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The elephant in the room: Recession

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While global market headlines about high interest rates, persistent inflation, US debt, the impact of artificial intelligence (AI) and US-China tensions have been dominating the news, the elephant in the room is a recession.

As central banks continue to aggressively fight inflation, they are tightening financial conditions and accelerating the global growth slowdown. Internet search data suggests investors are anticipating an economic slowdown. According to Google, searches for 'recession' in the US were up over 350% in 2022. The majority of portfolio managers are now anticipating that the US economy will fall into a recession this year, according to a Bank of America Merrill Lynch survey. Nevertheless, there is no consensus on just how bad it will be, with some expecting a deep and painful contraction, and others expecting a shallow downturn.

Understanding the cause and effect of recessions has been one of the enduring areas of research in economics. A recession is generally defined as a significant decline in economic activity that lasts for an extended period. It is typically characterised by a contraction in Gross Domestic Product (GDP), a rise in unemployment, decreased consumer spending, and a slowdown in business activities and financial markets volatility. In the US, the National Bureau of Economic Research (NBER), a private research organisation, maintains a chronology of the beginning and ending dates of US recessions but uses a broader definition with a number of measures of activity to decide the dates of recessions. As central banks around the world continue to raise interest rates with a degree of synchronicity not seen over the past five decades, a decline in demand for goods and services is likely to ensue, and this would eventually result in a recession.

Because recessions have many potential causes, it is a challenge to predict them. The behavioral patterns of numerous economic variables including credit volume, asset prices, and the unemployment rate around recessions have been documented. Although they might be the cause of recessions, they could also be the result of recessions. Even though economists use a large set of variables to forecast the future behavior of economic activity, none have proven a reliable predictor of whether a recession is going to take place. Changes in some variables such as asset prices, the unemployment rate, certain interest rates, and consumer confidence appear to be useful in predicting recessions, but economists still fall short of accurately forecasting a significant fraction of recessions, let alone predicting their severity in terms of duration and amplitude.

Proponents of the elephant in the room are looking at the monetary tightening in the US and Europe as sufficient to influence demand and spending behaviour, especially if China cannot or will not provide any significant stimulus to strengthen its recovery. The lagged impact of higher interest rates should cause a further pullback in investment and, eventually, hiring. As straight forward as it may sound, asynchronous data across sectors and geographies have made this cycle difficult to track, let alone forecast. Supply-side disruptions, large shifts in the composition of demand, and staggered post-pandemic reopening's may have weakened the signals that a recession is inevitable. Any central forecast of a recession carries lower weight than usual.

Recessions normally result in difficult periods for equity markets, but those periods do not dominate the investment landscape. Since 1945, the US economy was in recession for only 15% of the time, meaning that it expanded the other 85% of the time. Considering the historical long-term average GDP, the economic pullbacks associated with recessions are smoothed out into a positive long-term GDP growth trend. Nominal US GDP has risen by over 6% per annum, while earnings have risen by over 7% per annum on average since 1945. This year,

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however, has brought a lengthy list of challenges to the popular opinion of a recession. Economic data has generally improved and the stock market has rallied into double digit returns over this period. Perhaps, portfolio asset allocation decisions based on the premise that the economy, and already successful businesses, could lose the ability to adapt to tightening financial conditions, or that the challenging periods are going to last much longer than they have previously, may be out of sync based on the historical record.

Even though recessions are a normal part of the business cycle, investors are often more concerned about other severe disruptions in the financial sector, such as banking crises, stock market crashes, or credit crunches, which can have a significant impact on the overall economy. The inverted yield curve, the recent decline in inflation and the SVB banking crisis are all widely viewed as signs of recession but nothing is ever certain. It is easy to understand why some investors have become tired of waiting for the so-called 'Godot recession'. These investors are waiting for a decline in market indices, making it the most anticipated bear market ever, before shifting assets into equities.

However, investors should remember that, market timing hurts portfolio returns. The worst and best days in a market often occur near one another, and you cannot afford to miss the big up days. Keeping portfolios fully invested remains important. What investors should focus on is the value of active asset allocation, which is about choosing what to invest in and when. Strategic asset allocation should capture higher bond yields. Shifting to more defensive and income-oriented equities should be prominent whilst exploring potential opportunities that may come from ongoing trends, like the rise of AI or nearshoring. Individual stock selections should be restricted to companies that investors would be content to own through a recession. This means high-quality businesses with resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle. This requires foresight and a willingness to act.

Sources
Gavekal Research & Bloomberg Economics

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