



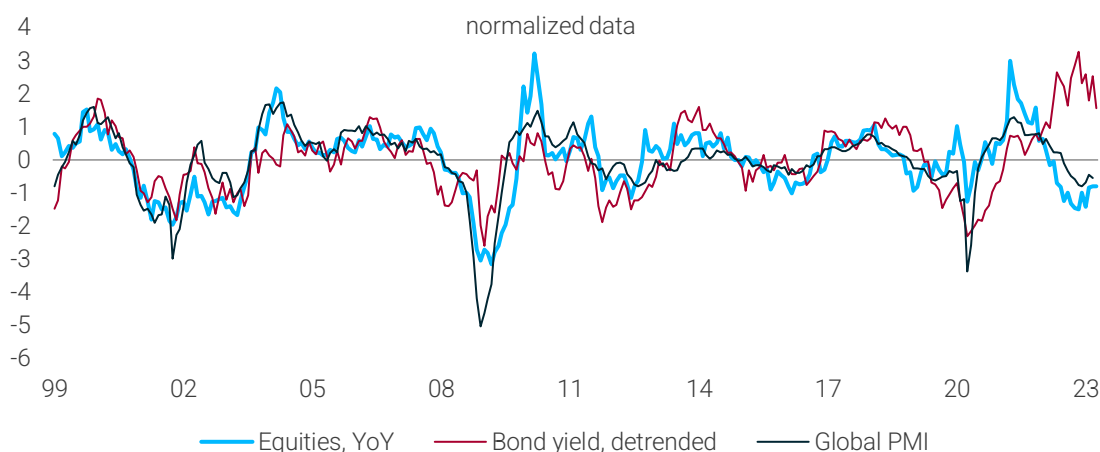
Macro Picture

RECESSION – A THREAT TO MARKETS?

Dario Perkins

After a choppy four months, investors are back to worrying about recession risks. Banks are tightening lending standards, which could further undermine the already struggling global economy, even as ebbing inflation alleviates the pressure on central banks to keep raising rates. But how much of this consensus downturn is already “priced in” to financial markets?

Chart 1: A recession would reduce yields, but the equity outlook is more complicated



Source: TS Lombard estimates, Datastream, Markit

PENDULUM SWINGS

So far in 2023, investors' focus has swung from recession to inflation and back to recession. While all the classic warning signs have been in place for some time, banking-sector stress could be the event that pushes the global economy into a more serious downturn. The odds of a true recession have certainly increased, but we are still looking at a mild one by historical standards.

MONETARY WHIPSAW

The good news is that inflation has finally peaked, which, combined with banking stress, has reduced pressure on central banks to maintain the monetary squeeze. Though services inflation is proving sticky, it is clear we are not seeing a rerun of that 1970s nightmare scenario. The Phillips curve is shifting down and labour demand is falling even without a rise in unemployment.

MARKET DISCONNECT

Financial markets appear to be priced for a soft landing. While yields will likely drop further if a true recessionary dynamic takes hold, the behaviour of the stock market is more uncertain. Much will depend on what happens to earnings, where the bullish case is a repeat of what happened during the 1990 recession. But even a mild recession could bring significant equity volatility.

RECESSION – A THE THREAT TO MARKETS?

The year 2023 has provided an incredibly choppy environment for macro investors. We have already seen market narratives flip from worrying about recession to inflation anxiety ([remember the “no landing” scenario](#)), and back to recession fears, with just a brief sojourn on [“soft-landing island”](#). Various forces have contributed to these swings in sentiment, including unusual seasonal patterns in global data, the lingering distortions from the pandemic and the war in Ukraine, and the usual ambiguities that always set in around potential turning points in the economic cycle. Of course, many of the classic recession markers have been warning of danger for some time. Yield curves are deeply inverted, global manufacturing output is contracting, durable goods demand has turned down, construction activity has plunged, and popular “leading indicators” have rarely been weaker. Yet, it seemed until recently that the consensus was overstating the risks to the global economy. Since this was [not an ordinary business cycle, the odds of a soft landing always seems better than the historical track record](#). Has the situation changed? It seems increasingly likely that central banks have fumbled the soft landing. Not only have they raised interest rates at an unnecessarily rapid pace, but they [have finally started to “break things”](#). Thanks to the recent stress in global banking, the authorities are no longer in control of broad monetary conditions.

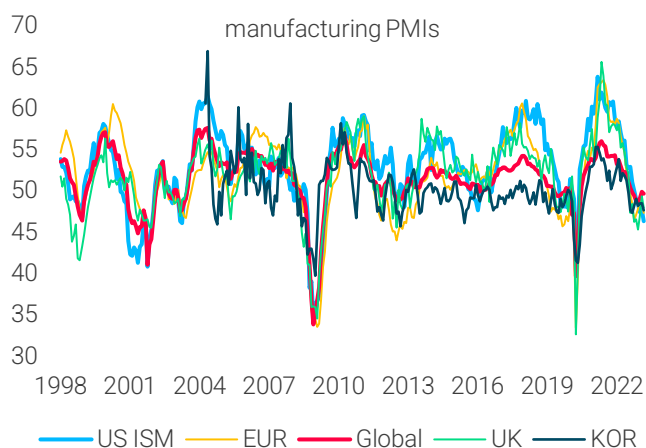
The good news is that inflation seems to have finally peaked. Global goods prices have turned lower; and although services inflation is proving stickier, there is now no doubt that central bankers’ worst fears about a potential rerun of the 1970s are no longer justified ([in fact, they always seemed rather farfetched](#)). Not only is the Phillips curve shifting back towards pre-COVID norms, but we are also seeing a reduction in labour demand – even without a material increase in unemployment (suggesting we are on a steep part of the Beveridge curve). While the improvement in inflation might have come too late to prevent a mild global recession, it has at least reduced the pressure on central banks to continue with their rapid tightening cycle. For the first time since before this inflation outbreak, we should see the authorities adopt a more balanced policy approach, paying closer attention to the real economy. And if true recessionary dynamics kick in – the classic reflexivity that often arises as companies start to reduce their workforce – reduced inflation anxiety will allow central banks to respond faster and more forcefully. Monetary policy has become an unnecessary source of macro instability over the past two years. After panicking about inflation and raising interest rates too far, clear evidence of a recession could soon have the opposite effect, whipsawing central banks into early rate cuts.

What would a mild recession mean for financial markets? Arguably, the soft-landing thesis is still the only scenario that reconciles the current constellation of global asset prices. Central banks could cut interest rates back to a more neutral setting – consistent with the inversion in bond markets – without the earnings destruction that threatens equity prices. The impact of a genuinely recessionary dynamic is more uncertain, even if the downturn is mild by historical standards. Bond yields would have further to drop, but the reaction from stock markets depends on the interaction of various forces pushing in opposite directions. The most bullish scenario for equity investors would be a repeat of what happened in the US during the 1990 recession. The combination of tight monetary policy, supply shocks (from the Iraq war) and banking stress caused a fairly “average” contraction in GDP, but equity markets largely shook off the downturn. It helped, of course, that valuations were low and corporate earnings remained resilient. Perhaps we can expect something similar this time, especially as valuations have already declined and a large part of the US stock market is apparently more responsive to interest rates than to the state of the macro economy. But it is important to remember that true recessionary dynamics are inherently unstable, and even a mild downturn would bring significant uncertainty. We will not know a recession is mild until it is over. Investors should position themselves cautiously. Whatever happens, the remainder of this year could be even bumpier than the first four months.

