

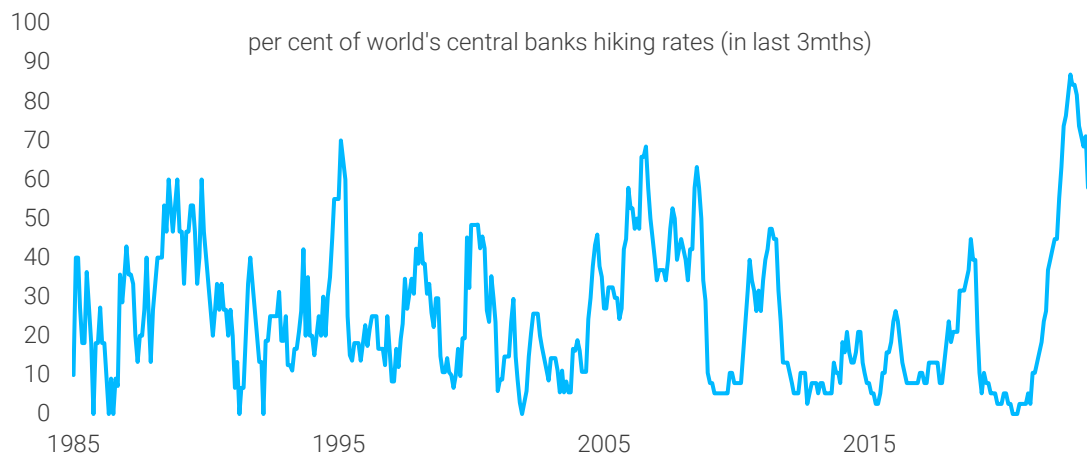
Macro Picture

YOUR PARTY, OUR HANGOVER

Dario Perkins

The US has enjoyed a powerful economic boom over the past three years, but it is the rest of the world that seems to be suffering all the nasty aftereffects. Fooled by the fake business cycle and various terms of trade shocks, the central banks of Europe have been whipsawed into tightening monetary policy too far. Is the “reverse currency war” entering a new phase?

Chart 1: The return of monetary divergence?



Source: BIS, TS Lombard

AMERICAN PARTY

While the US has defied gloomy consensus expectations, the rest of the world seems much closer to a genuine recession. We see several explanations for this divergence, including (i) initial demand conditions/momentum; (ii) global terms of trade shocks (worse outside the US); (iii) trade/industrial exposures, (iv) the role of China; and (v) different sensitivities to monetary policy.

GLOBAL HANGOVER

From a weak starting position, central banks outside the US have been whipsawed by the fake COVID business cycle into tightening monetary policy too aggressively, creating unnecessary collateral damage in their domestic economies. The good news is that, so far, this has not triggered a true recessionary dynamic. We are still talking stagnation rather than a crash.

MONETARY DIVERGENCE?

Some EMs have already pivoted to rate cuts, even with US resilience keeping the Fed on hold. Could DM central banks find themselves in a similar situation or will we enter a new phase of the “reverse currency war”? Our worry is that European central banks will want to see Fed easing before they end their own monetary squeeze, causing a further slide into recession.

YOUR PARTY, OUR HANGOVER

We all know that “overexuberance” at a party can lead to a nasty hangover the following day. And the same is supposed to apply in economics, with a cyclical boom inevitably followed by a cyclical bust. Yet, despite a post-COVID boom that was almost exclusively confined to the United States, it is the rest of the world that seems to be feeling all the horrible aftereffects. While [the US economy continues to defy the gloomy predictions of market economists](#), Europe, China and various emerging economies seem to be much closer to suffering [true recessionary dynamics](#). So, what explains this underperformance of the rest of the world? Why, for example, is Europe suffering a hangover from a party it never attended? We explore several explanations: (i) initial conditions/the starting position of the US (including greater levels of pent-up demand and fiscal stimulus), which kept the economy growing even after the Fed had taken away the proverbial punchbowl; (ii) the global terms of trade shock from food and energy prices, which was a much bigger deal in the rest of the world compared with the US; (iii) manufacturing and trade vulnerabilities, which left the economies of Asia and Europe more susceptible to the pandemic “bullwhip” business cycle; (iv) relative sensitivities to China’s structural economic slump; and (v) the impact of monetary tightening, which, somewhat ironically, has been stronger outside the US.

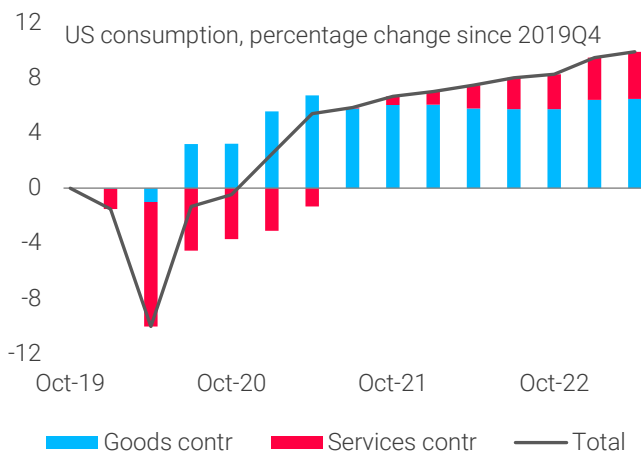
While all five forces have contributed to the underperformance of the rest of the world, we think our bullwhip framework is a compelling way to interpret these recent trends. The combination of US fiscal stimulus and lockdowns produced an unsustainable boom in goods demand and trade, which deflated as US consumption pivoted back to domestic services. Europe and Asia were particularly exposed and are now suffering the aftereffects. But the important question is what this means for the prospect of a more serious global recession. Assuming the US economy remains resilient, the recession threat for the rest of the world is largely about whether manufacturing weakness spills over into other areas of activity, particularly the services sector and labour markets. As we always point out, [true recessions are a process](#) – not an event – and the role of the labour market is crucial. Once employment starts to contract, a nasty reflexive dynamic kicks in, whereby reduced spending hurts profits and triggers further job losses. Right now, there is still no sign of this dynamic anywhere in the DM world: healthy margins and lingering labour shortages are supporting employment. But the risks are clearly growing.

