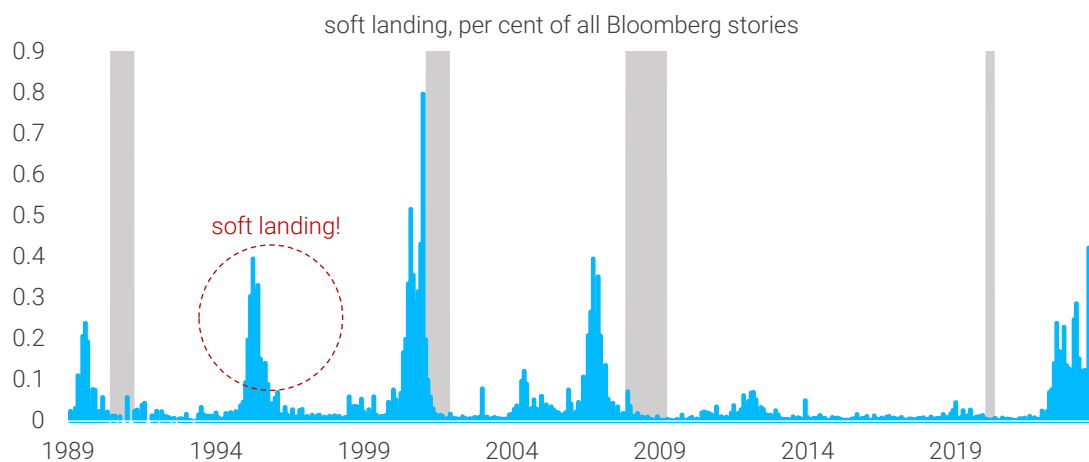


Macro Picture

IS THE 2024 CONSENSUS WRONG?

Dario Perkins

Consensus forecasts appear to have flipped to forecasting a “soft landing” in 2024 from expecting a recession 12 months ago. But this is mostly marketing, presumably to justify a more constructive view on risk assets. We assess the risks around these forecasts, which are skewed towards near-term weakness, faster policy easing, and then a stronger recovery.

Chart 1: A harbinger for disaster? Why do economists always assume a soft landing?

Source: Bloomberg, TS Lombard

IT'S ALL IN THE MARKETING

The vast majority of sellside economists are expecting a soft (or soft-ish) landing in 2024, a totally different vibe from 12 months ago, when everyone was using the dreaded “R” word. But the shift in consensus views is much less dramatic than it might seem. Forecasters now expect negligible growth instead of the mildest recession in history (i.e., barely a recession at all).

THE START OF SOMETHING

Contrarians should find the near unanimity of the soft-landing consensus somewhat unsettling. Historically, most soft landings have, in fact, been hard landings in disguise. There are various reasons for this error, including forecasting biases, reflexivity in labour and credit markets, concealed financial imbalances and even the potential for economies to hit their “stall speeds”.

THE BIG PIVOT

We think the risks are skewed towards economic weakness in the near term, not least owing to the recent deterioration in labour markets. But with inflation falling rapidly, central banks now have the option to head off further economic damage. Early rate cuts – already priced into easier financial conditions – could halt the recessionary slide and drive a strong recovery in 2024.

IS THE 2024 CONSENSUS WRONG?

There is one theme running through every sellside year-ahead piece on the macro outlook for 2024: the firm prospect of a soft landing. The vast majority of sellside economists – most of whom were saying recession was “inevitable” 12 months ago – now believe the global economy can escape the recent episode of monetary tightening with only minimal collateral damage. On the surface, this is a big turnaround in narratives. But when we dig deeper, we discover that the basic macro environment the consensus now sees for 2024 is not such a radical departure from the environment it was expecting for 2023. Sure, the profile for GDP is somewhat higher and the US avoids the “technicality” of outright contraction; but the reality is that most economists have shifted from [predicting the mildest recession in history \(barely a recession at all\)](#) to forecasting a period of negligible expansion. We see this most clearly in projections for unemployment, which have barely budged. The real difference is in the way the sellside is marketing their outlook. Whereas a “recession” demanded a cautious stance on risk assets 12 months ago, the “soft landing” label allows a more constructive view. And this sits well with the way positioning has shifted, after a year in which the buoyancy of equity markets caught everyone by surprise.

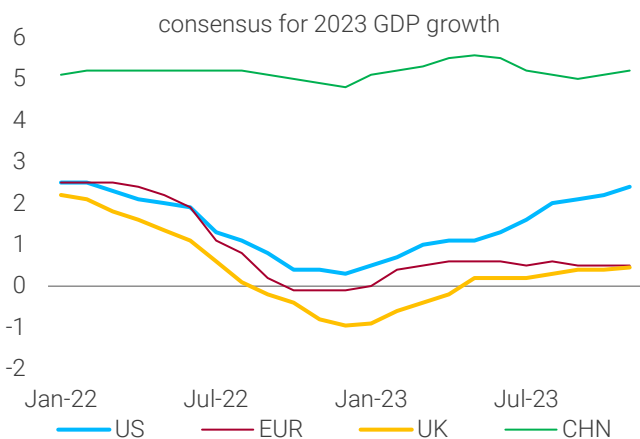
Having talked up the prospect of a soft landing for [the better part of 18 months](#), we are not going to abandon this view now. But there is something unsettling about the near unanimity of the new market consensus. The contrarian would point to the chart on the front page, which shows that every major downturn has been preceded by talk of a soft landing. While this is not sufficient reason for pessimism, it does raise an important question: what is it about the early stages of a recession that can cause people to confuse it with something more benign? We suspect the answer is partly to do with the way economists make their forecasts: they tend to incorporate new information only incrementally, which biases their projections at major turning points. But these forecast errors tell us something more profound about the very nature of recessions themselves, which always come with reflexivity and “non-linearities”. Once employment starts to contract, psychology shifts and/or the credit cycle turns, even a mild downturn can turn into something nastier – especially when it exposes deeper underlying macro-financial imbalances. This is something to watch in early 2024, particularly as labour-market activity has stalled.

While near-term risks are skewed towards further weakness, the good news is that rapidly falling inflation has given central banks the opportunity to reduce interest rates and halt any further slide towards recession. This is policy optionality that did not exist 12 months ago, when the authorities were worried about repeating the so-called “mistakes of the 1970s”. So, the big question for 2024 is whether central banks will be willing to take this opportunity and reverse course (since high interest rates were always the likeliest trigger for a true recessionary dynamic). Here we see encouraging similarities to what happened in 1995 – the textbook example of a soft landing – with Jerome Powell seemingly willing to play the role of Alan Greenspan. Like the maestro, Powell has the opportunity to dodge a recession and instead deliver a strong recovery (perhaps even setting the US economy up for a period of sustained expansion). Of course, there are doubts about whether policymakers in Europe will follow his lead, especially given the supply pessimism and policy defeatism that has gripped both the ECB and the BoE. But even Europe will benefit from a US recovery, especially when combined with a revival in manufacturing (the end of the bullwhip cycle) and an improvement in real incomes (the end of Europe’s “cost of living crisis”). So, is the consensus wrong? Yes, of course, like always! This time we think it could be underestimating the potential for a growth scare in early 2024, the likely policy response and the strength of the subsequent recovery. Sellside economists expect a dull 2024. They are forgetting that even soft landings can be bumpy and adrenalin-inducing. And none of this is “priced in”.