1. PENDULUM SWINGS

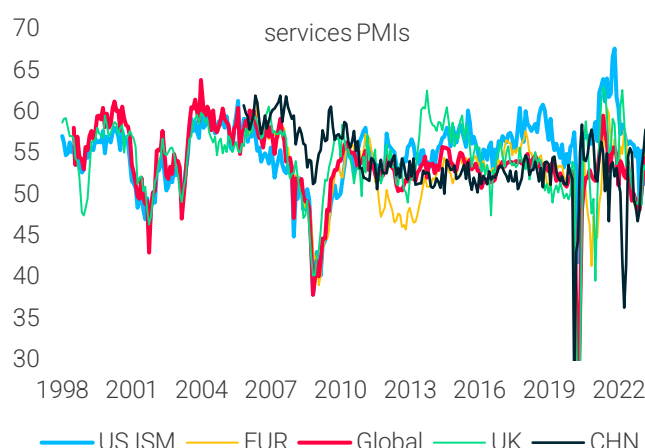
The year 2023 started with [an overwhelming consensus](#): the world was facing imminent recession. But within a few weeks the prevailing narrative had shifted. Thanks to stronger-than-expected global data, China's reopening and some big revisions to the US CPI, fears of a "hard landing" gave way to the "no landing" hypothesis – the idea that monetary tightening had not yet broken the post-COVID economic expansion. [Activity seemed to be reaccelerating](#), which meant inflation would remain a problem. And central banks responded by warning – once again – that investors had underestimated how much interest rates needed to rise. By the end of March, however, the narrative had shifted yet again. Following an episode of acute stress in the global banking sector, the recessionistas are back in the ascendency. It seems central banks' hawkishness has finally "broken something" in markets, which could mean the global economy is facing a more serious and protracted downturn. Even [the economists at the IMF and the Federal Reserve](#) – who are not known for tabloid levels of bearishness – have finally relinquished their hopes for a "soft landing". For most investors, the recession is a matter of "when", not "if".

Chart 2: Manufacturing in deep recession



Source: Markit, TS Lombard

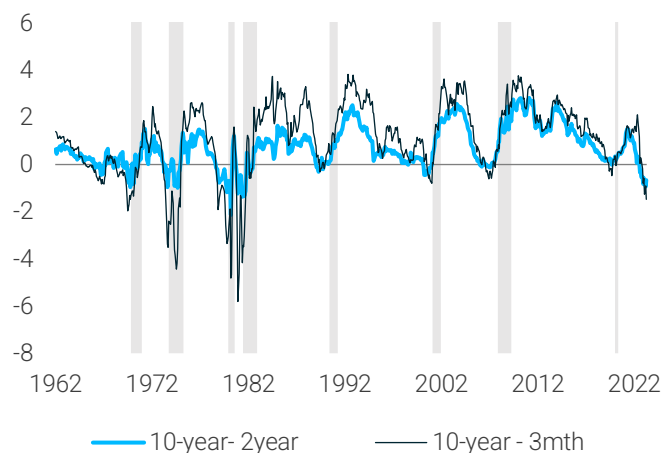
Chart 3: Services sectors are more mixed



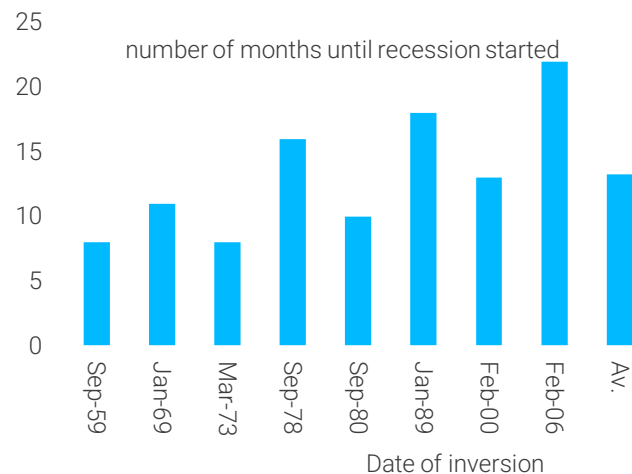
Source: Markit, TS Lombard

Recession markers

It is true, of course, that many of the classic recession markers have been signalling a problem for some time. Yield curves are inverted, which, at least for the US, [has a compelling record identifying cyclical turning points](#) (even if the lags are often long and variable – Chart 5). And many of the most cyclical parts of the global economy are already in contraction territory. Manufacturing output is down, world trade is falling, construction activity has plunged, and the demand for consumer durables – housing and autos – remains exceptionally weak. When these data are combined into "leading indicators", which is a popular pastime for market economists, the result seems to be an unmistakably recessionary dynamic (Chart 6). Yet, as we have pointed out ad nauseam over the past 18 months, the peculiarities of the post-COVID cycle mean it is dangerous to put too much weight on conventional leading indicators. Given the artificial boom in manufacturing and durable goods demand during the pandemic, we [were always likely to see a reversal in these trends as the world returned to normal](#) – without this necessarily triggering a broader economic contraction. Services activity and labour markets would remain resilient, offsetting the weakness in the more cyclical (and distorted) parts of the economy.

Chart 4: Deepest US inversion since the 1980s


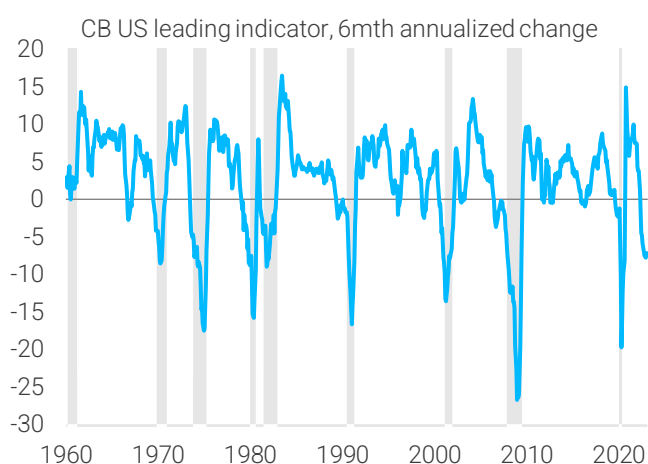
Source: Bloomberg, TS Lombard

Chart 5: Another long and variable lag


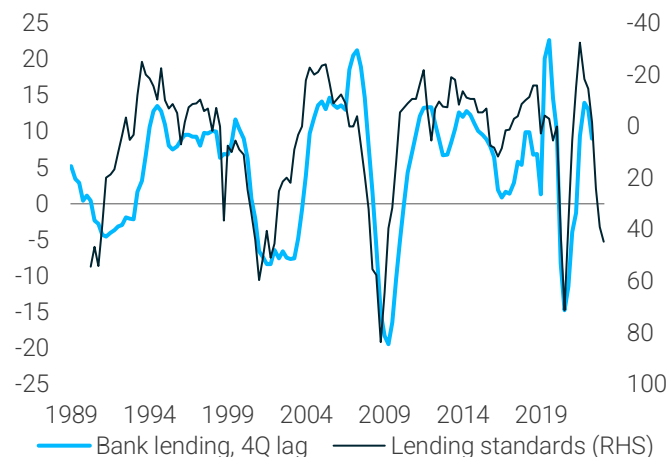
Source: Datastream, TS Lombard

Pendulum swings to recession

It remains extremely difficult for investors to distinguish genuine recessionary developments from the continuing distortions associated with the pandemic and the war in Ukraine. The fake business cycle of the past three years does not fit the usual cyclical ups and downs of the global economy, which is why market narratives have been pivoting wildly from one month to the next. Yet through all this noise, there has been one unambiguous source of aggregate demand destruction – monetary policy. Central banks have been raising interest rates aggressively; and with inflation staying high, they have now moved beyond simple policy normalization. Rightly or wrongly, the authorities believe they need to actively reduce demand, particularly demand for labour, as they try to force inflation back down to a level consistent with their longer-term targets. The evidence suggests these policies are now having the desired effects, which go beyond the (artificial) recessionary dynamic that always seemed inevitable as the world exited COVID-19.