One important threat, particularly in Europe, is that central banks will not ease monetary policy quickly enough to halt the recessionary slide ([especially now that oil prices are rising again](#)). In 2022, European central bankers found themselves engaged in a largely futile “reverse currency war” with the Fed, in which aggressive US monetary tightening forced the ECB and the BoE to match the Fed’s hawkishness in an effort to defend their currencies. Viewing this in the context of our fake (bullwhip) business cycle, we can now make the case that some of those central banks have already gone too far, whipsawed into an extremely tight monetary stance (tighter than the US) that is no longer warranted based on domestic economic conditions. As recession risks build, the ECB and the BoE will soon find themselves in a situation where a more neutral policy setting would be appropriate. (Several EM central banks have already reversed course.) But can the Europeans ease monetary policy as long as US resilience keeps the Fed on hold? The worry is that they will need to wait for global weakness to blow back to the United States, which would eventually put the Fed in a similar position. But that could be a slow process – one that compounds the policy mistakes already made in Europe. And, of course, monetary insouciance in the face of domestic economic weakness will do nothing to support European currencies.

1. AMERICAN PARTY

While the US has – so far – dodged the recession that most economists thought was “inevitable”, the rest of the world seems to be on the brink of a more serious economic slump. This seems odd: if recessions are the result of classic “overheating”, as unsustainable booms turn to bust, why is the current economic downturn more acute in economies (such as the euro area) that never contributed to the boom in the first place? Below we show that recent macro divergences are mostly the result of the unique nature of the post-COVID economy, particularly [the fake bullwhip cycle in manufacturing and international trade](#), which has had a disproportionately large impact on activity outside the US. But monetary policy has compounded these trends. In trying to match Fed tightening and protect their currencies, some central banks – particularly in Europe – have been whipsawed into raising rates too aggressively. The US post-COVID party has become a European hangover, another instalment of America’s “exorbitant privilege”.

Chart 2: The post-COVID US economic boom



Source: OECD, TS Lombard

Chart 3: US demand inflated global goods

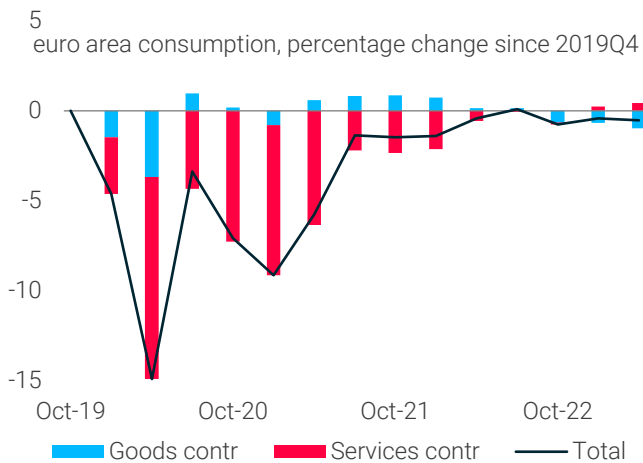


Source: OECD, TS Lombard

US-RoW divergences

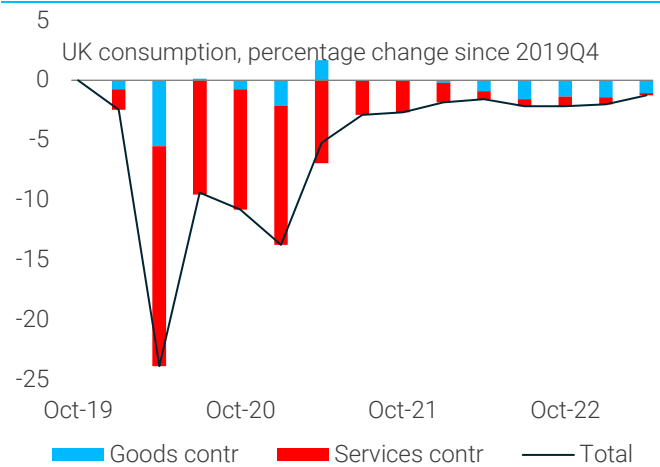
In [the previous Macro Picture](#), we showed that most economists have significantly upgraded their forecasts for US GDP since the summer. It seems the 2023 downturn has been cancelled, with most projections back to where they were 12 months ago – before the sellside’s gloomy marketing campaign. But while economists’ anxiety about the US economy has diminished, pessimism about other parts of the world has continued to grow. GDP forecasts for the euro area and the UK remain unusually bearish, while China’s economy – and, by extension, much of Asia’s – has turned out significantly weaker than the consensus expected (despite the Chinese authorities abandoning their zero-Covid restrictions). Even if the US avoids recession, the rest of the world may not be so lucky. On one level, this seems rather ironic. The 2023 recession was supposed to be the result of Fed “overtightening” designed to counter an inflation problem that largely originated in the US. So, not only did America export its inflation problem to the world (a problem that was often worse outside the US in the first place), but now it seems to have dodged the global recession that was supposed to cure that inflation problem. Perhaps this is another example of “our currency but your problem”, to use that famous John Connolly quote from 1971.

Chart 4: No such boom in the euro area



Source: OECD, TS Lombard

Chart 5: UK has barely recovered at all

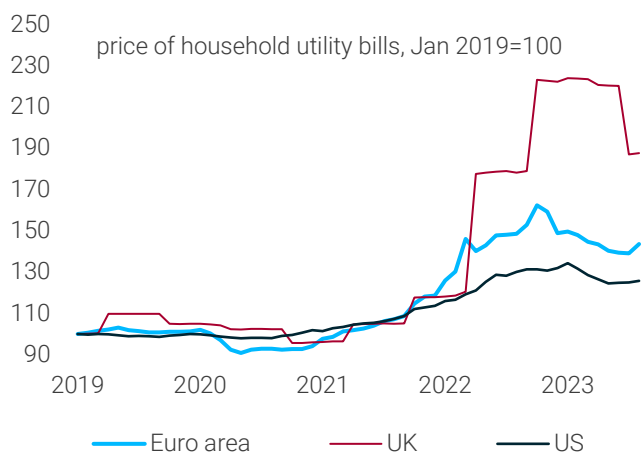


Source: OECD, TS Lombard

US as the source of the boom

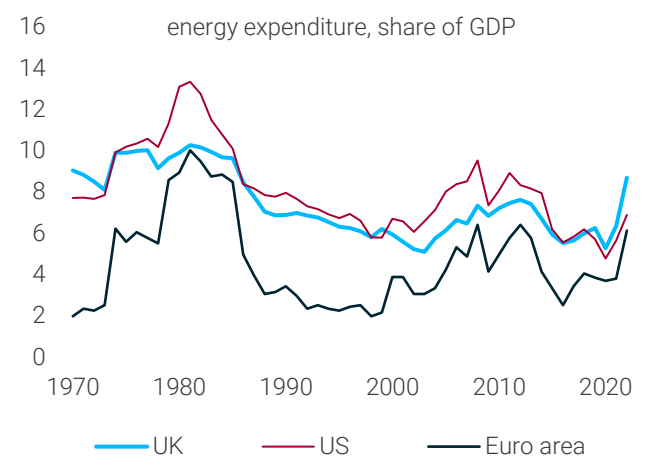
To see how the inflation problem originated in the US, you need only glance at Charts 2-5 which show the crucial role US consumers played in post-COVID "overheating". Not only did the US economy drive the initial surge in global goods demand (which put enormous pressure on global supply chains), but the US services sector also experienced considerable pent-up demand as the economy reopened from the pandemic. The situation in Europe and much of Asia has been totally different: consumer goods demand has been much more subdued, even during lockdown periods, and services spending has barely recovered to pre-pandemic levels. There is no real evidence of pent-up spending, let alone the YOLO attitudes that appeared in the US. Even today, real consumption in the euro area and the UK remains stuck below the levels we would have expected three years ago. So, for those pundits who want to blame high inflation on rampant demand and excessive fiscal stimulus – the popular narrative in markets – it should be clear that this phenomenon applies only to the US. No "boom" is discernible elsewhere.

