The Great Reset

By: Richard Maparura, Senior Portfolio Manager, Asset Management, Butterfield

2022 was a memorable year, characterised by high inflation, geopolitical turmoil, and aggressive tightening by major central banks. Stock markets moved in and out of bear market territory throughout the year and, for the first time in market history, bonds and equities both fell by double digits. Inflation flipped the bond-equity correlation positive, causing an average 60/40 portfolio to record double digit losses. The bull market that began after the Global Financial Crisis has come to an end and signals a great reset.

As we head into a new year and a fresh start for performance benchmarks, results from a recent Bloomberg survey show economists believe there is a 70% probability of a mild recession in 2023. This may turn out to be one of the most anticipated recessions of all time but that does not mean it will not hurt. Bad news, even when expected, often still causes a shock upon arrival. If unemployment rises, followed by the decline in consumption and companies missing their earnings forecasts, equities and other risky assets may take that badly, regardless of how much the recession was anticipated. This will be worse if inflation remains high, restricting central banks from cutting interest rate.

While consensus expectations point to a mild recession with lingering inflation and tighter-for-longer monetary policy, a contrarian view would forecast one of two extremes, a much deeper downturn or a goldilocks returns. The outlook, however, remains hinged on whether central banks will be able to rein in inflation while keeping economies out of recession. It is hard to see an outcome which would be positive for risky assets. Either economic growth remains resilient, which would force central banks to keep on tightening, or growth falters and a global recession ensues, both of which are negative for risky assets. This warrants a look at some of the tail risks for 2023.

Mortgage defaults

Households without long-term fixed rate financing will face steep increases in their monthly mortgage payments as interest rates reset higher. Mortgage rates have been rocketing worldwide as central banks hiked rates, causing shocks to consumer spending across major countries. Any substantial rise in unemployment may also cause defaults as this affects the consumers' ability to repay mortgages. Also, the continued fall in home prices may incentivise defaults in countries where mortgages do not have full recourse to the borrower. The higher the rates go, the higher the odds of mortgage defaults and increasing unemployment, resulting in a loop that likely tips global income into a much deeper recession. There is a significantly greater risk that mortgage shocks may be experienced in the United Kingdom, Norway, and New Zealand than in the United States, France, Germany, and Italy based on the mortgage structures.

Hawkish central banks

Market participants appear to have priced in the expectation that central banks are near the end of their rate hikes. However, major central banks are making it clear they still have a long way to go. Despite slowing down the pace of rate hikes, central banks have indicated that they will remain sufficiently restrictive to ensure a timely return of inflation to the 2% target. In the US, the Fed has indicated that any change in policy will not happen until the labour market weakens. However, since the labour market is a lagging economic indicator, by the time the labour market data deteriorates meaningfully enough for the Fed to change policy, the global economy may have already slid into a deeper recession than currently anticipated. Overtightening monetary policies by central banks presents more downside risk to the market's expectation of a mild recession in 2023.

Zero Covid-19 policy

China's reopening is unfolding at a surprisingly rapid pace that looks similar to most other countries' reopening experiences, with accelerating economic growth fuelled by consumer spending and rising inflation. It is not unreasonable to expect a surge in pent-up spending from over a billion consumers after a year of restrictions, aided by soaring excess cash deposit balances. This could positively translate to an upside risk to earnings estimates for companies with China sales exposure, but more importantly it could also drive a rebound in global inflation for both commodities and goods. Any surge in consumer spending could coincide with global inflation moderating and central banks pausing rate hikes. The timing will not be ideal as market participants' disappointment from the resurgence in inflation may overshadow any improvement in the earnings outlook, forcing stocks lower than initially anticipated.

Ukraine war escalates

The market appears to be pricing in the hope that the intensity of the Ukraine war subsides and perhaps moves towards a negotiated resolution that ends military hostilities and de-escalation. There are fears that the path to end the fighting may require Ukraine reclaiming Crimea from Russia, something that may prolong the conflict and lead to further escalation by the latter. An escalation by Russia could take the form of further large-scale attacks on civilian infrastructure or restrictions on export capacity through military constraints on the use of shipping routes. But more significantly, it may take the form of using prohibited nuclear, biological, or chemical weapons to defend what Russia sees as its territory, drawing other countries into the conflict.

Conclusion

The pre-eminent global concern will be sticky or rising inflation. This will lock central banks in the hawkish corner, meaning persistently higher neutral interest rates, higher cost of capital and lower asset valuations globally. Central banks will be eager to nudge growth below potential to achieve sustainable price stability. Market opportunities have already reset and investing in 2023 should be more diversified across equities with durable cash flows, quality bonds with significant coupons, and alternatives with volatility-reducing attributes. Investors should stay defensive, possibly underweight equities, neutral on government bonds, and a cash allocation as dry powder. Should the global recession turn out to be a mild one, there could be an attractive re-entry point into risky assets. If the recession turns out to be much deeper, the defensive positioning will minimise losses.

Sources
Charles Schwab Research & Bloomberg Economics