Chart 6: Collapse in US leading indicators


Source: Conference Board, TS Lombard

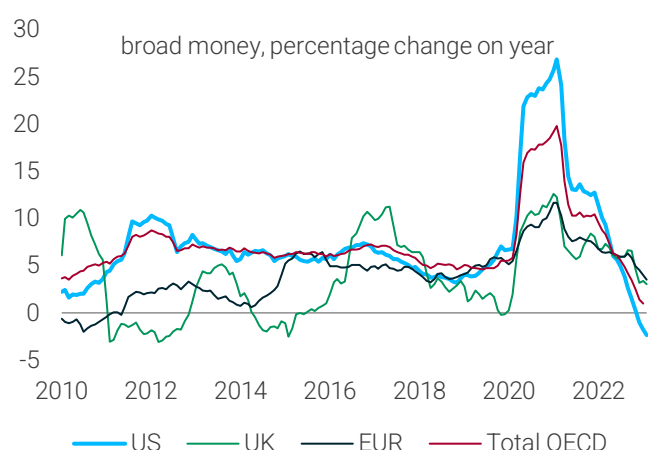
Chart 7: Recessionary bank lending standards


Source: Federal Reserve, TS Lombard

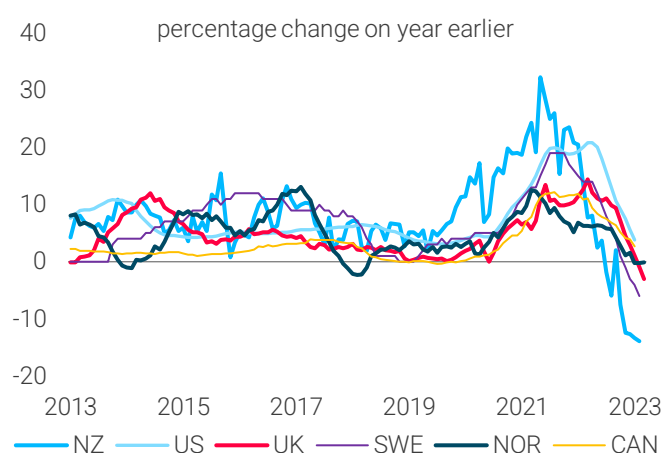
The monetary squeeze

To assess the impact of this policy squeeze, some commentators are pointing to the (highly unusual) contraction in various “broad money” metrics, particularly in the US. When combined

with evidence of deposit flight – particularly among smaller US banks – this contraction in the money supply has only increased the sense that central bank’s policy tightening has gone too far. The good news is that the contraction in broad monetary aggregates is probably overstating the severity of the monetary squeeze. The small decline now under way must be seen in the context of the massive expansion in the money supply that occurred during the pandemic. The bad news, however, is that the problems we are seeing in the global banking system could still have a material impact on the world economy. We know that banks are tightening their lending standards, and this can only amplify the effects of policymakers’ previous actions. Monetary policy is even tighter than it seems, but by a degree that is now largely intractable.

Chart 8: The big monetary squeeze


Source: National sources, OECD, TS Lombard

Chart 9: House prices headed for contraction


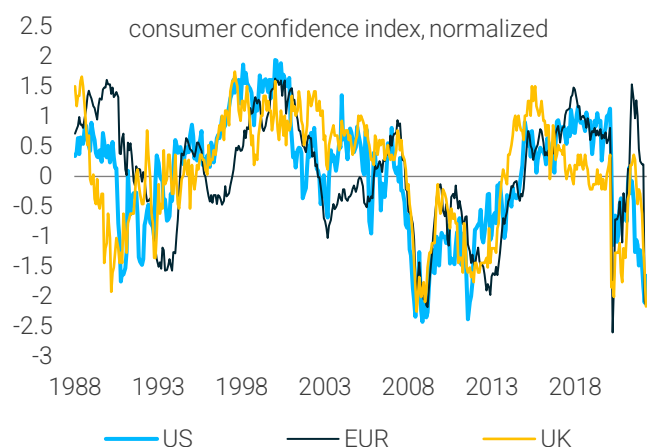
Source: National sources, BIS, TS Lombard

Uncontrolled disinflation

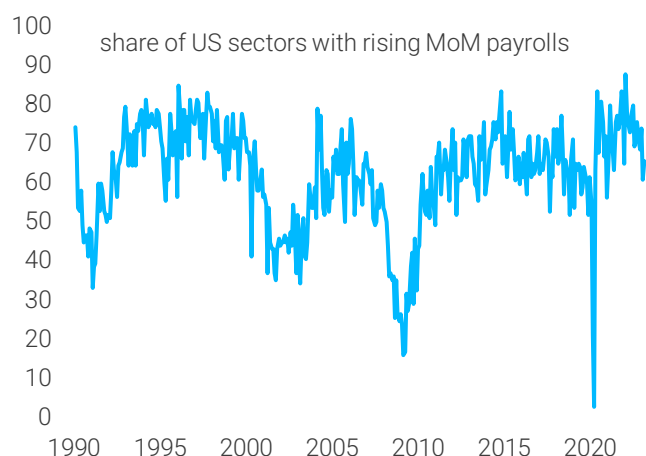
Since we can no longer assess the true stance of monetary policy – because it is impossible to translate banks’ lending decisions into a simple and timely “effective” policy rate – there is a good chance that central banks are losing control of monetary policy. Sure, the stress in the banking system will help to curb inflation, but it will do so in a way that is uncontrolled and might involve significant collateral damage to the global economy. The authorities are trying to balance the demands of financial stability and price stability, albeit with extreme levels of uncertainty. There is a greater risk of a genuine recession, by which we mean a situation in which GDP falls and unemployment rises. As we have explained elsewhere, the contraction in employment is the hallmark of the recessionary dynamic because this is where reflexivity kicks in. Rising unemployment damages consumer confidence and reduces spending (even among those people who keep their jobs), which leads to further declines in corporate profits and additional job losses. There is a recessionary process, and it goes beyond any “technical” definition involving GDP.

Recession – reasons for cautious optimism

Given the potential reflexivity involved, it is always dangerous to try to assess the likely length and magnitude of a recession before it has even started. Economists have a habit of underestimating reflexivity, which is why they always tend to downplay the magnitude of cyclical downturns. We showed in previous analysis that Fed officials, for example, have underestimated the severity of every US recession since the 1960s, even when they correctly identified a major turning point in the US economy. Bearing these caveats in mind, we believe there are good reasons to think the

Chart 10: Consumers are depressed


Source: Datastream, TS Lombard

Chart 11: US job gains are narrowing


Source: BLS, TS Lombard

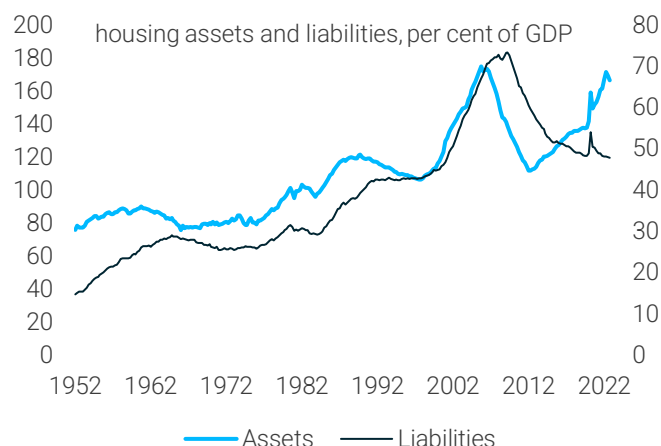
current downturn will be relatively mild, especially compared with what happened after the subprime bust (one of the deeper recessions). We take some comfort from the following points:

1. **Excess labour demand:** Most economies have large numbers of unfilled vacancies. In principle, this means monetary tightening could destroy a large number of jobs before it actively puts people out of work. Fewer job openings would mean slower wage growth and potentially less inflationary pressure, without a material increase in unemployment. Of course, there is no guarantee that the jobs that are lost will be in those sectors that currently have unfilled vacancies. “Mismatch” could increase. But the sectors that seem most sensitive to tighter monetary policy and the bursting of COVID bubbles – namely real estate, construction, tech and wholesale/distribution – could withstand a sizeable reduction in demand before they start laying off workers. In contrast with previous business expansions, there has been no big misallocation of resources in recent years.
2. **Strong profit margins:** Margin expansion has been responsible for the recent wave of inflation, as the interaction of strong demand and serious supply constraints has allowed companies to raise their prices. This means the corporate sector has more capacity to absorb a deterioration in profits before it starts laying off staff. And in a tight labour market, where it might be difficult to replace lost workers, there is an added incentive for companies to hang onto their employees. Labour hoarding is common in Europe and Japan. It is rarer in the US, but there are examples (such as the late 1960s and the mid-1990s) where a tight labour market forced companies to tolerate declining margins rather than try to restore profitability by firing workers. Obviously, this dynamic is harder to sustain the longer the downturn lasts and the greater the reduction in demand is. But non-labour costs should help because input prices are falling sharply and companies are unlikely to pass these onto consumers (meaning an expansion in non-wage margins).
3. **Support from real incomes:** Falling real wages have been responsible for much of the global economic slowdown since mid-2021. Companies raised their prices, which eroded real spending power – a process we called “volume destruction” (as opposed to genuine “demand destruction”). Wages have accelerated, but less quickly than prices. Now that inflation is starting to come down, this lag between wages and prices will start to work in favour of household spending power. Real incomes should recover. This is one of the lessons from the 1970s, where commodity-induced inflation always caused the economy

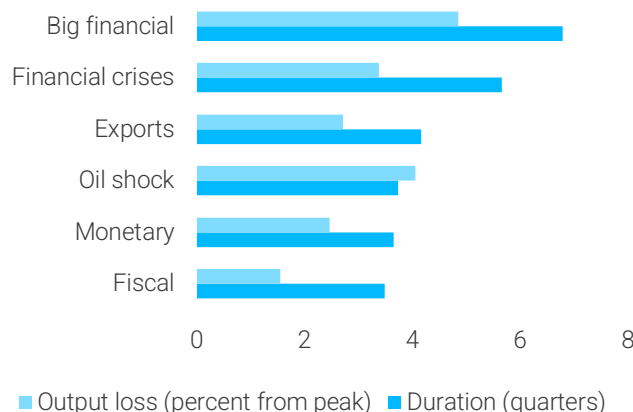
to contract, but each contraction was followed by a rapid reacceleration once the worst of the inflation was over. By failing to recognize the impact that inflation itself has played in the current sluggishness of the global economy, the consensus is underestimating the speed of the recovery, especially where poor supply temporarily drove inflation higher.

4. **Healthy balance sheets:** The worst downturns typically involve balance-sheet recessions, where, following a period of rapid debt accumulation, the private sector is forced into a period of sustained deleveraging. Today, we see relatively few financial imbalances of that nature. Asset prices have certainly increased over the past decade, but – outside of China – this has not been matched by significant debt accumulation. With [a few notable exceptions](#), most developed economies have lower private-sector debt ratios than they had a decade ago, when the world started to recover from the subprime crash. Even real estate markets, which were particularly buoyant during the pandemic period, have not generated the sort of debt vulnerabilities that arose during the early 2000s. Mortgage generation has been relatively muted and concentrated among those groups with decent repayment prospects – institutional investors and prime borrowers. While a decline in asset prices, real estate or equity markets could certainly cause significant damage to confidence and spending, any systemic fallout looks limited. From a macro perspective, [the risk is more Dotcom II than Subprime II](#).
5. **Interest rate stabilizer:** To the extent there are financial imbalances today, they are largely the result of [a decade-long duration bet gone wrong](#). Many investors assumed interest rates would be close to zero forever, while rapid monetary tightening has exposed the error in certain business models, highlighting weaknesses in their balance sheets. Banking is the obvious example, though – [as we highlighted in the previous Macro Picture](#) – there are likely to be other areas of vulnerability in global markets. The good news, however, is that this makes interest rates an automatic financial stabilizer of sorts. As growth weakens and rate expectations drop, stress in the financial sector will self-correct, which should help to alleviate some of the drag on economic activity. We have seen this dynamic play out recently. Banking-sector stress reduced terminal interest rates, which curbed banks' unrealized losses and breathed fresh life into real estate.

The broader point is that when COVID-19 began, there were relatively few underlying economic or financial imbalances. The expansion that preceded the pandemic had lasted a long time by historical standards, but it had also been unusually tepid. Outside the financial sector, businesses and households had behaved cautiously, while new regulations constrained traditional bank lending. Obviously, there were some parts of the financial system – such as institutional investors, private equity and smaller (less-regulated) banks that had engaged in riskier activities – but their direct macro footprint remained relatively limited. This means the main problem today is not some deep underlying vulnerability, which threatens a large, multi-year recession; rather, it is inflation. Or, more precisely, central banks' efforts to tame inflation. In contrast with the big balance sheet-induced recessions of the past 30 years, the depth and duration of the next downturn is likely to depend on what happens to inflation and what the central-bank policy response is. Will inflation remaining high mean that the authorities maintain their monetary squeeze, regardless of the damage to the real economy? Or will lower inflation allow them to pivot quickly and end their squeeze? The answers to these questions could determine how bad things get from here.

Chart 12: Latest housing bubble unleveraged


Source: Federal Reserve, TS Lombard

Chart 13: Balance-sheet recessions are the worst


Source: IMF

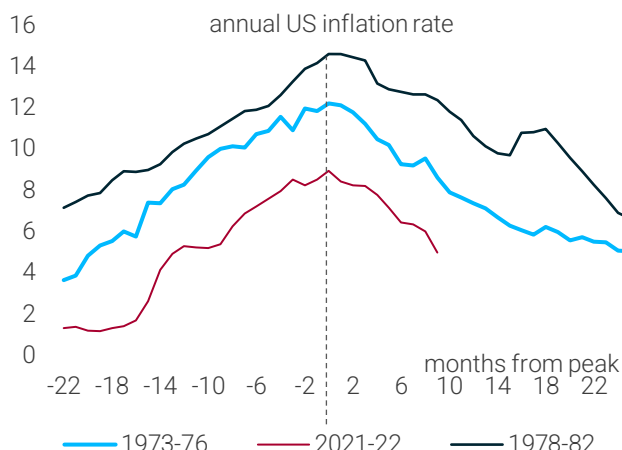
2. MONETARY WHIPSAW

Twelve months ago, central banks feared [a nightmare rerun of the 1970s](#) that would see them lose control of inflation and find themselves stuck in persistent stagflation. That risk has not materialized. Inflation expectations remain stable and headline inflation rates have peaked, with Phillips curves beginning to shift back to where they were before the pandemic. Even with labour markets that remain tight, there is no sign of the “wage-price” spirals central bankers feared. In fact, wages could slow even without a material rise in unemployment. While services inflation is proving stickier than the authorities would like, the combination of lower goods inflation and tighter bank lending standards should be sufficient to allow central banks to end their tightening cycles in the coming months. If the economy were to deteriorate faster than they expect, clear evidence of “peak inflation” would allow the authorities to respond more quickly – ensuring a relatively mild and short-lived global downturn. We see the possibility of a policy whipsaw whereby, after having panicked about inflation and raised interest rates too far, central banks will be forced amid fears about economic growth to ease faster than the consensus realizes.