Chart 6: Differential energy-price shocks



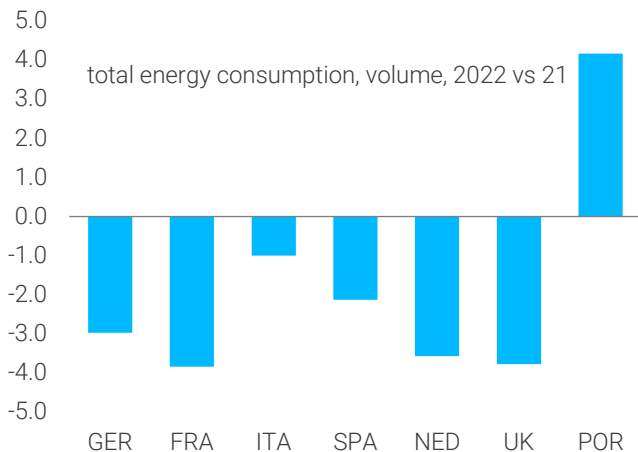
Source: National CPIs, TS Lombard

Chart 7: Energy consumption squeeze



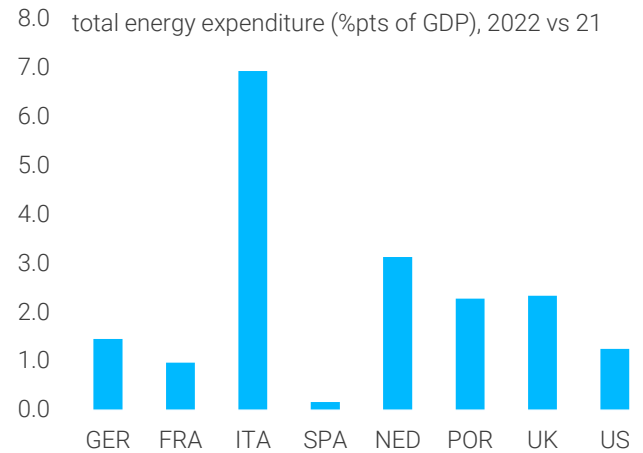
Source: IEA, Eurostat, ONS, TS Lombard

Chart 8: Europe cut energy demand



Source: IEA, TS Lombard

Chart 9: Energy bills rose despite demand cuts



Source: TS Lombard estimates

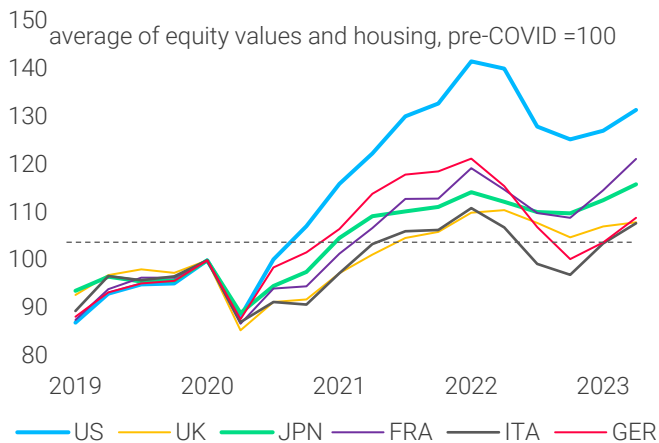
Anatomy of the slowdown

According to consensus, the 2023 recession was going to be all about monetary tightening. Central banks would need to squeeze demand to reduce inflation, which would inevitably cause output to decline and unemployment to increase. And most economists thought the recession would start in the US, which would seem a fair assumption, given the dominant role US consumers have played in inflating the post-pandemic global economy. At the start of the year, there was even talk of “decoupling”, which was the idea that the rest of the world might be able to shake off a US downturn – particularly if the US recession was mild and offset, at the global level at least, by China’s reopening. So, the “decoupling” we seem to have now – US resilience while the rest of the world is on the brink of a serious economic slump – is the exact opposite of what was supposed to happen. How did we end up in this situation? We think several forces can explain this divergence:

- 1 **Initial conditions:** Starting from a position of strength (i.e., an economic boom) gave the US an advantage over other developed economies. Owing to greater momentum in consumer spending, wages and employment, it has been harder to “break” the US economy through monetary policy – particularly compared with the situation in Europe, where most economies started out with a degree of fragility (growth rates closer to potential stall speeds). But the US has had other important macro advantages, particularly its larger overhang of fiscal stimulus. Although many parts of the world had so-called “excess savings” on a par with the US, American consumers had seen larger increases in their net wealth, which made them more inclined to run down their savings during the reopening. US households’ willingness to reduce their saving rates also provided a degree of insulation from the global cost of living crisis, ensuring spending volumes kept rising even as real wages declined.
- 2 **Terms of trade shocks:** The US had another advantage over many other nations – it was relatively self-sufficient in food and energy. This meant the economy suffered less from the supply-side shocks that resulted from Russia’s invasion of Ukraine. The negative terms-of-trade shock that Europe experienced was particularly acute, which led to an additional squeeze on households’ real spending power. Even today, with the price of natural gas far below the peaks of last autumn, the cost of energy in Europe is still far above pre-war levels, posing a persistent supply problem. The good news was that most European economies

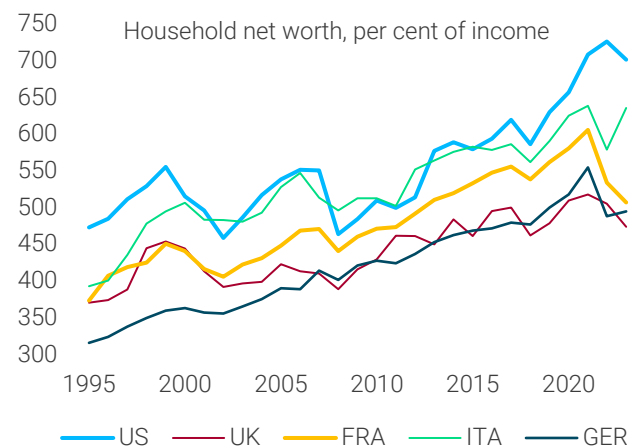
were able to reduce their energy consumption in order to cut their energy bills. At the same time, governments provided large fiscal support programmes, which helped the economy. Even so, most European nations are still spending around 2-3% of GGDP more on energy, which constitutes a material squeeze on the rest of the economy (roughly twice that of the US). And European governments are keen to withdraw their support programmes, which would be a problem this winter as seasonal energy bills start to increase again.