1. IT'S ALL IN THE MARKETING

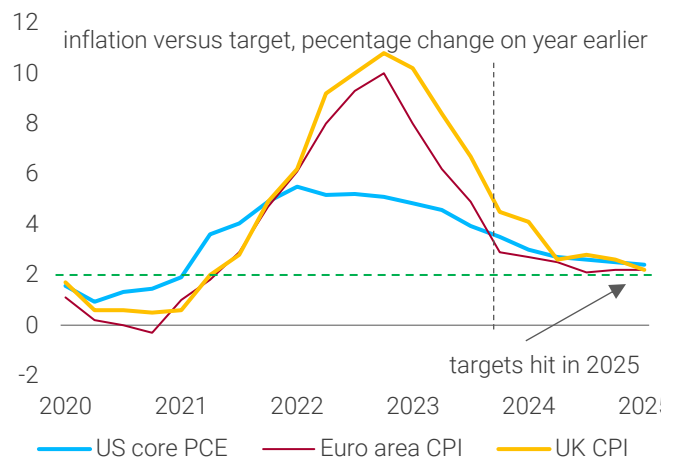
It's that time of year when many investors reflect on what has happened over the past 12 months while trying to figure out how the consensus and, more important, their peers are positioned for the year to come. And there is certainly no shortage of views on offer, with the sellside busily publishing chunky "year-ahead" tomes, their last opportunity to harass (sorry, I mean "engage with") their clients before the start of the seasonal festivities (and much-deserved holidays). Because we know that it is tedious to trawl through hundreds of pages of long prognosticative sellside essays and that our clients are busy (or, at least too busy to respond to emails from our sales team), we like to devote our final Macro Picture of the year to a discussion of the emerging consensus. What are our peers in the macro community saying? How much uniformity is there in those views? And where do we think this consensus is likely to be wrong? While the cynic would say this is just a thinly veiled attempt to engage in the same exercise as the rest of the sellside without acknowledging it as such (a year-ahead publication in disguise), we like to think we are providing a valuable service. And this year we have unearthed something important: namely, that the big shift in macro narratives – from recession to soft landing – is not all that it seems.

Chart 2: The recession that didn't happen in 2023



Source: Bloomberg, TS Lombard

Chart 3: Inflation to converge (slowly) on 2%?

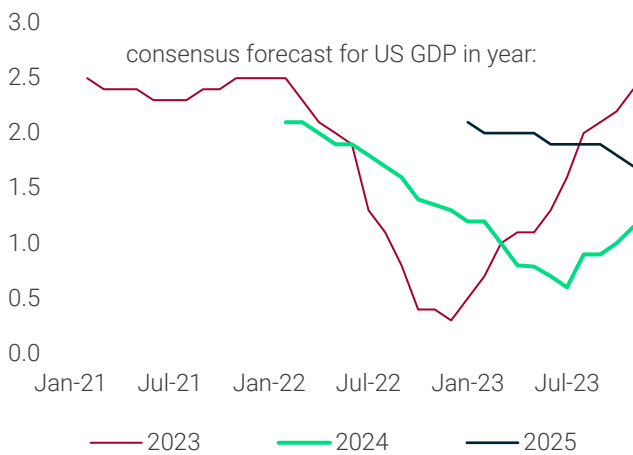


Source: Bloomberg, TS Lombard

The Christmas blockbuster

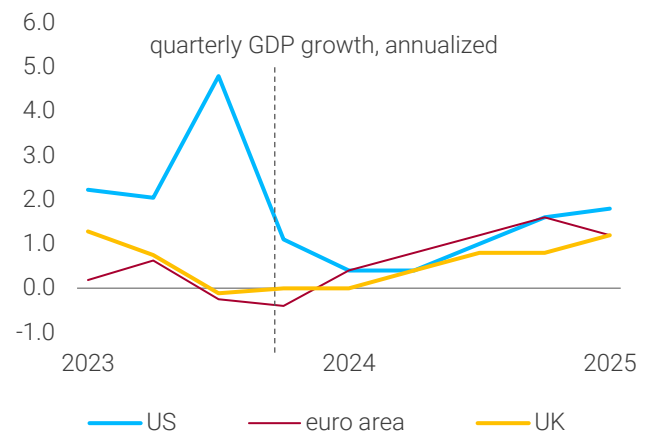
For economists in Europe and the US, December is all about the big "year-ahead" publication. Even though nobody reads these voluminous tomes (except, maybe, other sellside), they must be really long so you can showcase your vast intellectual capacity. There used to be a first-mover advantage to this game: everyone was desperate to get their New Year forecasts out before their competitors, so publication dates kept edging forwards. But there are clear risks to publishing such research in mid-October. If you are lucky, your "deep, thematic long-term analysis" will still be mildly relevant in mid-January. More often than not, your forecasts will disintegrate during the period between Christmas and New Year. (These days, of course, you are lucky if your "year-ahead" analysis is even remotely valid on Christmas Eve, when you set your "out of office" – indeed, market turbulence, global pandemics and even sudden scientific discoveries (COVID vaccines, ChatGPT) have all managed to shift forecast narratives.) But we digress. The broader point is that we have read dozens of these reports in recent weeks and found an amazing uniformity of view. By summarizing this view, we can save TS Lombard clients a lot of time.

Chart 4: The most 'economicsy' forecast ever



Source: Bloomberg, TS Lombard

Chart 5: Negligible GDP growth in 2024?



Source: Bloomberg, TS Lombard

What our peers are saying

Table 1 summarizes what the large investment banks are saying, based on the reports we were able to secure for free (for some reason, our competitors at other independent research providers are less willing to share their analysis). There is one term that appears in practically all these reports: “soft landing”. Either the authors explicitly endorse the soft landing thesis or they describe a slight variation on that theme (the “soft-ish” landing). In any case, reading across this vast and mind-numbingly tedious literature, the takeaway is that 2024 will be an environment of:

- (i) **Further sequential – but gradual – slowing across most of the major economies** (2024 will be a little weaker than 2023). Even rare recession calls (for, e.g., the euro area and the UK) are expected to be incredibly mild or “technical” in nature.
- (ii) **Inflation converging gradually on 2%, but never quite getting there** (the consensus clearly believes our long-term view that 2% is the new floor, rather than the ceiling).
- (iii) **Central banks start to normalize policy** (downwards this time!). The Europeans will move more slowly because inflation is lagging (despite greater recession risks).
- (iv) **The US dollar is likely to depreciate** owing to the relatively dovish Fed and “overvaluation” (and not just because that has been the prevailing trend recently).
- (v) **Constructive view of equity markets** – most see low, single-digit returns since a soft landing is “already priced in” and it is hard to get excited about current valuations.
- (vi) **Bond yields down modestly** owing to easier monetary policy and further disinflation. (Sellsiders are suddenly less worried about the imminent US fiscal crisis. Funny that!)

Riveting stuff. As is often the case, the consensus for the year ahead appears to be a mere extrapolation of the trends seen during the final few months of the current year – in this case, slowing global growth, continued disinflation and a dovish pivot from central banks. Yet, in terms of narratives, the near-universal acceptance of a “soft landing” seems a very different story from what economists were saying 12 months ago. Back then, the consensus believed a global recession was inevitable because it was the “necessary sacrifice” for restoring price stability.

Afterall, with inflation at multi-decade highs and unemployment at historical lows, everyone who believes in the Phillips curve (most of mainstream economics) knows that creating “slack” in the labour market – i.e., putting people out of work – is the only way to achieve a sustained reduction in inflation when the economy is presumably already “late cycle”. But it hasn’t worked out like that. “Immaculate disinflation” – lower inflation without higher unemployment – has forced a rethink.

Table 1: The (terribly exciting) consensus outlook for 2024

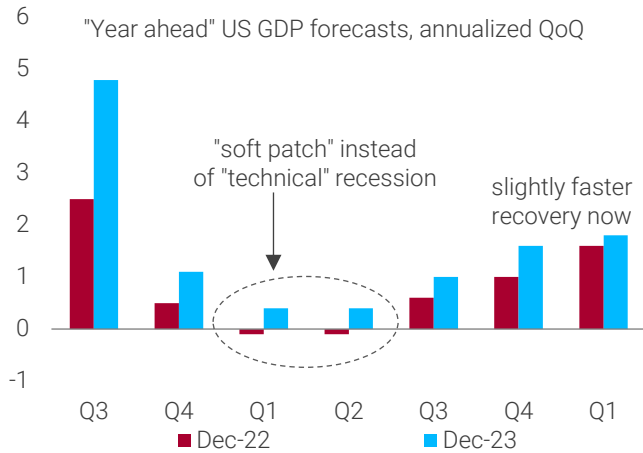
Institution	Landing	Inflation back to 2%?	Rate cuts for 2024?			SPX target	10-year	USD
			Fed	ECB	BoE			
Barclays	Soft-ish – mild deceleration	Nearly	No	Yes – gradual	Yes – gradual	4800		up, down
BNP	Soft-ish – flirts with recession	Nearly	Yes – gradual (Q2)	Yes – gradual (Q2)	Yes – gradual (Q2)	4300	3.9	1.15
BoA	Soft – mild deceleration	Nearly	Yes – gradual (H2)	Similar to Fed	No	5000	4.25	1.15
Citi	Mild recessions	Nearly	Yes	Yes	Yes	5100	4.3	
DB	Mild recession					5100	4.1	
Goldmans	Soft – resilient	Nearly	Yes – gradual (H2)	Little earlier than Fed	Little earlier than Fed	4700	4.6	1.1
HSBC	Soft landing		Yes – gradual			5000	3	
JPM	Soft-ish – flirts with recession	Nearly	Yes – gradual (H2)			4200		
Lazard	Soft landing	Yes	Yes	Yes but late	Yes but late			
Morgan Stanley	Soft-ish – further slowdown	Nearly	No	No	No	4500	4	
Soc Gen	Mild recession	Nearly	Yes – gradual (H2)	Yes but late	Yes – gradual (H2)	4750	3.75	1.15
UBS	Soft – mild deceleration	Nearly	Yes – gradual (H2)	Slightly more than Fed	Slightly more than Fed	4700	3.5	1.12
Wells Fargo	Mild recession	Nearly	Yes – 225bps from H2	Yes – gradual (H2)	Yes – gradual (Q2)	4625		up, down