Peak inflation

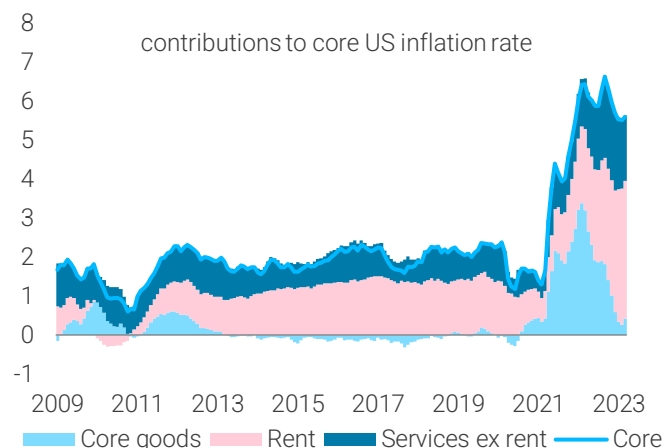
Investors and policymakers have been looking for signs of “peak inflation” ever since prices first started to accelerate more than two years ago. Now the evidence is undeniable. Headline inflation rates have already dropped significantly; and while this is partly due to favourable base effects, it is clear that sequential monthly and three-month rates have dipped from their scary readings 12 months earlier. Of course, goods prices are responsible for much of this improvement – a trend that should continue in the months ahead. Food, energy, and other commodity prices are down significantly, which will eventually feed into “core” CPI components. Globally, we are also seeing a large decline in consumer goods demand, a contraction in trade and a significant downturn in manufacturing – all of which should ensure continuing disinflation in the goods components of the CPI, with the possibility of outright declines in those prices. As officials acknowledge, this was always where [the disinflationary process would start](#).

Chart 14: Peak inflation – but a peak like the 70s?



Source: Datastream, TS Lombard

Chart 15: Inflation has spread to services

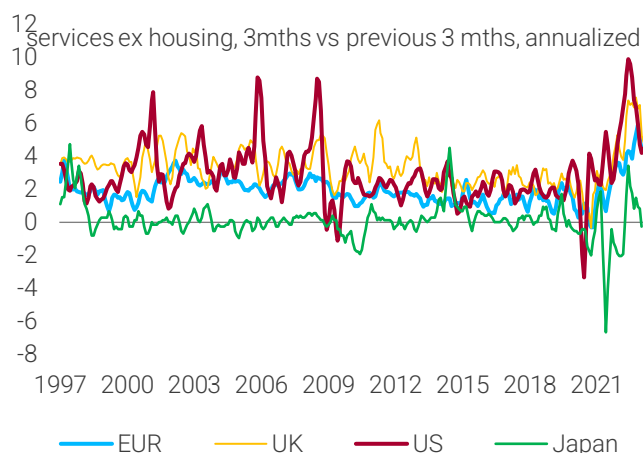


Source: Datastream, TS Lombard

Stickiness in services

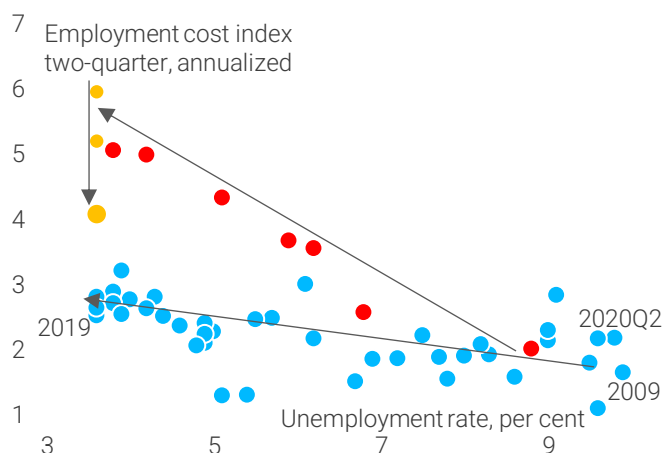
While disinflation has started in the goods sector, it is less prominent in the services sector. In line with central bank analysis, it is helpful to break services prices down into two parts – housing and non-housing; this applies in particular to US inflation metrics, as housing in that country has a significant weight (the weight is smaller in Europe because European measures do not include homeowners' housing costs). Official measures of housing costs remain elevated, but there are good reasons to expect them to come down during the second half of 2023. Private rental metrics, which typically lead the official measures by around 12 months, have already fallen significantly. So, the only lingering inflation concern for policymakers is in non-housing services, especially where these prices are linked to developments in the labour market. Central bank officials are worried that tight labour markets and rapid wage gains will keep these components of the CPI rising at pace that will leave overall inflation running above their 2% inflation targets. This perceived "imbalance" in labour markets – excess demand for workers – is now the main justification for the monetary squeeze.

Chart 16: The focus for policymakers



Source: Datastream, TS Lombard

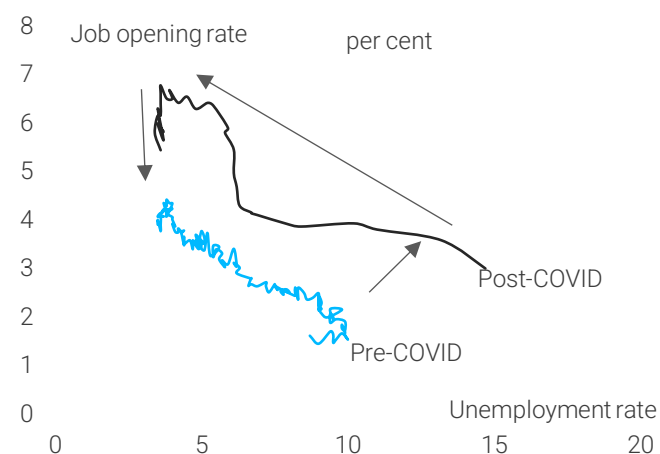
Chart 17: Phillips curve shifting down



Source: BLS, TS Lombard

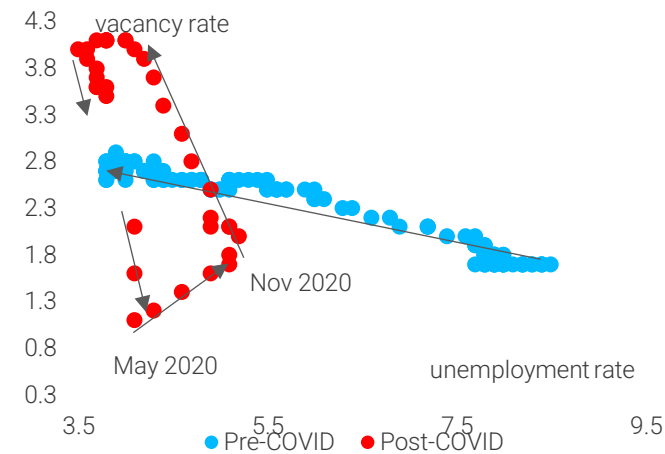
The central bank focus on non-housing services prices remains rather questionable. Not only are the banks focusing on an extremely narrow measure of inflation, but it is not even clear that wage developments in these sectors are the underlying driver of price developments. Often, inflation trends here are little more than a spillover effect from commodity prices, while there is no real evidence that wages in these sectors are growing unsustainably quickly. The important point, however, is that no DM economy is experiencing the wage-price spirals the authorities had feared. Real wages keep declining; and there is even evidence that nominal wages are starting to slow, which is not what we would expect if the labour market were “overheating”. Once again, central banks have been misled by the erroneous belief in a stable Phillips curve. If the Phillips curve exists, it seems to be shifting back down to where it was before the pandemic (Chart 17). And to the extent monetary policy has destroyed labour demand, this is happening (so far) without a rise in unemployment – which suggests we are on an unusually steep Beveridge curve. As we explained in a previous Macro Picture, this has echoes of what happened after WW2.