Chart 10: US saw largest wealth gains



Source: BIS, OECD, TS Lombard

Chart 11: Wealth drove US dissaving

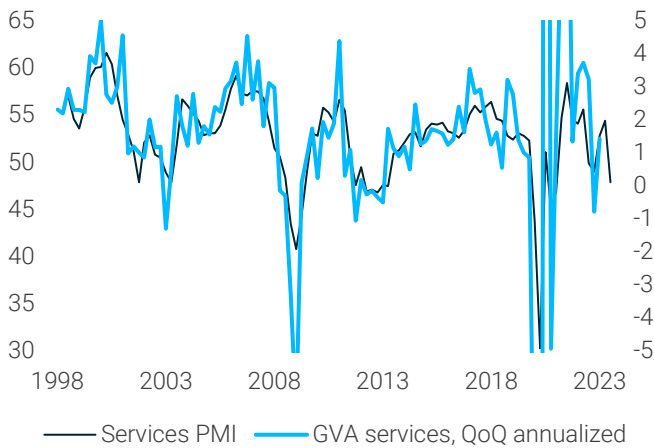


Source: OECD, Datastream, TS Lombard

- 3 **Manufacturing and trade exposures:** The bullwhip cycle in global goods demand and inventories has had a powerful bearing on the trajectory of the post-COVID economy. US demand pivoted into consumer goods during 2020-21 before swinging back to domestic services, which had a profound impact on international trade and manufacturing activity throughout the world. From a US perspective, the risk that this would trigger a genuine recession was always less than the gloomy consensus realized. Manufacturing and expenditure on consumer goods would surely contract, but there would be offsetting resilience in the (more important) consumer services sector, which would support employment and prevent a true recessionary dynamic taking hold. But from the perspective of the rest of the world, this situation has been far more challenging – for two reasons. First, other economies would suffer the hit from reduced US goods demand without necessarily enjoying any benefits from stronger US services activity (i.e., on balance this was a negative demand shock for the global economy, even if it was a *relative* demand shock for the US). Second, given the sheer size of the industrial sector in parts of Europe and Asia, it was always possible that manufacturing and export weakness could trigger broader domestic spillovers. Countries like Germany and China would be particularly vulnerable.
- 4 **China's slump:** The bullwhip recession in global trade and manufacturing has exposed the underlying fragility of China's economy – something the two-year export boom conveniently concealed. As we have argued for some time, China's growth model is, in effect, broken, with a huge unsustainable credit splurge propping up the economy and masking the structural slowdown. Without further stimulus – which the authorities are reluctant to provide – the economy will continue to struggle, which has obvious knock-on effects to the rest of the world. Not only are exporters in Europe and Asia experiencing more difficulties exporting to China because of weak demand in China, but they are also finding it tougher to compete globally – especially after the recent depreciation of RMB. European car producers are having

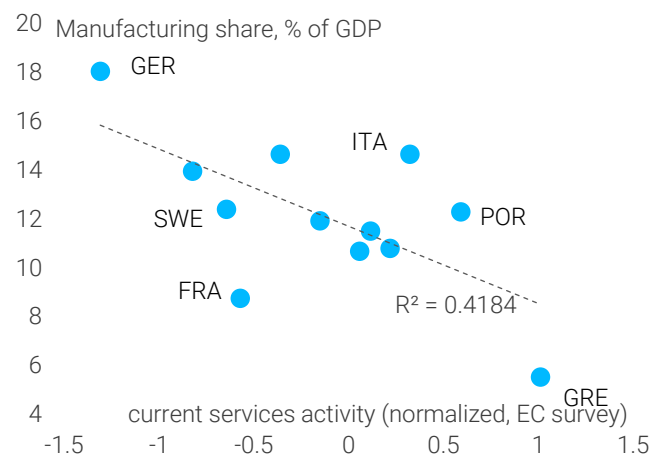
a particularly tough time owing to [China's sudden success in the global EV market](#). This is another reason the big exporter nations are at a relative disadvantage compared with the US, which tends to be more insulated from global trade and less geared to China.

Chart 12: European services deterioration



Source: S&P, TS Lombard

Chart 13: Manufacturing spillovers have started

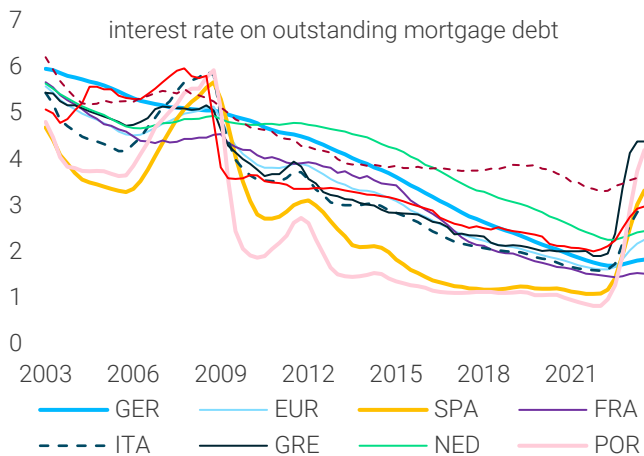


Source: S&P, TS Lombard

- 5 **The impact of monetary policy:** Finally, most recession narratives have been focused on Fed policy tightening and the idea that the central bank would eventually “overtighten” and break something in the US economy or the wider financial system. But it is possible that by trying to match Fed interest-rate hikes, other central banks have reached that point first, either because their economies were less able to withstand tighter monetary policy or – more likely – because the same amount of interest rate hikes has delivered a larger monetary squeeze. Remember, monetary tightening works through a variety of channels and part of the impact depends on the structure of outstanding debt markets. With the same increase in interest rates, an economy with large numbers of variable-rate mortgages and floating-rate corporate loans will suffer a much larger squeeze than an economy where loans carry mainly fixed-rate borrowing costs. And this seems to be the case when comparing the impact of US monetary tightening with the situation in other parts of the world. Our analysis suggests the BoE and the ECB have delivered a larger monetary squeeze than has the Fed, and this, too, has contributed to the relative outperformance of the US economy.