Source: TS Lombard

Under the hood

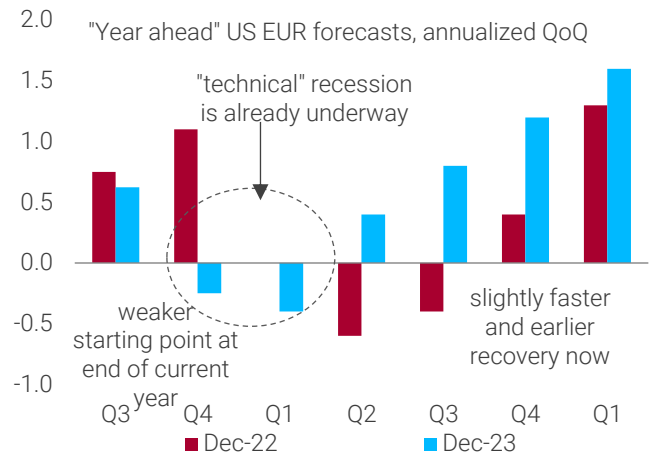
A “soft landing” instead of a “recession” sounds like a big deal until you dig deeper into the details of those consensus forecasts. For this analysis, we rely on the Bloomberg survey (“ECFC” on the Terminal), which polls a large sample of professional economists every month. As we should expect from the shift in sellside narratives, forecasters have revised up their forecasts for US GDP significantly since the start of the year. For 2023 as a whole, the latest survey gives annual US GDP growth of around 2.5%, compared with an expectation of just 0.3% back in the January. Yet, while economists have been raising their projections for 2023, they have also been cutting their forecasts for 2023. The latest estimate – at 1.1% - is half the growth rate they had 12 months ago. This is the most “economicsy” move ever! The consensus still expects a deterioration in the US economy – presumably owing to the “long and variable lags” from tight monetary policy – but that slowdown now occurs later (and is a little milder) than the one economists imagined at the start of 2023. To make this point more clearly, we can compare the latest quarterly GDP forecasts for 2024 with economists’ forecasts for 2023. Chart 6 shows that these downgrades are trivial. While the consensus no longer has a “technical” US recession (two quarters of falling GDP) during the next six months, it is still expecting only negligible expansion in Q1 and Q2. It turns out that the difference between a soft landing and a recession is a matter of basis points!

Chart 6: Trivial revisions to 12-month outlook



Source: Bloomberg, TS Lombard

Chart 7: Euro-area 'recession' already under way

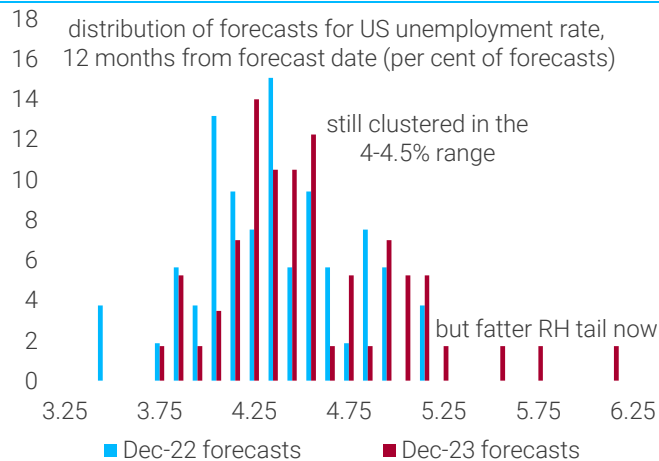


Source: Bloomberg, TS Lombard

Sellside marketing

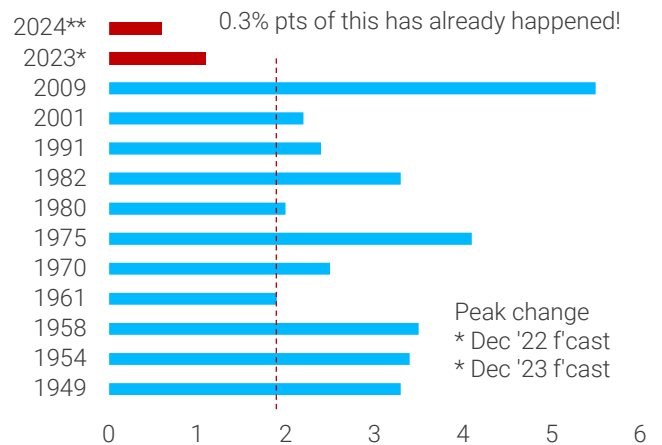
The broader point here is something we pointed out 12 months ago. While most of the consensus was spinning their recession narrative at the start of 2023, the downturn they were forecasting would, in fact, have been the mildest recession in history (barely a recession at all, in fact). Now they have forecasts for 2024 that are not wildly different from what they had for 2023, but they are giving those similar projections a totally different spin – “soft landing”. Ultimately, the best way to judge the severity of an economic downturn is to look at what it does to unemployment, not quarterly GDP. Comparing today’s distribution of US unemployment forecasts for 2024 with what the survey produced 12 months ago shows that the expected depth of the downturn has not really shifted. And, more important, these entire distributions fall well short of what we might expect in a truly recessionary scenario. The US has never had an official (NBER) recession without unemployment rising by at least 2 percentage points. Twelve months ago, almost nobody expected a downturn of that magnitude. Today we have the same story. (In fact, the tail of the consensus distribution has shifted to the right, with a few more nasty outliers.)