Chart 18: A steep part of the Beveridge curve



Source: BLS, TS Lombard

Chart 19: UK Beveridge curve 'normalizing'



Source: ONS, TS Lombard

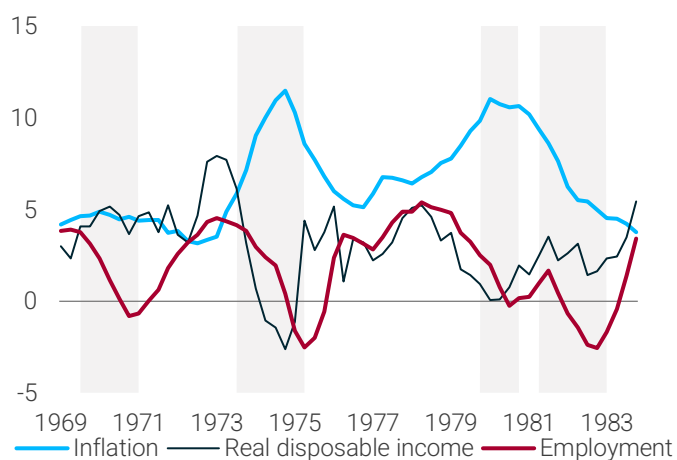
This is not the 1970s

At a minimum, recent developments in wages and labour markets suggest policymakers are not facing a rerun of the 1970s. This is not surprising, as we have pointed out many times over the last two years (see, for example, [here](#) and [here](#)). While tight labour markets have increased the bargaining power of workers in particular sectors, this follows 40 years in which the neoliberal supercycle has continuously crushed labour power. Trade unions have largely disappeared, and globalization caused a massive increase in the effective supply of labour internationally. Even if these structural forces are starting to wane and the neoliberal supercycle is on its way out, the situation today is a far cry from the dominant position workers held in the 1970s. UK worker militancy, which has picked up and is making lots of headlines in the British press, looks extreme by recent standards, but it is nothing compared with what the country experienced 40 years ago. And the UK is seeing one of the stronger reactions from workers (matched only by the French).

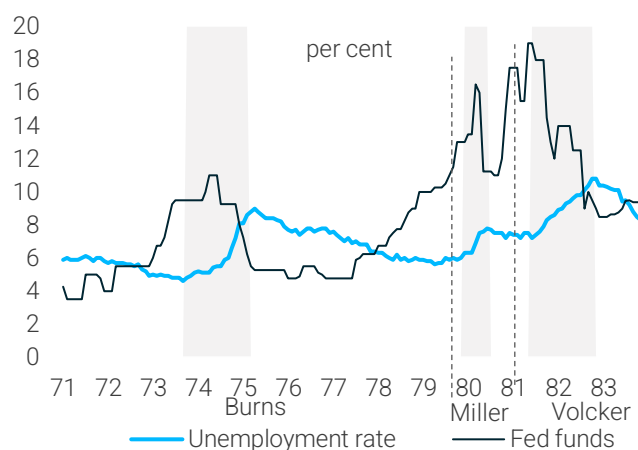
Avoiding the errors of the 1970s

These structural differences are important because central banks say they are determined not to repeat the perceived policy mistakes of the 1970s. They believe their predecessors were too quick to cut interest rates each time their economies weakened, which is what allowed inflationary expectations to become unanchored. Charts 20-22 illustrate what happened. The two

big energy-induced inflation shocks – in 1973 and 1979 – squeezed real incomes and caused the economy to contract. But as soon as headline inflation dropped, real incomes recovered and central banks cut interest rates, which meant that underlying price trends settled on a higher path. Wage demands always lagged headline inflation and companies tried to protect their margins. These problems did not disappear until the mid-1980s, at the cost of a deep recession, when central banks – with the support of new neoliberal politics – kept interest rates high and eventually squeezed the inflationary pressure out of the system. The fact we are not seeing those same dynamics today is encouraging. The absence of a 1970s-style wage-price spiral gives central banks more room for to respond, should the economy deteriorate faster than they expect.

Chart 20: Recessions in the 1970s


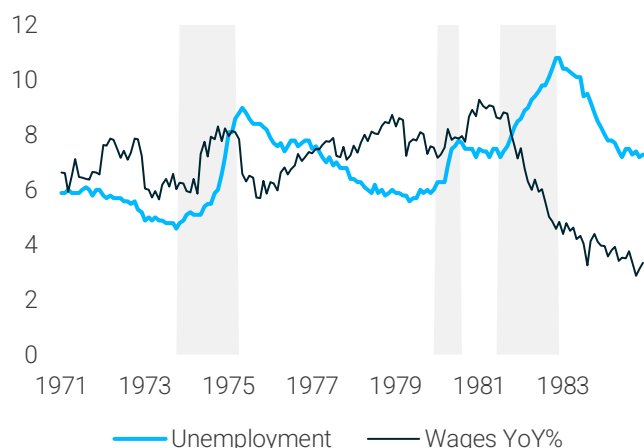
Source: BLS, BEA, TS Lombard

Chart 21: Policy mistakes of the 1970s


Source: BLS, BEA, TS Lombard

Monetary whipsaw

In recent months, central banks haven't taken every opportunity to rule out imminent policy easing, even as yield-curve inversion has deepened. Real wages have plunged, but officials still say they are focused on inflation and avoiding the mistakes of the 1970s: they want to "keep it", which is an obvious reference to Paul Volcker. But it is easy to sound hawkish when labour markets are solid and unemployment is at historical lows. And no central bank is going to talk about the possibility of rate cuts when they are still tightening monetary policy – they will always dangle the threat of further hikes in front of markets, right up until the moment they want to reverse course. But if labour markets genuinely cracked and employment started to decline, which is the true definition of a recessionary process, we should expect a swift response from monetary policy. In contrast with the Volcker era, there is no political tolerance for a sharp rise in unemployment today. After central banks panicked about inflation and raised interest rates aggressively, recession would likely come from their tightening policy too far. The good news is that they are likely to reverse those policies quickly, as soon as there is clear evidence of a genuine recession dynamic. A central bank "whipsaw" would ultimately limit the depth and duration of the downturn.

