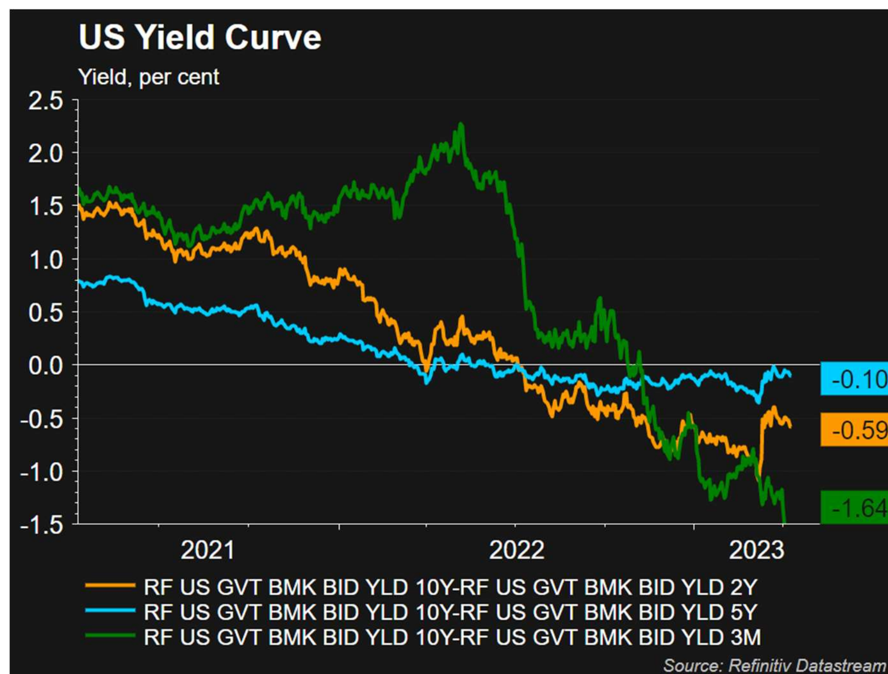
Recession, Inflation and Credit Suisse

RECESSION

An inverted yield curve has among the best track records in forecasting recessions in the U.S. post-war period. The U.S. yield curve is currently deeply inverted and has been for some time, that's a sign a recession's on the way. However, the jobs market disagrees. The U.S. is adding jobs, as of the January report, and unemployment is historically low. Given the consumer is the majority of the U.S. economy, it's fairly unlikely for the U.S. to see a recession when employment is rising. So, will we see a recession in 2023, or won't we?



At the end of 2022 the New York Federal Reserve estimated the probability of a U.S. recession at 47% on a 12-month view. That's high. Ironically, it's a greater probability than before the past 4 U.S. recessions. There are good reasons why the yield curve should predict recessions and its historical track record is strong. However, no economic indicator is perfect, so maybe the yield curve is getting it wrong this time. Nonetheless, it's important to remember that the yield curve is a forward-looking indicator. That means we can't write off the yield curve's recessionary signal just yet.

In contrast to the pessimism of the inverted yield curve, the U.S. economy added almost half a million jobs in January 2023, 315'000 in February and 236'000 in March. That's also broadly consistent with 2022, when the economy added over 400,000 jobs each month. The growth in employment was relatively broad-based. If an economy is adding jobs consistently, then a recession is less likely, that's because consumer spending is a major driver of economic growth and tends to increase with employment. So, the jobs market doesn't offer any real sign of recession currently.

So, Could There Be a Recession? The optimism from the jobs market and pessimism of the yield curve are not entirely contradictory. The scenario that would reconcile them is a U.S. recession later in 2023.

That’s because the yield curve is a forward-looking indicator, whereas the jobs market is an assessment of recent economic performance. In past economic cycles the job markets have turned quickly, with unemployment rising in just a few months as a recession emerges. Just because the jobs market is strong now doesn’t mean it couldn’t weaken on a 6-month view. However, for this to play out we would need to see the jobs data start to weaken in the coming months, clearly that’s something we haven’t seen just yet. For example, economist Claudia Sahm estimates that the U.S. economy is in a recession when the 3-month average of the unemployment rate rises by half a percent from its 12-month low. Despite current strong jobs data, that’s still quite possible for 2023, though there are no signs of it currently and to the extent that we continue to see a string of robust jobs reports, so any chance of recession will fade.

Other economic indicators are more suggestive for pessimism for the U.S. economy. The housing market, as measured by new building permits is relatively weak. Rising mortgage costs and low affordability aren’t helping the housing market either. Housing is a relatively small part of the economy, but swings in housing activity can be large, meaning that a soft housing market can contribute to a recession.

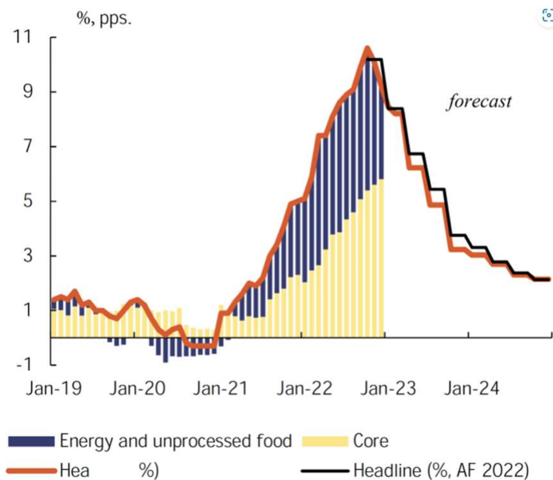
Consumer expectations are relatively negative and various business surveys are soft too. All of these suggest economic growth may be sluggish in 2023, however it’s unclear if that translates to a recession or not. That said, there are positive indicators too, the stock market is among the best leading indicators of the economy and has generally rallied in 2023 so far. That may be a good sign, for now.