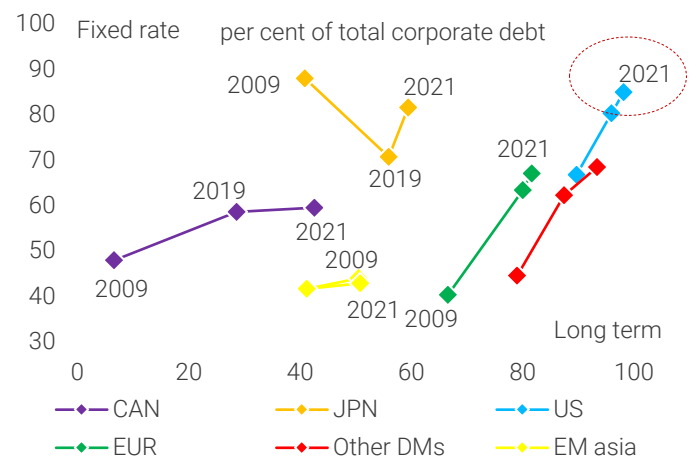
We have long felt that many market economists have been using the wrong framework to analyse the post-COVID economy. Instead of thinking in terms of classic business-cycle dynamics, they should have been using our bullwhip cycle-analysis. Seen in this context, it is not surprising that the US has dodged a serious downturn in 2023. Nor it is surprising that many other parts of the world are now much closer to experiencing a genuine recession, not least because of their outsized exposures to the manufacturing sector and the additional negative shocks they have suffered from the Ukraine war and China’s domestic weakness. But it seems central bankers have also been using the wrong framework to understand the post-COVID economy. In trying to match Fed policy tightening with their perverse “reverse currency wars”, the likes of the ECB and the BoE have become a source of additional macro volatility over the past 18 months. Whipsawed by the fake business cycle, they now find themselves in a situation where they may have already overtightened monetary policy. So, what happens next? Will some parts of the world suffer a recession even if the US avoids that fate? And if so, how bad will those recessions be?

Chart 14: Big monetary shock in Europe



Source: ECB, BoE, TS Lombard

Chart 15: US corporates insulated from rate hikes



Source: BIS, TS Lombard

2. GLOBAL HANGOVER

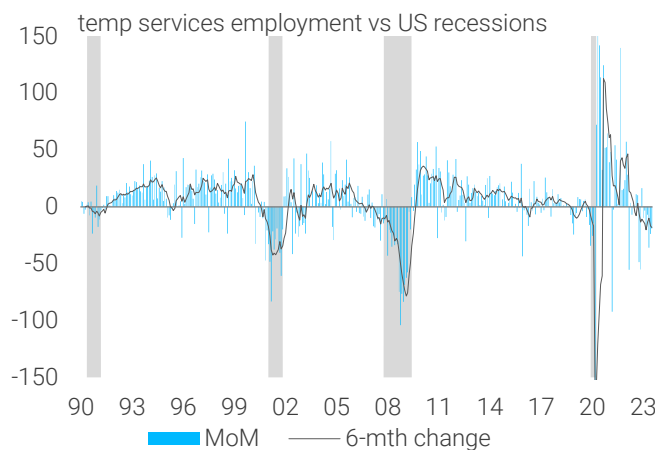
While most economists abandoned their US recession calls in the summer, the threat of a recession has not gone away – on the contrary, that risk seems higher than it was at the start of the year. Profit margins have shrunk, a lot of excess demand for workers has already been destroyed (making net job losses more likely, on balance), stricter lending standards have produced a more indiscriminate tightening in monetary policy and higher oil prices are once again sapping real wages (this time without the offset from lower savings). But we think US recession is still a risk to the outlook rather than an inevitability and that the threat remains lower in the US than in other parts of the world. The countries that are most exposed continue to be those with big sensitivities to global trade, particularly those where manufacturing weakness is already starting to spill over into domestic services activity. But the good news is that we are still looking at recessions that are likely to be extremely mild by historical standards. This is because, despite a decade of ZIRP, most economies are free from the sort of deep underlying macro-financial imbalances that have typically been the catalyst for deep and protracted downturns. Our main worry is whether all parts of the world will get the monetary response they may need.

Soft landing not assured

For more than a year now, we have argued on these pages that there was nothing inevitable about a US recession. Not only were economists misreading the business cycle, but they were putting too much weight on faulty leading indicators. We identified a number of forces that would prevent a US recession in the short term, including an overhang of fiscal stimulus, a recovery in real wages, historically elevated profit margins and large labour shortages. US companies would be slow to cut employment, which would prevent the classic recessionary “reflexivity” from kicking in (the process whereby rising unemployment destroys confidence and spending, which reduces profits, which leads to further job losses.) Naturally, we stand by this analysis – a soft landing is still the likeliest scenario. But it is still a little unnerving to see most of the high-profile recessionistas suddenly capitulate and embrace our analysis from 12 months ago. While their behaviour is understandable from a reputational point of view – there is only so long you can be wrong in this industry – we think the risk of a US recession has, in fact, increased since the start of the year. Profit margins have narrowed, excess savings have diminished (with oil prices again

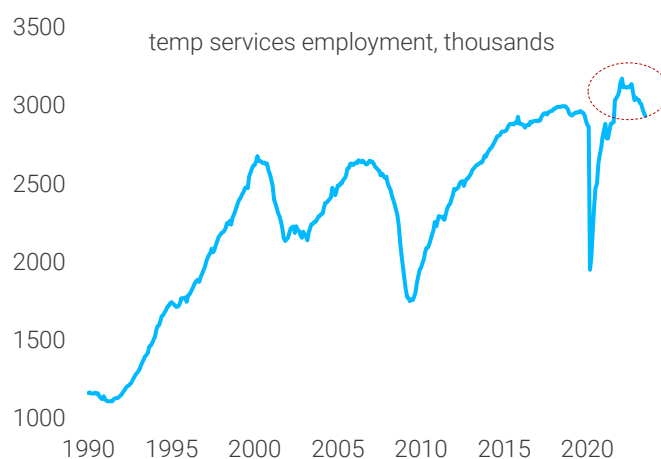
sapping real incomes) and a lot of excess labour demand has been destroyed. Even if (net) job losses are not imminent, investors should remain vigilant about recession risks for the remainder of this year.

Chart 16: Pre-recessionary US labour trend?



Source: BLS, TS Lombard

Chart 17: But levels suggest mere normalization



Source: BLS, TS Lombard

'Pre-recessionary' jobs market?