Chart 8: Jobless forecasts largely unchanged



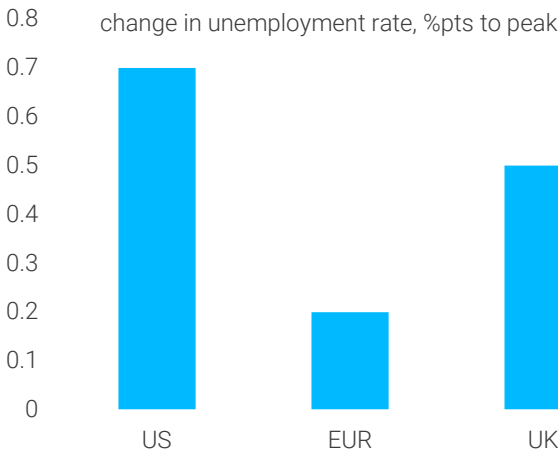
Source: Bloomberg, TS Lombard

Chart 9: This was never a proper recession anyway



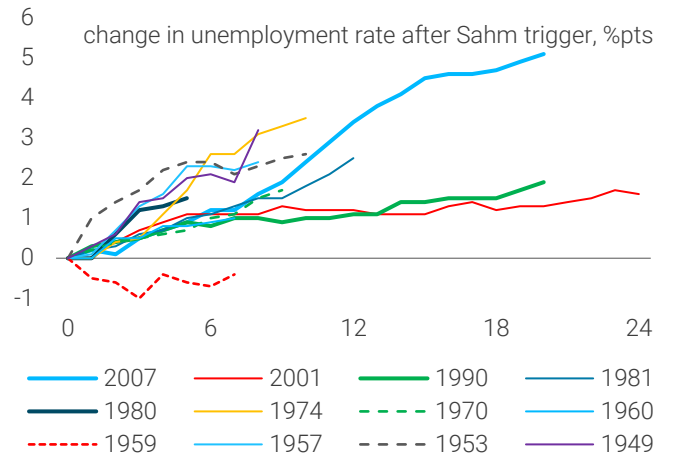
Source: BLS, Bloomberg, TS Lombard

Chart 10: Expected rise in unemployment



Source: Bloomberg, TS Lombard

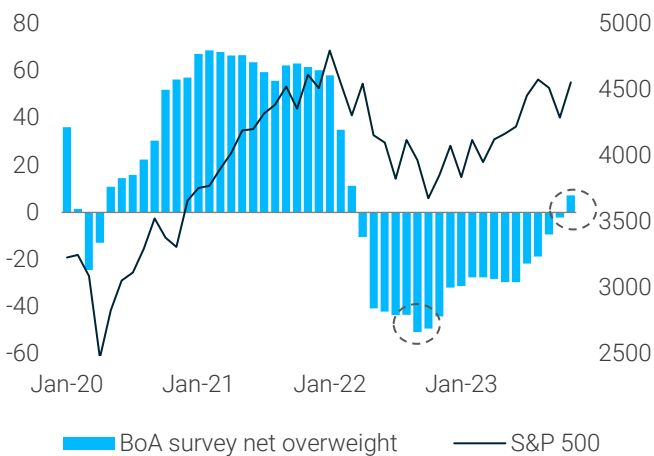
Chart 11: Real US recessions are more severe



Source: BLS, TS Lombard

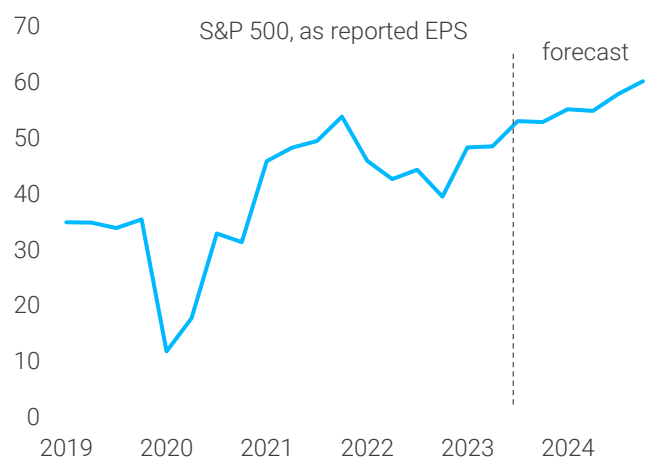
It seems odd that what most sellside economists are basically doing is marketing the same set of forecasts with a totally different spin. But perhaps the explanation comes down to credibility and market positioning. At the start of 2023, the consensus was bearish on risk asset. According to the BoAML survey, portfolio managers had a clear underweight position in equities. Talking about “recession” was a way to justify that bearish stance, based on the idea that an economic downturn would hit corporate earnings. Since then – largely thanks to a rally in stock markets that caught most pundits by surprise – views on equity markets have shifted. Asset managers have flipped back to a small positive position in global equities. And the “soft landing” label is a good way for sellside to yield to this more constructive outlook. Most of the 2024 outlooks we read explicitly mention the possibility of further equity gains, even “if valuations are expensive”. From a credibility point of view, there is only so long sellside economists can keep using the “R” word, particularly when the equity market doesn’t seem to care about their gloomy prognosis.

Chart 12: Prices drive narratives



Source: BoA/ML Fund Manager survey via X

Chart 13: Earnings recession already over?

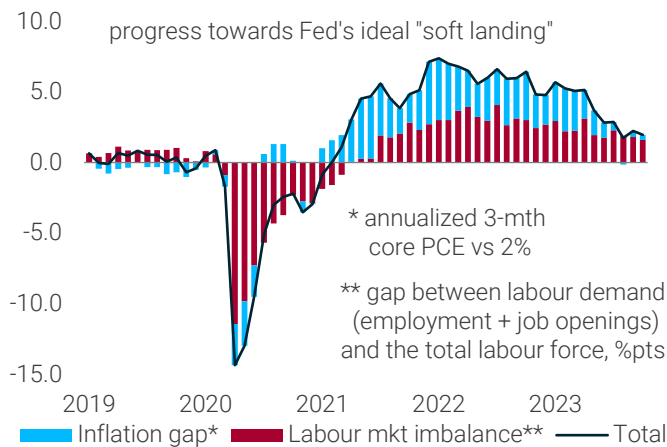


Source: S&P, TS Lombard

2. THE START OF SOMETHING

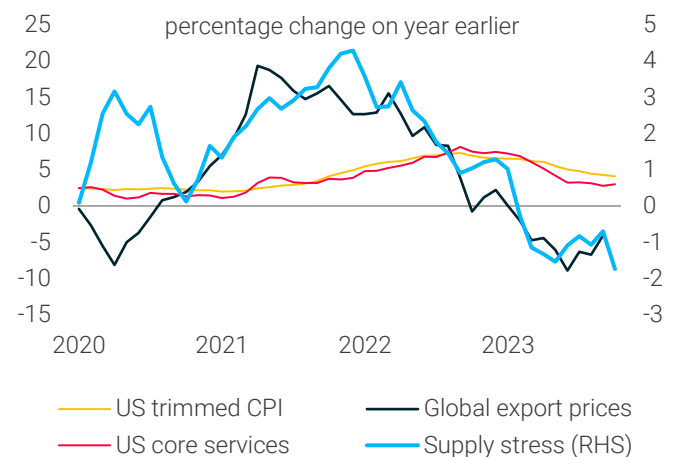
Our analysis shows that despite the very different marketing spin, the sellside outlook hasn't really shifted over the past 12 months. Most economists continue to expect negligible ("below trend") growth, mild disinflation and a (gradual) dovish pivot from central banks. But where could these forecasts go wrong? Having emphasized the resilience of the global economy throughout 2023, we must admit that it is somewhat unsettling to see everyone else in the industry suddenly embrace our soft-landing thesis. Not only have recession risks increased in recent months (thanks to slowing labour-market activity), but the contrarian would point out that such a strong consensus for a soft landing is often the harbinger for something terrible to happen. And this isn't just a matter of superstition; it also tells us something important, both about the biases inherent in economic forecasting and about the nature of recessions themselves (which tend to be "non-linear" and come with strong "reflexivity"). So, could the consensus be making the same classic mistake again by underestimating the potency of the current downturn? In the near term, the risks are skewed in that direction. The first few months of 2024 could be rather shaky.

Chart 14: Soft landing is 75% complete



Source: BLS, BEA, TS Lombard estimates

Chart 15: Maybe inflation was always transitory



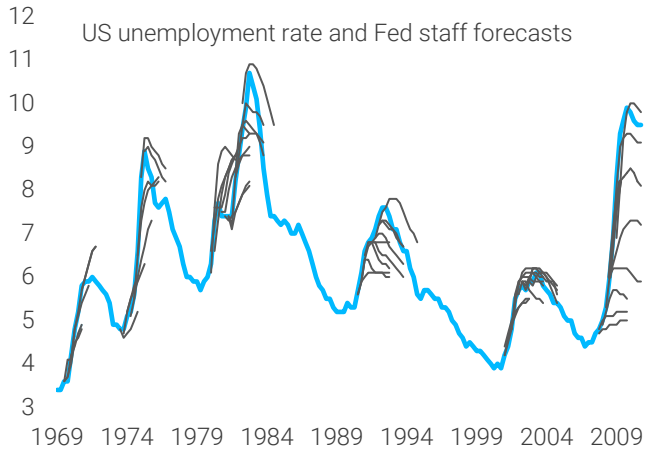
Source: New York Fed, BLS, TS Lombard

This time is different?