We’re currently seeing relatively high divergence in economic indicators. The stock market and the jobs market both suggest optimism. However, other indicators with robust track records are casting a shadow, especially the yield curve. One way to reconcile this would be if a U.S. recession were to occur later in 2023. Nonetheless, the clock is ticking on that recession forecast, if the U.S. is to see a recession, then we would expect some weakness in the job market in the coming months. We’re not seeing it currently. It’s also conceivable that the U.S. sees a recession as the job market holds up, perhaps based on extreme weakness in a sector such as housing or a different economic shock, but that would be historically unusual.

INFLATION

After the annual inflation rate of the Eurozone hit a record level of 8.4% in 2022, experts are predicting whether inflation rates will rise or fall in 2023. A decrease in the prices of raw materials could suggest that inflation will slow down. Plus, the labor market has remained resilient at the beginning of this year, and wages could also increase. Despite this positive outlook, the global economy remains vulnerable to unpredictable geopolitical shocks that could lead us back on a re-inflationary path.

In 2022, the annual inflation rate in the Eurozone hit a record level (8.4%) since the Eurozone’s creation in 1999, mostly because of disruptions in the global supply chain and by the energy crisis provoked by the conflict in Ukraine. Now the question that must be asked is whether inflation rates will rise or fall in 2023 and beyond. Indeed, a few factors seem to suggest that the European Central Bank’s (ECB) inflation target of 2% could be reached if other circumstances don’t intervene to maintain it at high levels.



Source: European Commission Winter 2023 Economic Forecast

Is the worst behind us? A decrease in the prices of raw materials could suggest that inflation will slow down. After inflation peaked at 10.6% (year-over-year) in October 2022, the most recent data in January showed a decrease to 8.5%. The fall in raw material prices after historic highs is an important reason why prices are rising more slowly. Indeed, food, living and energy costs make up 35% of the global Harmonized Index of Consumer Prices (HICP).

Supposing that tensions don't return to these highly volatile markets, the baseline effect (that's to say, with the transitory effects removed) in the months to come will be ever more favorable, thus lowering global inflation.

CREDIT SUISSE

After the April 4 General Assembly in Zurich, playing the blame-game and issuing a personal judgment no longer seem a necessity. What is, unfortunately, true is that Switzerland's image of extreme reliability has been hit pretty severely. Back in the 90's the Swissair collapse put a dent on the country's self-esteem, but -as big a blow to its image- it was ultimately limited to the transportation industry. Credit Suisse, however, impacts a much larger industry and important industry that has always worked hard to demonstrate its true value. Switzerland's role as banker to the world's rich was built on a reputation for institutional discretion and dull reliability. That only made the scandals, public legal battles and mounting losses at Credit Suisse Group AG more striking and harder to comprehend. In March, a slow-burn crisis turned into full-blown panic, clients ran for the door (an estimated 65 billion have been withdrawn from the bank during Q1 2023) and the Swiss government swooped in to arrange a hasty takeover by local rival UBS Group AG. Thus, an icon of Swiss financial prowess that was established in the mid-19th century and rose to become one of the world's 30 systemically important lenders was no more.

What went wrong? Its willingness to engage with clients that some other banks avoided, such as disgraced financier Lex Greensill and failed New York-based investment firm Archegos Capital Management, lost it billions of dollars and compounded the sense of an institution that didn't have a firm grip on its affairs. Many fed up customers voted with their feet, leading to unprecedented client outflows in late 2022. The loss of business was especially dramatic in Asian wealth management, which for many years had been an important source of profit growth. No wonder some small investors present in Zurich on April 4 outright called for arresting the responsible leaders who, in their eyes, dilapidated the lifetime savings of ordinary citizen.

Credit Suisse stock ended up slumping as much as 31% on March 15 when the chairman of its largest shareholder, Saudi National Bank, ruled out investing any more in the company. This prompted Credit Suisse to ask the Swiss central bank for a public statement of support. The cost of insuring the bank's bonds against default for one year surged to levels not seen for a major bank since the global financial crisis of 2008. Aware of the potential economic fallout if Credit Suisse collapsed, the central bank offered to lend it as much as 50 billion Swiss francs ($54 billion) and buy back up to 3 billion francs of

debt. This bought Swiss authorities a little time to find a more sustainable solution. Over the following weekend, they forced the bank into the arms of its local rival UBS for about $3.25 billion — less than half its market value when the shares closed the previous Friday.

Why does it matter beyond Switzerland? Credit Suisse's crisis came shortly after the failure of three US regional lenders and underscored how some less well-managed financial institutions have struggled since the era of rock-bottom interest rates came to an end. Its demise may push other banks to lower their risk profile, which means issuing fewer of the loans that enable economies to grow. That would make it harder for central banks to keep raising benchmark rates to cool red-hot inflation without causing recessions. Investors have been abandoning bets on more rate hikes and now see US rate cuts coming as early as the summer. European Central Bank President Christine Lagarde said on March 16 that the financial market turmoil could hit credit conditions and dampen confidence. However, she said the banking sector was "in a much, much stronger position than where it was back in 2008."

Marcello Tedeschi, Apr 25, 2023