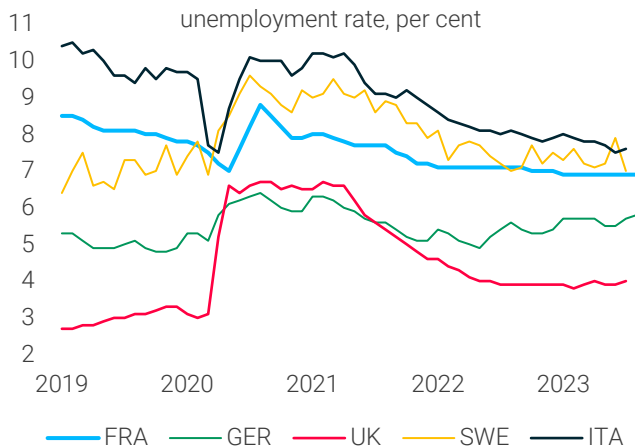
An interesting question is whether the recent slowdown in the US labour market has made the US more vulnerable to classic recessionary dynamics. Perhaps, in some sense, employment trends are already "pre-recessionary". Certainly, there has been no shortage of pessimistic commentary on the state of the US labour market over the past few months, with pundits identifying all sorts of indicators to argue that employment trends are weaker than they seem. Regular users of #fintwit will have seen supposedly pre-recessionary charts covering hours worked, temporary jobs, the recent pattern of negative employment revisions and even certain discrepancies between labour market surveys. Our read of the data, however, is that we are not yet seeing anything alarming in the US labour market. Right now, the broad thrust of the data is consistent with a normalization in activity, after the exceptionally strong recovery from the pandemic, rather than anything more ominous. In fact, right now we are seeing a much better balance between demand and supply in the US labour market, which should make Fed officials more comfortable with medium-term inflation dynamics. While the path to a soft landing was always going to be bumpy and alarmingly narrow, so far, the US economy still appears to be on that path.

Labour markets outside the US

Other developed nations – particularly in Europe – seem to be closer to experiencing genuinely recessionary labour markets. With larger exposure to manufacturing and exports, there is obviously a risk that weakness in the industrial sector spills over to other parts of the economy, triggering aggregate job losses (especially when combined with the larger hit from monetary tightening). Indeed, in the UK and some euro area economies, this process may have already started. Not only has services activity deteriorated, but the largest deterioration is happening in economies that are most exposed to post-COVID swings in the global industrial cycle (Chart 13). The good news, however, is that – like in the US – we are not yet seeing genuine cracks in European labour markets. Services activity and employment have stalled, but high-frequency data (such as the PMIs) remain consistent with broad stagnation rather than outright recession. And this is not surprising. With continued labour shortages and historically high profit margins,

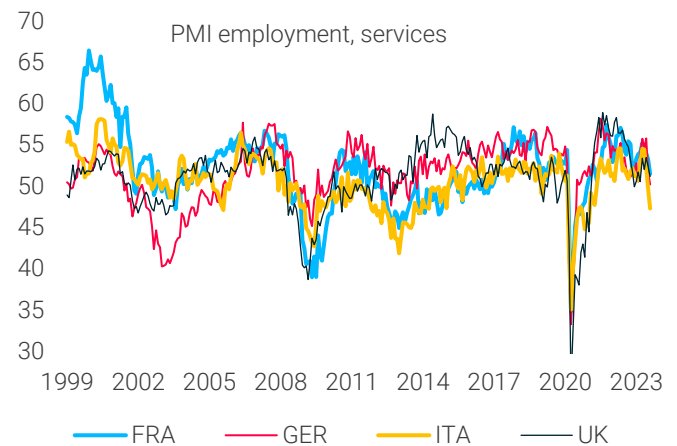
European companies – like their counterparts in the US – are under no immediate pressure to start laying off workers. In fact, the tendency to hoard labour is stronger in Europe thanks to the region's hefty hiring and firing costs. So, for the time being at least, it seems we are still talking about "technical recessions" in European GDP rather than a genuine recessionary dynamic.

Chart 18: European labour markets still not cracked



Source: National sources, TS Lombard

Chart 19: No clear recessionary signal – yet!



Source: S&P 500, TS Lombard

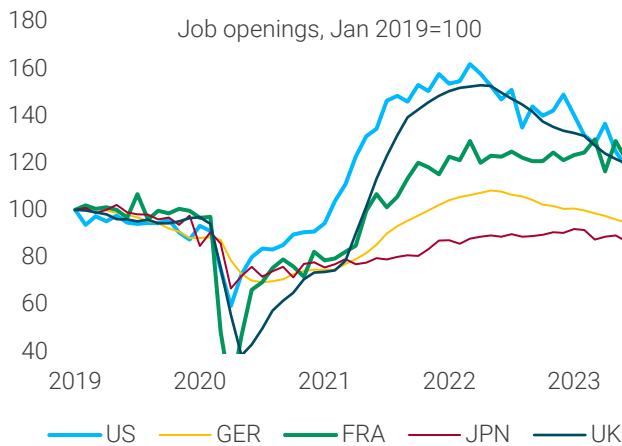
The risk – mild recession

The European tendency to hoard labour is best illustrated by Germany's performance during the 2008-09 global recession. Despite a massive 5% decline in industrial production, exports and GDP, German companies hung onto their staff and unemployment did not increase. Although Germany has specific government policies that encourage labour hoarding (for example, Kurzarbeit – the template for COVID furlough schemes), this is a reminder that economists must be careful not to exaggerate the risks to European labour market, even with industrial output and exports once again under pressure. More broadly, there has always been good reason to think any post-pandemic recession – in Europe or elsewhere – would be extremely mild by historical standards: not only has the credit cycle had an extremely modest amplitude, but there has been no obvious misallocation of resources. To illustrate this point, we calculate the share of employment that looks susceptible to post-COVID normalization in the global economy. For most DM economies, it is hard to see large-scale job losses. The current situation is nothing like that of the early 2000s, when a long credit bubble inflated an unsustainable boom in housing and construction. A "balance-sheet" recession is not on the cards; rather, we could end up with something that looks much closer to the inventory-centred corrections of the post-WW2 years.