Chart 1 (front page) shows that the number of Bloomberg stories about soft landings always spikes ahead of major US recessions. In fact, there was only one large spike that wasn't associated with recession: 1995-96, which is literally the textbook example of a soft landing. On social media, charts like this one are often used as a "gotcha" moment directed against those pundits who think the global economy can avoid another hard landing today. "Look, you are making the exact same mistake again!" But that is not our intention here, especially as we have always believed that a soft landing was an entirely plausible endgame for a post-COVID expansion that has never conformed to normal business-cycle dynamics (in large part because it wasn't a normal business cycle). Instead, we think it is useful to ask why we see this pattern in Chart 1. What is it about a recessionary downturn that – at least in its early stages – always tricks economists into thinking it is something benign? After all, this is not just something we see in Bloomberg news coverage. Twelve months ago, we showed that policymakers usually make the same mistake. From Chart 16 it can be seen that although Fed officials have correctly predicted higher unemployment ahead of every US recession – which means they recognized that the

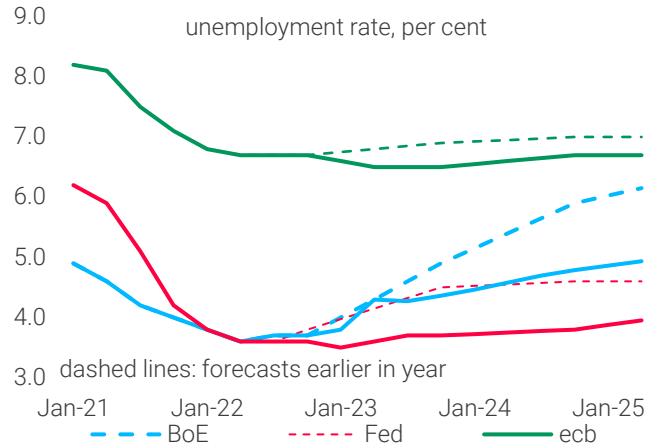
economy was deteriorating in real time – they always underestimated the severity of the downturn, leading to systematic forecast errors.

Chart 16: A systematic forecast bias



Source: Federal Reserve, TS Lombard

Chart 17: Were central banks too gloomy this time?



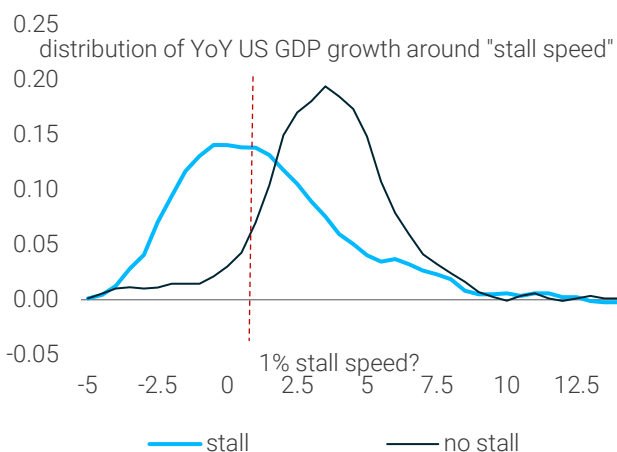
Source: Fed, ECB, BoE, TS Lombard

We think there are several explanations for this pattern of false soft landings:

- (i) **The way economists produce forecasts:** Economists have a habit of incorporating new information only incrementally in models that tend to assume an unhealthy degree of mean-reversion. When an economist sees the economy beginning to deteriorate, which often starts slowly, they will invariably assume this is part of a modest downturn. This means there is always a degree of “forecast smoothing” in consensus projections, either because making large changes can undermine the forecasters’ credibility, or – more likely, especially in the financial industry – because an economist who is on the public record defending their previous viewpoint will not want to abandon it until it becomes totally untenable. (We see a similar bias ahead of strong booms, which economists also have a habit of missing). According to a recent study by the IMF, which found that economists had successfully predicted just five out of 153 recessions (internationally) since 1992, this is because they are “slow to absorb bad news”. The Fund concludes “our main finding is that while forecasters are generally aware that recession years will be different from other years, they always miss the magnitude of the recession, typically by a wide margin.” Economists often fail to acknowledge a recession even when they are already in one.
- (ii) **Sectoral spillovers:** While economists’ training undoubtedly contributes to the large forecast errors they make around cyclical turning points (by urging practitioners to assume the status quo in the absence of better information), it is also likely that these mistakes tell us something deeper – about the recessionary process itself. A good example would be where a problem in one part of the economy, such as the housing market, spills over into a broader episode of economic weakness. Even if economists are aware of the initial problem, they might fail to take account of the wider spillover effects. The classic example would be the subprime crisis in 2006-07, which the consensus at the time thought was “contained”. Chart 21 lends some support to this view. Recessionary periods first show up with weakness in a minority of sectors, which eventually spreads elsewhere. On this basis, perhaps we should be worried about recent US trends, at a time when the breadth of payroll gains has narrowed and half of the industrial sector is experiencing declining output.

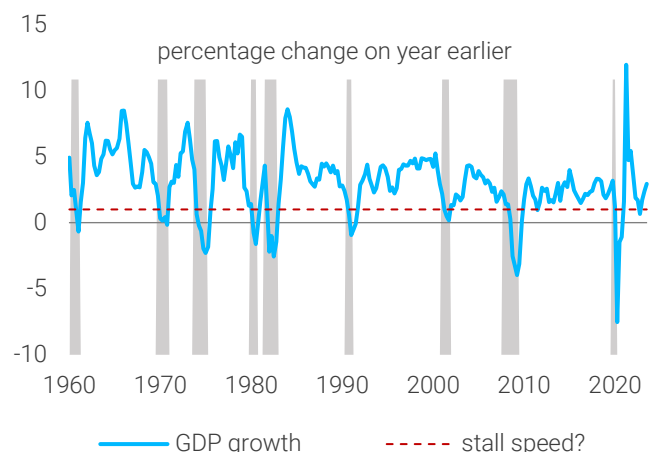
- (iii) **Sources of reflexivity – labour markets:** Sectoral spillovers can trigger non-linearities and reflexivity, which are hard to capture in simple forecasting models. But they are not the only thing that can create “explosiveness” in the recessionary dynamic. We have always placed a great deal of emphasis on labour-market developments, particularly for understanding US recessions – since US companies are relatively free to adjust their staffing levels without incurring large costs (which is not the case in the euro area or Japan). When people start to lose their jobs, there can be an aggregate decline in confidence and consumer spending, which then feeds back into lower corporate revenues, potentially triggering additional rounds of redundancies. And it does seem that the US labour market exhibits this spiralling effect because once the US unemployment rate rises by a small amount, it typically jumps by a lot. (The basis of the Sahm rule, which uses a 0.5% pt rise in the jobless rate as a critical – but not infallible – US recession marker). This is what some economists have in mind when they ask why the US never experiences (European-style) “mini recessions”. US unemployment either rises by a trivial amount or it rises a lot, which, as explained above, is rather worrying when looking at 2024 forecasts.
- (iv) **Sources of reflexivity – credit markets:** Like labour markets, the credit cycle can create a degree of reflexivity that is hard to capture in economic models. This is obvious where large macro-financial imbalances have built up, such as asset-price bubbles and unsustainable debt growth. A deteriorating economy will cause asset prices to decline, while making it harder for the private sector to service its debts, unleashing a vicious cycle of defaults, bankruptcies and rising unemployment. But these dynamics are not unique to history’s big financial crashes and “balance sheet recessions” (such as subprime, or Japan and Sweden in the early 1990s). We could also see a milder version of this process which, even if it is not sufficient to trigger a systemic crisis, would still render consensus forecasts hopelessly optimistic. The BIS has warned that this sort of tightening in financial conditions often comes as a delayed response to monetary tightening, typically two or more years after central banks have raised interest rates. Chart 25 shows we are approaching that point.

Chart 18: Evidence for a stall speed in the US?



Source: BIS, TS Lombard

Chart 19: The US economy stalls at 1% YoY?