Chart 22: Wage trends kept inflation sticky


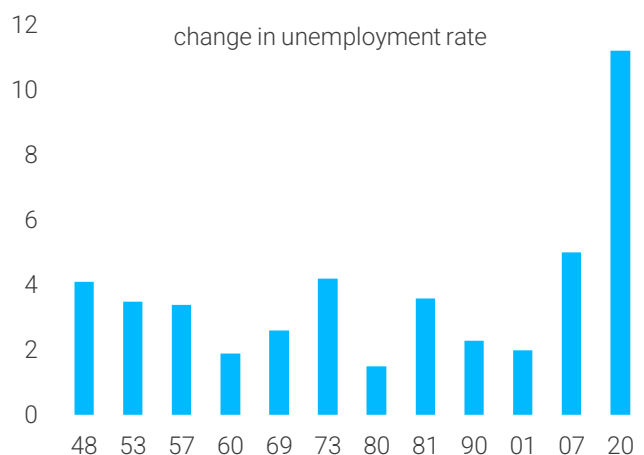
Source: BLS, BEA, TS Lombard

Chart 23: Recent militancy in context

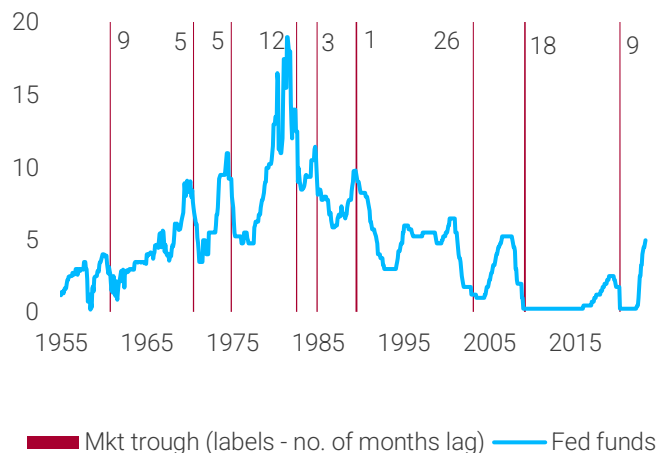

Source: ONS, TS Lombard

3. MARKET DISCONNECT

While a recession is not yet inevitable, central banks' aggressive policy tightening has become an important source of demand destruction; and, given the stress we have seen in the global banking system, there is a good chance they are now losing control of the disinflationary process. We see the possibility of a central bank whipsaw, where the global economy deteriorates faster than they expect, forcing a quick monetary pivot. The result would likely be a mild recession, with the depth of the downturn depending on how quickly the authorities change course. The tricky question for investors is what this means for markets. Since recession is now the consensus view, is this scenario already priced in? Or can we expect a more significant market reaction – particularly from equities, where we are yet to see a deterioration in corporate earnings? We think there are reasons for cautious optimism about the stock-market response; but even a mild recession is likely to cause a significant increase in uncertainty, which will test investors' nerves.

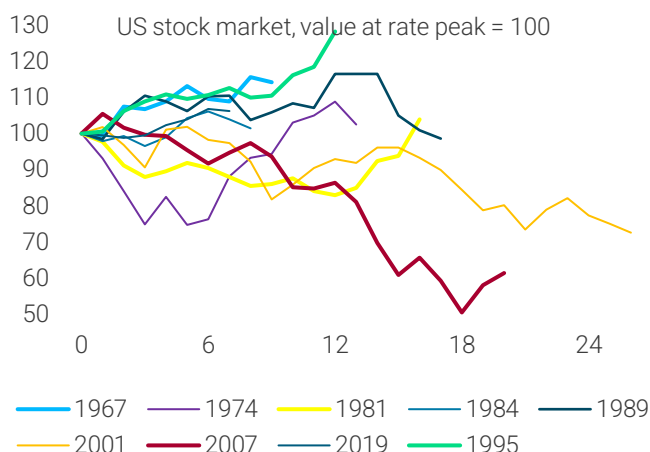
Chart 24: Recession severity by start date


Source: BLS, NBER, TS Lombard

Chart 25: Bear markets trough after first hike


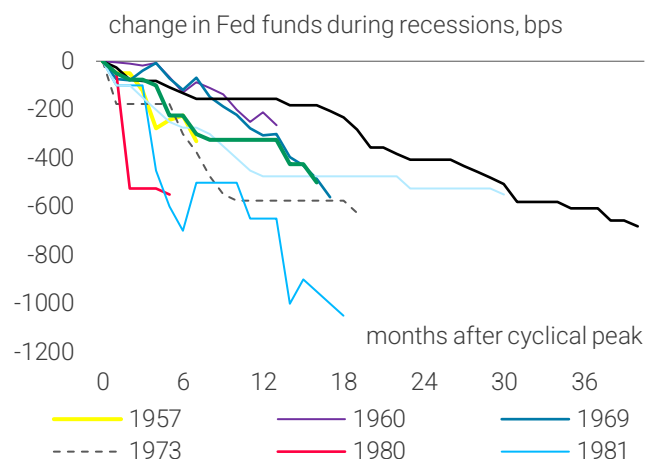
Source: Fed, Datastream

Chart 26: US equities after Fed rate cuts



Source: Datastream, TS Lombard

Chart 27: Fed policy during recessions

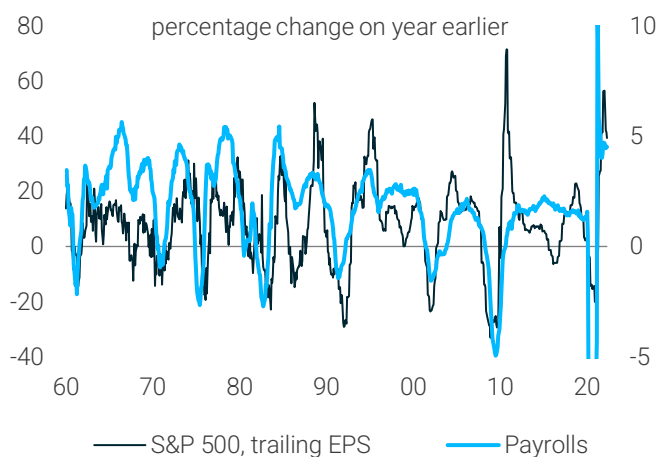


Source: Fed, Datastream, TS Lombard

What is priced in?

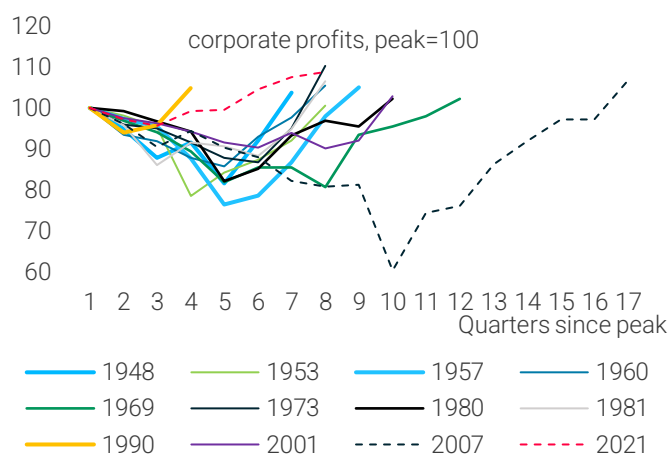
Yield curves are deeply inverted – a classic recession marker – but stock markets seem remarkably buoyant, partly, it seems, on the assumption that earnings will remain resilient (certainly relative to the 15-20% reduction in profits that usually takes place during a recession). Unsurprisingly, there are lot of commentators who believe this market pricing in inconsistent. In fact, the soft landing is arguably the only scenario that would reconcile the current constellation of global asset prices. If inflation were to drop sharply, central banks could cut interest rates back to a more neutral setting, which might allow the economy to dodge a genuine recession. While it sounds a little far-fetched, this is exactly what happened in 1995 – the textbook example of a soft landing. The issue with this analogy, however, is that inflation was never really a problem in 1995. The Greenspan Fed raised interest rates aggressively to head off an inflation problem that never materialized, giving officials the space to cut rates as soon as the economy started to weaken. But in the current tightening cycle, central bankers have violated our Paolo Maldini rule of soft landings. By reacting late – that is, once inflation had appeared – they were poorly positioned to tackle the problem. And given the recent stress in the banking system, which has led to an uncontrolled tightening in lending standards, that 1995 outcome now looks harder to achieve.