To sum up the story so far:

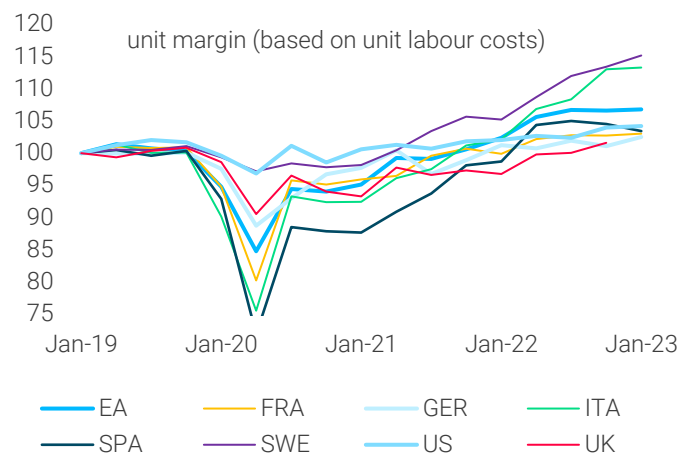
- Global recession risks are higher now than at the start of the year, despite many recessionistas flipping the other way and markets pricing "higher for longer";
- The threat of a recession is greater in Europe than in the US: not only is the bullwhip manufacturing cycle a net contractionary force in Europe, but higher energy prices and aggressive monetary tightening are producing a larger recessionary impulse; and
- If recessions materialize anywhere in the coming months, they are likely to be extremely mild: balance sheets are strong, labour shortages persist and there has been no big misallocation of resources, even in the bubbliest parts of the post-pandemic economy.

Chart 20: Normalization in labour demand



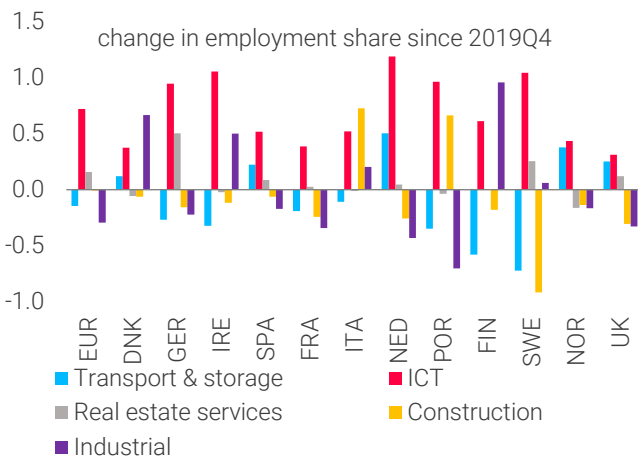
Source: OECD, national sources, TS Lombard

Chart 21: Fatter margins support employment



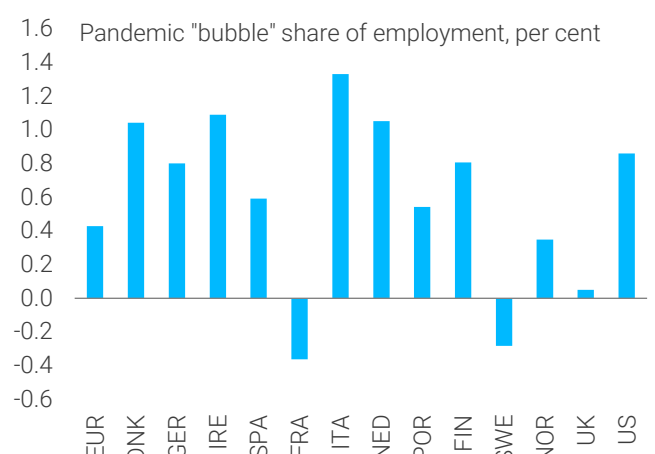
Source: National accounts, TS Lombard estimates

Chart 22: Employment at risk from recession



Source: Eurostat, ONS, BLS, TS Lombard

Chart 23: Looking at mild recessions



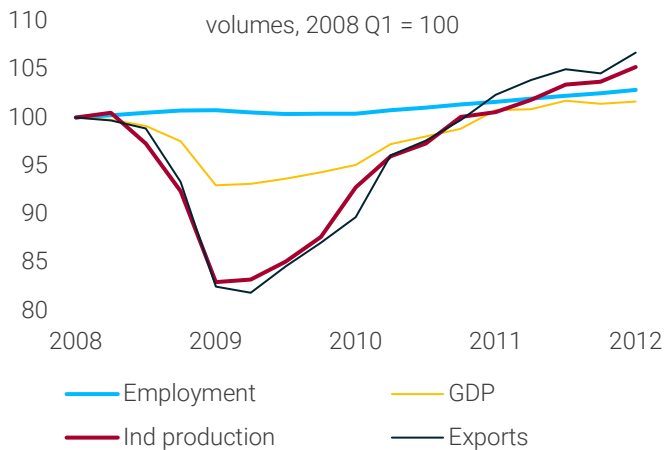
Source: Eurostat, ONS, BLS, TS Lombard

3. MONETARY DIVERGENCE?

For more than 18 months, central banks everywhere have been raising interest rates aggressively in a desperate attempt to bring inflation under control. In 2022, there were even signs of a "reverse currency war", because no policymaker wanted to exacerbate their inflation problem by allowing their exchange rates to slide (which is what would have happened if they had failed to match the hawkishness of their peers). Now, however, we seem to be reaching a point where domestic economic conditions in some parts of the world no longer warrant such an extreme monetary squeeze – particularly in jurisdictions where the authorities have been whipsawed by the fake bullwhip cycle into overtightening. This sets up an interesting monetary dilemma. Can the likes of the ECB and the BoE ease monetary policy to halt their potential slide into recession even in an environment where domestic US resilience keeps the Federal Reserve on hold? Or will

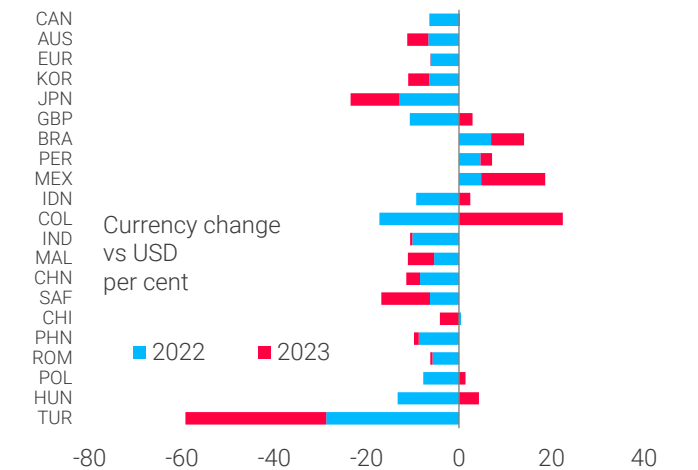
they wait for the Fed to pivot first, which would presumably happen only if there was a much steeper deterioration in global demand – since US policymakers can be somewhat insensitive to global vulnerabilities? How much will America’s exorbitant privilege cost the world this time?

Chart 24: Germany’s job-rich recession in 2008



Source: Bundesbank, Datastream, TS Lombard

Chart 25: Could the reverse currency war return?