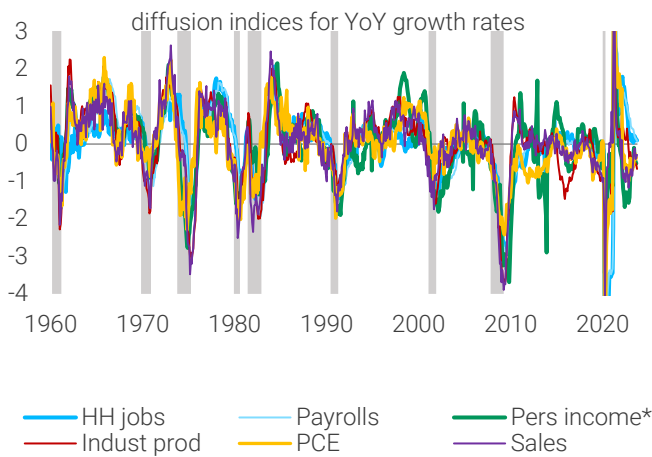


Source: BEA, TS Lombard

Implicit in many of these explanations is the idea that the economy can hit a sort of “stall speed”, which economists miss because their models do not – perhaps cannot – capture the non-

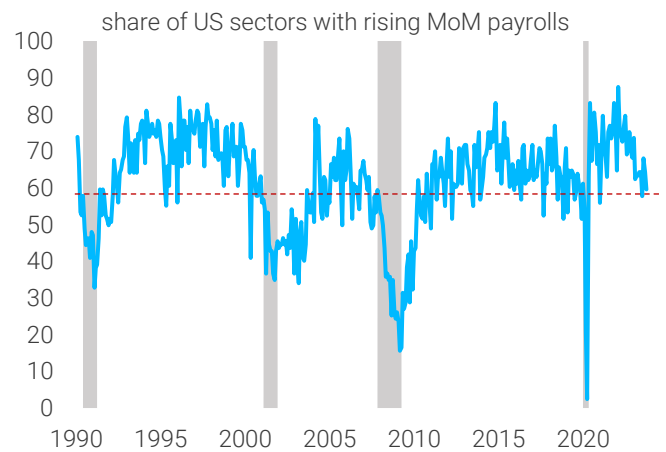
linearity and reflexivity that is endemic to the recessionary process. This is not a new idea, of course. The macro stall speed was a particularly popular idea in the early 2010s, when, after the recovery from the GFC, policymakers were worried about a double-dip recession. [An influential paper by a Fed economist, Jeremy Nailwaik](#), found that once US economic growth dropped below a certain threshold, it was typically followed by discrete deterioration in performance. Further research supported this notion, with several studies settling on the idea that the critical stall speed was 1% GDP growth, measured in year-on-year terms – see for example Sheets (2011), Sheets and Sockin (2012) and [Ho and Yetman \(2012\)](#). But it is fair to say that this idea remains controversial and the evidence for a stall speed outside the US is rather mixed. A comprehensive [study by the BIS \(2013\)](#) using a range of statistical procedures found discrete stall speeds in just 11-14 out of 51 major economies. And owing to the lengthy period of subpar expansion after the global financial crisis – without frequent recessions – interest in this topic has dried up.

Chart 20: Labour markets the source of resilience



Source: BEA, TS Lombard

Chart 21: Breadth declines before a recession?

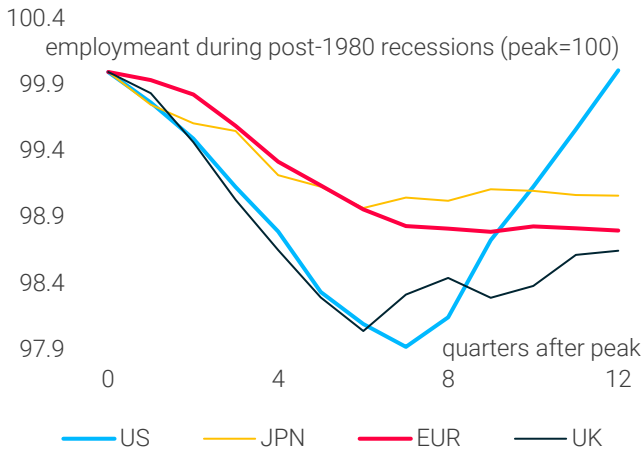


Source: BLS, TS Lombard

Close to stall speed?

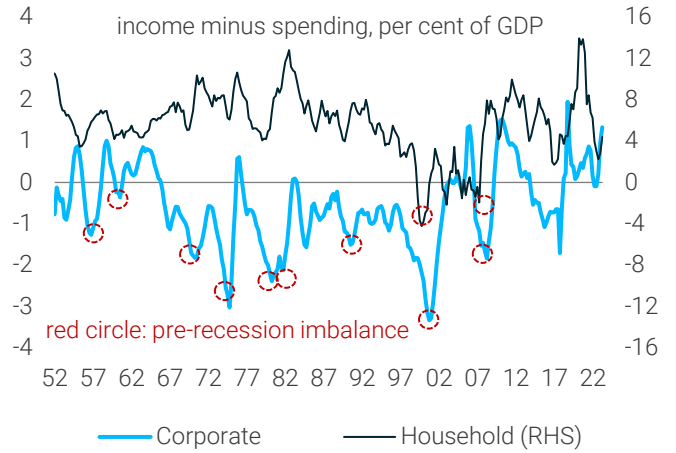
Stall speed or not, the risks to consensus macro forecasts are skewed to the downside, at least for the next three to six months. Looking at the six categories the NBER uses to define recessionary periods for the US, the labour market has been the main source of economic strength (see Chart 20, which replicates [the John Hussman method](#)). But labour market resilience is starting to fade, which is not surprising given the pressure on margins and the turn in the credit cycle – both in the US and elsewhere. If employment genuinely cracks, we could again see the classic reflexivity that consensus forecasts always miss. Right now, we think this threat is particularly serious in Europe, where central banks have already overtightened monetary policy. The good news for the ECB is that euro-area labour markets are notoriously sclerotic. Demand could deteriorate further without immediately triggering large-scale job losses. (That would still be bad news for European equities because labour hoarding hurts corporate profits, which is also the reason why European downturns often last longer and are followed by slower recoveries – because it takes longer for the corporate sector to sort itself out, it is harder to get a V-shaped recovery.) But the BoE may not be as lucky as the ECB because UK employment is more responsive to economic weakness (Chart 22).

Chart 22: Could labour hoarding save euro area?



Source: OECD, TS Lombard

Chart 23: No screaming macro imbalance now

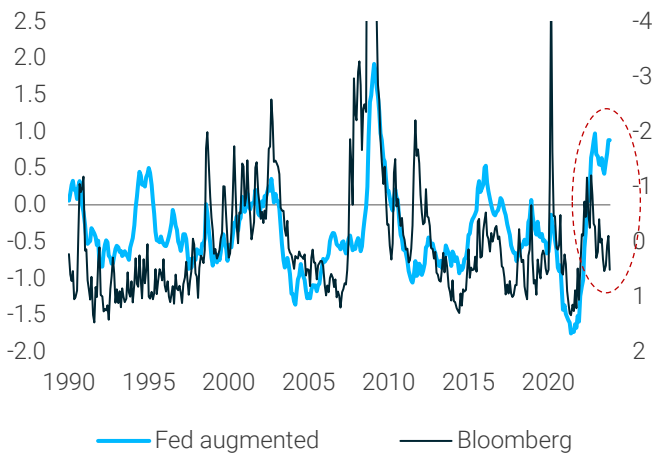


Source: Federal Reserve, TS Lombard

3. THE BIG PIVOT

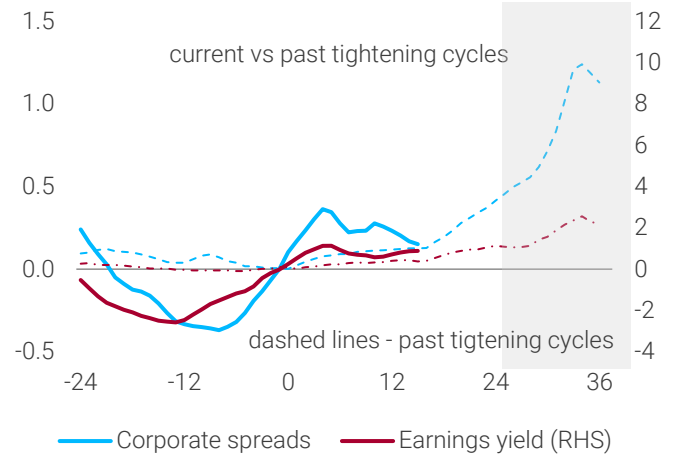
While near-term risks are skewed towards further economic weakness, the good news is that central banks have more policy optionality now than they had 12 months ago. Inflation is already back to tolerable levels in the US and is likely to continue its recent descent in other parts of the world, potentially a lot faster than policymakers have been expecting. This is important: it not only limits the downside to the global economy during the first half of 2024 (keeping any recession mild); it also raises the prospect of a stronger economic recovery. Falling inflation has given central banks the opportunity to repeat what happened in 1995, when Alan Greenspan used a “mid-course” correction in monetary policy to deftly steer the US economy away from recession and pave the way for a multi-year economic expansion. The only question is whether the authorities (particularly the Fed) will be willing to seize this opportunity. The consensus expects a dull 2024. Perhaps this is just a lack of imagination. How does an early 2024 recession scare,

Chart 24: Fed sees diverging financial conditions



Source: Federal Reserve, Bloomberg, TS Lombard

Chart 25: The big corporate squeeze still to come?



