiveness of measures deployed by policymakers to reduce the impact of the energy crisis on households and businesses. Central banks, confronted with the biggest inflation shock since the 1970s, will for their part probably continue to prioritize the fight against inflation over supporting growth. We truly seem to be in uncharted waters with the perfect storm brewing in the months ahead.

Concluding on a positive note, crises force transformations that can ultimately improve standards of living and make economies stronger. The pandemic signaled a major revolution of how business -and society in general- should operate in the years to come. Perhaps our "consumption for profit and endless growth" based model that made the world richer since the end of WWII needs to be rethought.

As per Rescad, we are not sure we reached the bottom in the stock markets yet. It takes time to create one, and we cannot discount a further deterioration. The recession might not be that severe, but our economies are facing systemic risks. We are however beginning to see encouraging signs for interesting stocks as far as their valuation is concerned. The recently announced issues with Credit Suisse is a clear example of problems not having been addressed at their root.

Marcello Tedeschi, October 15, 2022