Source: Datastream, TS Lombard

Reverse currency wars

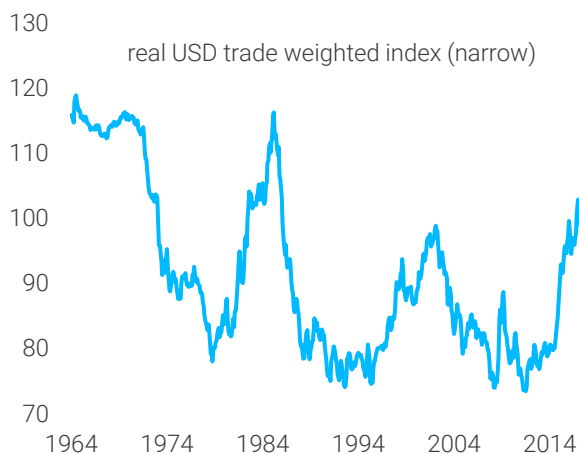
The post-pandemic episode of monetary tightening was the most synchronized in history, with around 90 per cent of the world’s central banks raising rates during the autumn of 2022. On one level, this was not surprising: the pandemic was a shared international experience, many of these central banks had eased policy in tandem during 2020 and the subsequent inflation outbreak was extremely broad-based. But there is no doubt that currency markets played a role, too. Central banks that failed to match the hawkishness of their peers saw their exchange rates depreciate, which only added to the cost pressures they were importing from the rest of the world. Policymakers may not have been able to repeat the trick of the Bundesbank – which used Deutsche Mark appreciation in the 1970s to insulate itself from the Great Inflation – but there was a definite sense, at least in Europe (and among certain EMs), that they should not allow currency weakness to make their situations even worse. This gave us the so-called “reverse currency war”.

The end of synchronization

The problem with the reverse currency war is that the monetary authorities were essentially amplifying the volatility of an already highly distorted business cycle. By responding to supply shocks and relative shifts in US demand, they themselves became a source of additional volatility in the global economy (breaking away from the “optimal Taylor frontier”). And after chasing the Fed, many central banks now find themselves in a situation where domestic conditions no longer warrant such a powerful monetary squeeze. Not only has the bullwhip cycle flipped in a way that hurts RoW-US growth differentials, but – as we showed in Section 1 – monetary policy is itself having a more contractionary impact outside the US. The solution seems obvious: we need to see some differentiation return to global monetary policy. Since the recession risk is all about monetary “overtightening”, those central banks that have been whipsawed by the post-COVID economy must try to undo the error, cutting rates to a more “neutral” setting. But, except for in a few EM countries, there is an obvious reluctance to ease policy ahead of the Fed, especially now

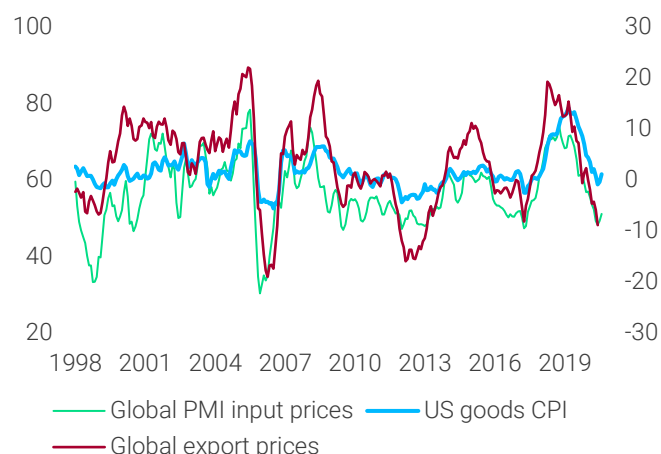
that oil prices are rising again. This is understandable in the case of the BoE, since the UK output-inflation trade-off seems to have deteriorated, but it is less forgivable in the case of the ECB.

Chart 26: Dollar to import global disinflation to US



Source: BIS, TS Lombard

Chart 27: Further global disinflation needed?



Source: S&P, CPB, TS Lombard

Waiting for the Fed

We have said that we expect, at worst, a mild recession in Europe. Companies are likely to hoard labour and private-sector balance sheets are in good shape. There has been no big misallocation of resources, despite a decade of NIRP and ZIRP. The credit cycle never really cycled, especially in those parts of Europe that experienced a decade of deleveraging. But our one reservation is about monetary policy. If the ECB (and to a lesser extent the BoE) have genuinely raised interest rates too far, they will need to be able to cut rates promptly should true recessionary dynamics start to materialize. Our worry is that these central banks will fall behind the curve, particularly if they are waiting for a Fed pivot to mitigate the risk of further currency weakness. The US is not exactly a “closed” economy, but it usually takes a sizable reduction in global demand to alter its trajectory and shift policy. If the authorities in Europe are waiting for weak global activity to blow back to the US and deliver Fed easing, they could be waiting some time. The situation today is not like the 2010s, when, facing supposedly stubborn lowflation, US officials were hypersensitive to global developments and dollar strength. The ultimate irony, of course, is that monetary insouciance in the face of deteriorating data will do nothing to support European currencies. The reverse currency war was always futile. This next instalment will be no different.

Bottom line

While the US has avoided recession so far in 2023, there are other parts of the world – particularly Europe and some Asian countries – that are much closer to experiencing a genuine economic slump. This divergence seems ironic. Europe and Asia barely contributed to the post-COVID “party” but are now suffering a “hangover”, while the US (the life and soul of the party) has somehow dodged that hangover. Although it is tempting to blame America’s exorbitant privilege, the story behind these divergences is far less extraordinary. It is another feature of the artificial post-COVID bullwhip cycle in global manufacturing. Not only has US demand pivoted away from consumer goods – to the detriment of economic activity in other parts of the world – but weakness in international trade and global manufacturing is now spilling over into domestic problems in countries like Germany and China, where industrial exposures are more pronounced. Ordinarily, of course, we might expect monetary policy to help narrow these divergences in

economic performance. But over the past 18 months, central banks have, in fact, become a source of instability for the global economy. By chasing Fed tightening in a (futile) effort to defend their currencies, central banks like the ECB and the BoE have engineered a monetary tightening that is even larger than that experienced in the US (against a domestic macro backdrop that is much less suited to higher interest rates). Ideally, having been whipsawed into “overtightening” monetary policy, those central banks with the most elevated recession risk should soon be looking to reverse course. The danger is that they will wait for the Fed to move first, which – owing to the relatively modest exposure of the US economy to any trouble in the rest of the world – could result in unnecessary damage. And it won’t do much to support their currencies either.

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