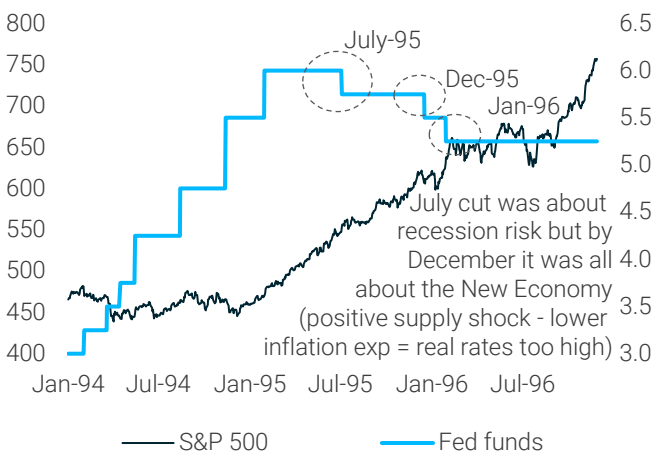
Source: BIS

followed by a big monetary response and an unexpectedly strong recovery, sound? And that's before we get into the US election season, which will bring its own unique set of risks.

Anticipating policy easing

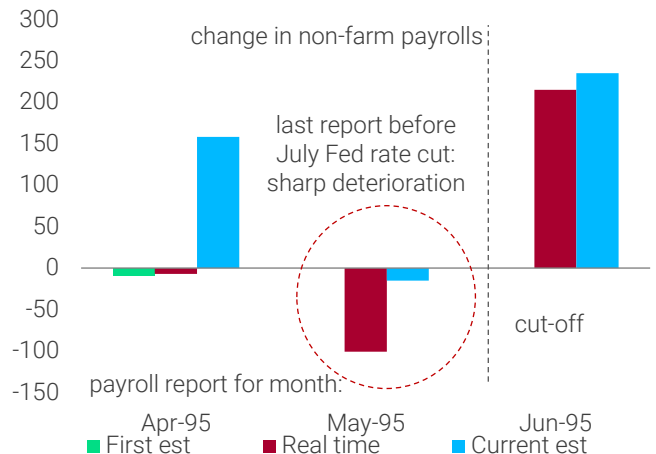
Even before sellside economists have finished marketing their chunky year-ahead publications, we are already seeing a dramatic shift in market pricing, as expectations for policy easing build. At the time of writing, we have forward curves priced for 100bps+ of rate cuts (from the Fed and most other central banks), starting in March, which is more aggressive than most sellside forecasts. The reasons for this are clear: global inflation data have turned unambiguously more benign and central banks have adopted a more dovish stance (with some Fed officials even opening the door to the prospect of imminent policy easing). On one level, this easing in financial conditions is already useful as it should help to put a floor under economic growth, which was already looking shakier. But there are two things to remember. First, the full impact of this easing in financial conditions will not be felt immediately – we should still expect economic data to deteriorate somewhat more at the start of 2024. Second, central banks will need to validate these market expectations. If the authorities try to resist the pressure for upcoming rate cuts, financial conditions could tighten once again. There is still a possibility of policy errors, particularly if the authorities are worried about “repeating the mistakes of the 1970s”, when some of their predecessors reduced interest rates too soon, allowing inflation expectations to trend higher.

Chart 26: The 1995 mid-course policy correction



Source: Datastream, TS Lombard

Chart 27: 1995 Fed got a little lucky?



Source: Datastream, TS Lombard

The 1995 template

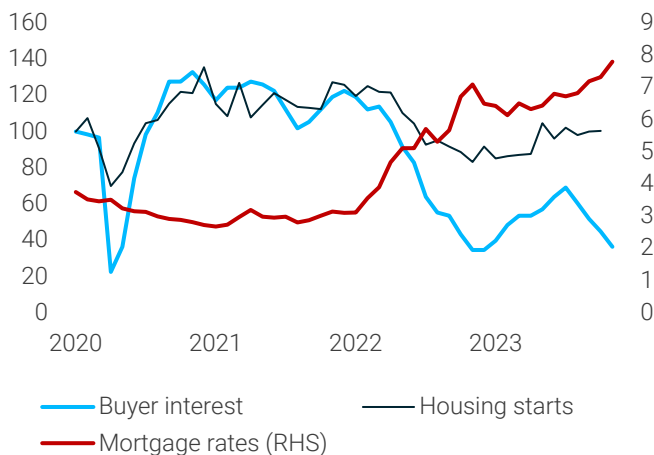
Tim Duy, the well-known Fed watcher, argues that central banks will need to cut interest rates *in anticipation of economic weakness* if they want to secure the soft landing. If they wait for the deterioration of the data – which is lagging – it will be impossible to halt the economy's slide. Yet this isn't what happened in 1995, which is always *the* textbook example of a US soft landing. Back then, after raising rates aggressively to a deliberately restrictive setting in anticipation of an inflation problem that never materialized, Alan Greenspan cut rates back to a neutral (a “mid-course correction”) as soon as the inflation risks became more balanced. Looking [at the transcripts of the FOMC meetings from that time](#), it is clear there are similarities to the situation we face today. In July 1995, at the time of the Fed's first 25bps rate cut, Greenspan said the Fed was not expecting a recession (“nobody [on the FOMC] thought the odds of a recession were better than 50:50” and the economy should “work its way through this period”) but having

“diffused the inflationary pressures that were building” (by “cutting the top off... a highly unstable and inflationary business cycle”), officials had to “ask ourselves whether a 6 per cent nominal Fed funds or a 3 per cent real funds rate is the appropriate rate to be at in the next six to 12 months”. Put another way, Greenspan believed overtly restrictive policy was no longer necessary.

Fed got lucky in 1995?

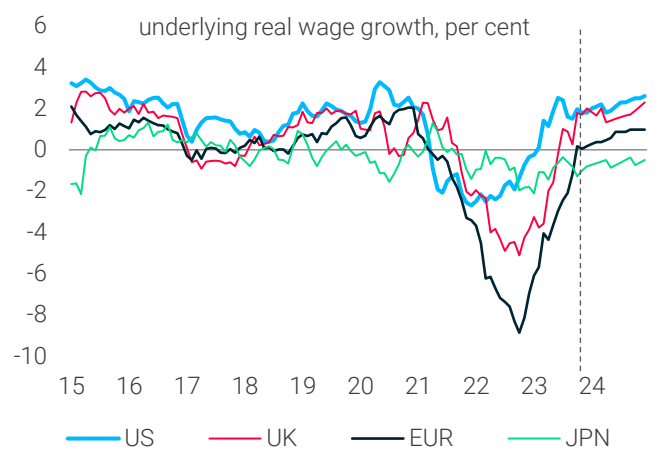
The 1995 mid-course policy adjustment was an “insurance” move that the Greenspan Fed could deploy because it was well positioned, with rates clearly in restrictive territory. But it is also important to remember that US officials got a little lucky in 1995. That first rate cut was set in motion by a dire May 1995 employment report, which had originally recorded a 111k decline in US payrolls, on the back of another, albeit small (7k) decline in May. It looked like the US labour market was beginning to break in response to a manufacturing/inventory correction that had been taking place for some time. Just one day after the Fed’s rate decision, on 7 July 1995, the June employment report painted a totally different picture. Not only was the May decline revised significantly higher (to -46k), but the survey also reported a powerful 215k bounce in employment. This was the reason July’s move was not followed by a rapid succession of further rate cuts. With the economy recovering, the Fed waited until December before it nudged interest rates lower again, and that was largely because Greenspan had become a tech enthusiast, recognizing an acceleration in US productivity long before it showed up in official US GDP statistics. Greenspan believed the “New Economy” justified “driving [monetary policy] without the handbrake on”.