Chart 28: Profits follow employment lower



Source: BLS, S&P, TS Lombard

Chart 29: Profits during US recessions

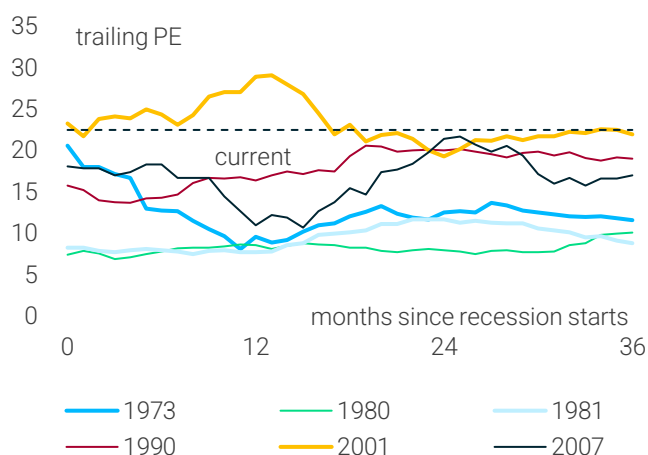


Source: BEA, NBER, TS Lombard

Implications of a soft landing

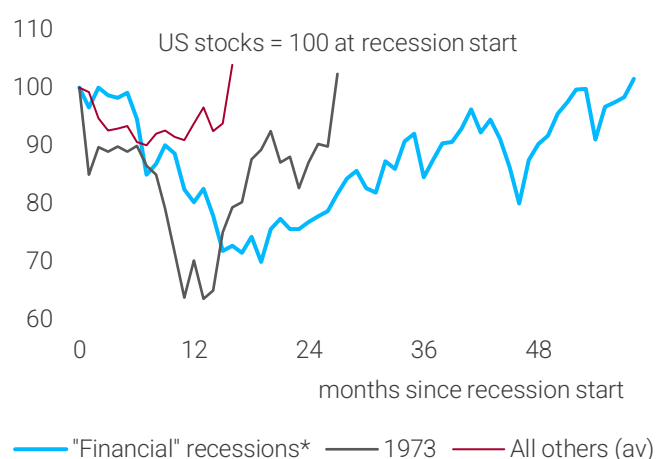
Let's assume that instead of the soft landing, the world economy – led by the US – experiences a mild recession. What would this mean for financial markets? First, of course, we need a more precise definition of "mild recession". This would be a scenario where both GDP and employment contract, leading to a rise in the unemployment rate. Given that the average increase in the US jobless rate during a recession has been around 3% pts – with a lower limit (for the recessions that started in 1990 and 2001) of around 2%pts – we could say that a mild recession would see the unemployment rate peak somewhere in the 4.5-6% range, around 50 to 250bps higher than where it stands today. As far as investment implications go, the effect on bond markets seems clear: central banks would cut interest rates significantly, more than validating the recent inversion in the yield curve. But the implications for equities are more ambiguous, with history offering mixed signals about how stocks might perform. The 1990 and 2001 recessions, which featured a 2%pts rise in unemployment, had wildly contrasting effects on equities: while the US stock market shrugged off the 1990 recession, it totally collapsed during the period 2000-03.

Chart 30: PE ratios during US recessions



Source: Datastream, TS Lombard

Chart 31: Equity response varies by recession type



Source: Datastream, TS Lombard

A repeat of 1990?

The bullish scenario would be a repeat of what happened in 1990. Although equity valuations are higher today than they were 33 years ago, they are still way below the levels seen during the Dotcom bubble. This makes sense because the 2001 recession started in the stock market and then spread to the real economy, whereas the 1990 downturn was caused by a combination of monetary tightening and a real-income squeeze – a situation that seems more relevant to the pressures we face today. The 1990 recession ended as soon as inflation pressures eased and the Fed cut interest rates, with none of the balance sheets strains that were evident in the more "financialized" recessions of 2001 and 2008. Ultimately, however, the implications for the stock market are likely to depend on what happens to corporate earnings. US profits suffered only a relatively modest and short-lived decline during the 1990 recession, which allowed investors to look through the weakness in the real economy. Can we expect a similar performance this time?

Earnings risk?

In recent weeks, stock markets have rallied even as the outlook for the global economy has deteriorated. One reason for this – particularly relevant for long-duration US equities – is that many investors think the discount rate matters more than economic growth. "The stock market is not the economy," as some TS Lombard clients like to remind us. These stocks also did well during COVID-19, even when there were doubts about whether the world economy would ever

fully recovery from the pandemic. But an important reason why these stocks performed well in 2020-21 is that their earnings performance was exceptionally strong. In contrast with many other sectors, some of the big “listed” companies benefitted from COVID lockdowns and pandemic-induced spending patterns (such as e-commerce and cloud technologies). This has created the perception that these parts of the stock market – which now account for a historically high share of the overall index – are “recession-proof”. Indeed, when we look at correlations between the earnings of the FAANG companies and the global PMI, a proxy for economic growth, we see that these companies are essentially acyclical. Combine this with lower interest rates, which boosts discounted earnings, and it is clear why investors are now buying stocks again.

Recession to test market bulls

While the rationale today is somewhat different, it is not unusual for risk assets to rally in anticipation of looser monetary policy. The real test will come when we see the first genuine signs of a recession, which is typically when labour markets start to crack. And the cracks start to emerge when reflexivity kicks in, which is the most dangerous part of the cycle for markets. Even if the recession is mild, we won't know that it was mild until after the event. Doubts about the timing and the effectiveness of the policy response always creep in, especially if the authorities initially try to remain hawkish. Investors should position themselves accordingly. At this point, chasing the recent market rally, even in those parts of the market that are perceived to be “recession proof”, could be akin to picking up pennies in front of a steamroller, especially if it turns out that these companies' earnings are not as insulated from the business cycle as everyone has been assuming. Recent profit warnings, which are concentrated in tech and [other COVID bubble areas](#), highlight the dangers.

Bottom line

Central banks have become a source of macro volatility over the past three years. While there was nothing inevitable about a recession in 2023, there is an increasing risk we will get one anyway – particularly now that the authorities seem to be losing control of the disinflationary process. If banks continue to restrict their lending, monetary policy will become even tighter – in a way that is uncontrolled and intractable for policymakers. The good news is that there is nothing particularly “organic” about this downturn, nor is there any deep underlying financial imbalance. This should ensure that the recession is mild, particularly compared with many modern-day macro-financial meltdowns, which have involved sustained private-sector deleveraging. At the same time, the outlook for inflation is improving, which should give the authorities room to respond to any unexpectedly sharp deterioration in their economies. Services inflation has been sticky, but it is clear that the authorities' obsession with the 1970s was misplaced. What we are seeing now is nothing like the Great Inflation episode. The question for investors is whether a mild recession would still have serious repercussions for financial markets, even though the consensus has been expecting such a downturn for some time. While we see reasons for optimism, even a mild recessionary dynamic brings considerable uncertainty, which would mean anxious times for risk assets. The second half of 2023 will remain a choppy environment for markets; and there is a plenty of scope for disappointment – especially as earnings deteriorate.