Chart 28: US housing is now very rate-sensitive



Source: DataStream, NAHB, TS Lombard

Chart 29: Real wage recovery a source of resilience



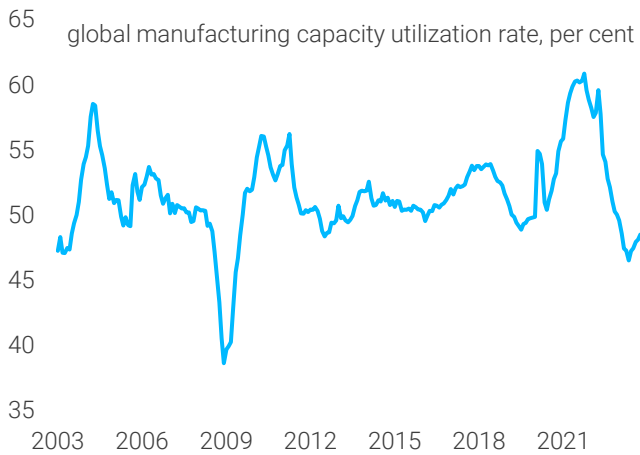
Source: ONS, BoE, Atlanta Fed, Eurostat, TS Lombard

A quick turnaround

We think there is a good chance of a repeat performance in 2024. If US data were to deteriorate – particularly if employment contracts – we think Jay Powell and his colleagues would react swiftly. And since the economy is free of underlying macro-financial imbalances – restrictive monetary policy is currently the dominant source of demand destruction – easier policy could deliver a quick turnaround. We have already seen, for example, that US housing market activity has been particularly sensitive to short-term swings in borrowing costs over the past two years (Chart 28). The important point is that US officials have not succumbed to the supply pessimism and policy defeatism we are currently seeing in Europe. Perhaps this is because they have a dual mandate rather than a sole European-style inflation objective. Or maybe it’s because 2024 is a US election year. Whatever the reason, the Fed has an opportunity to not just head off a recession before it

gains traction but, like the “maestro” Greenspan, set the US economy on a path of sustained expansion – one that could even lead to a productivity revival. We have always believed that the medium-term macro prospects are favourable and that the danger period was in the initial transition to higher rates, particularly with central banks whipsawed by the COVID cycle.

Chart 30: The bullwhip recession is complete?



Source: S&P, TS Lombard

Chart 31: Start of a US manufacturing revival?



Source: S&P, TS Lombard

Bailing out the European economy

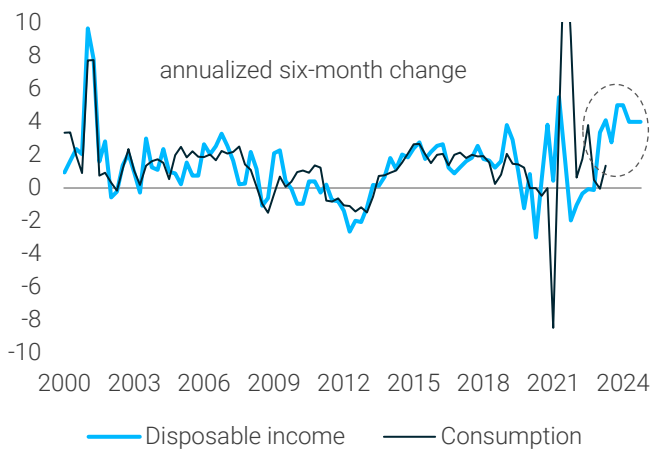
While US officials will pivot quickly to secure the soft landing, it is not entirely clear whether central banks in Europe will offer such a rapid policy reversal. ECB officials remain worried about second-round effects, while the BoE is adamant that the UK NAIU has risen (the exact opposite of what Greenspan was arguing in the mid-1990s, when he thought new technologies had reduced the NAIU). But even if the Europeans are hesitant rate-cutters, an early Fed pivot would alleviate some of their concerns about currency weakness, which means they should be able to follow the US policy lead. And, despite the widespread gloom about the European outlook in 2024, we wouldn't rule out the possibility of a positive growth surprise in 2024 (particularly if a little pragmatism returns to policymaking). Indeed, we see two potential routes to stronger European growth. First, there could be a revival in global manufacturing, especially when the bullwhip inventory cycle ends (which is overdue). Chart 30 shows global capacity utilization is starting at low levels, which means any recovery in orders will boost output. Second, after three years of Europe's cost of living crisis, there is a realistic prospect of a strong improvement in real incomes. If labour markets remained resilient, this would give consumers a lot of extra spending power.

Opportunities in markets

In recent months, there has been a lot of chatter about whether financial markets are already priced for a soft landing. For a small group of large-cap US stocks (the Mag7) this appears to be true – or, rather, they are priced on the basis that a US recession wouldn't hurt them. We have always been rather sceptical of this idea. Like the Nifty Fifty during the 1970s, it is dangerous to assume these mega-cap stocks are genuinely immune to all macroeconomic developments, particularly given their lofty valuations. Yet, they are good companies – but so were the Nifty Fifty, and they still suffered a decade of derating. A further deterioration in the global economy would test the thesis that the Mag7 are “bullet-proof”, which makes us cautious on risk assets. We think the better risk-reward lies elsewhere, particularly in those parts of the equity market that have struggled over the past 18 months. Sectors such as housing, financials, and US small-cap and

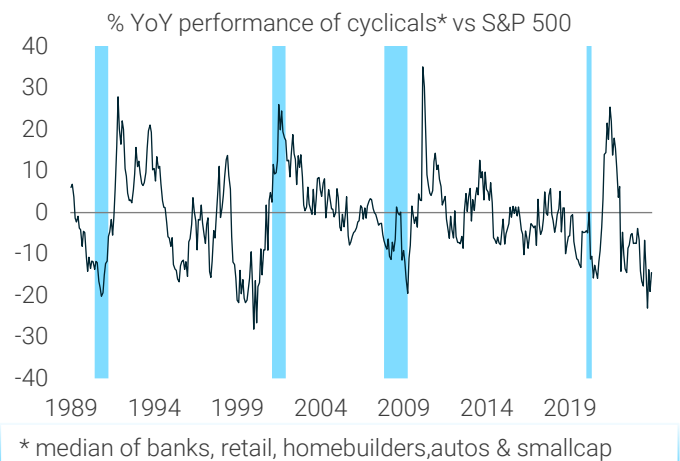
value stocks are already priced for a significant downturn (which limits their downside) and would benefit most from a strong economic recovery in 2024. We can see this from the Druckenmiller “recession indicator” (Chart 33), which is certainly not priced for a soft landing. Of course, it will be important to get the timing right, especially if there is a recessionary wobble at the start of the year. Meanwhile our view on bonds is largely unchanged. Yields peaked in October, with all that talk about a US fiscal crisis, but we are in a secular bear market of higher lows and higher highs.

Chart 32: Euro-area growth surprise in 2024?



Source: Eurostat, TS Lombard

Chart 33: The Druckenmiller recession proxy



Source: Datastream, TS Lombard

Bottom line

Consensus macro forecasts appear to have shifted from forecasting a recession 12 months ago to embracing the “soft landing” for 2024. But a closer look reveals that this shift is mostly marketing, presumably to justify a more constructive view on equity markets (having been caught out by the buoyancy of risk assets throughout 2023, when everyone was positioned for something nasty). The basic sellside macro thesis is still one of negligible growth, continued (gentle) disinflation and a gradual normalization. It doesn't matter that GDP is no longer “technically” expected to contract when forecasts for the labour markets – the true benchmark for the severity of an economic downturn – have barely budged. Where is this consensus likely to be wrong? Near term, we think the risks are skewed towards further economic weakness, with the potential for a shaky start to 2024. Economic models are badly equipped to deal with the reflexivity that can kick in, particularly if employment starts to contract. Labour market activity has slowed, profit margins have declined, and the credit cycle has soured. The good news is that with inflation now rapidly falling, central banks have a lot more policy optionality than they had 12 months ago. Early rates cuts could head off any further slide towards recession and even provide the catalyst for a powerful (non-inflationary) economic revival during the second half of 2024. The consensus expects a dull, “more of the same” macro environment for the next 12 months. But even soft landings are bumpy, and 2024 could produce a lot more excitement than people realize.

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