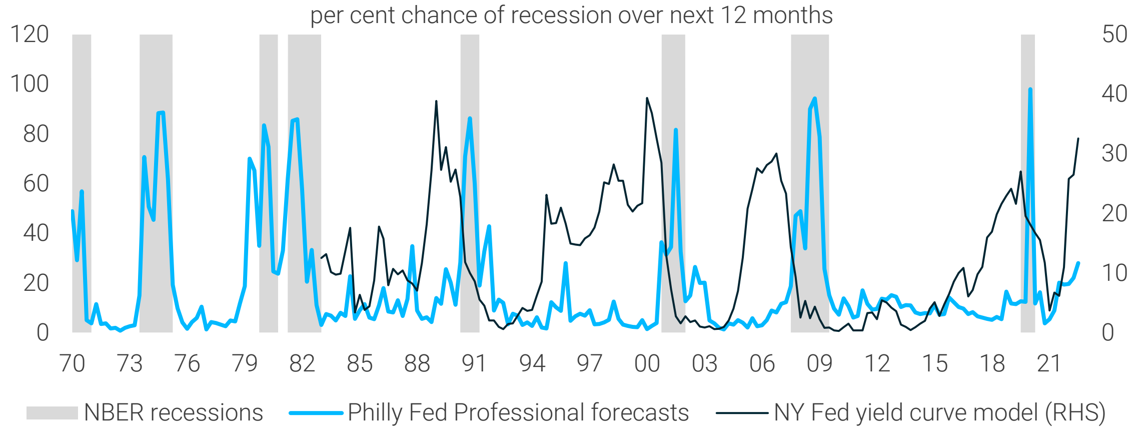
Macro Picture

HOW TO SPOT A RECESSION

Dario Perkins

Some parts of the world – including, perhaps, the US – are already in "technical recession". Yet this downturn could feel different from those of the last 20 years. Inventory swings and high inflation have caused volatility in the economy, a throwback to the era before the Great Moderation. Companies are likely to hoard labour, which will limit underlying disinflation.

Chart 1: Economists spot recessions only well after they have started



Source: Survey of Professional forecasts, New York Fed, TS Lombard

RECESSION WATCH

How do you know when the economy is entering a recession? Economic forecasts are unreliable, so it is better to look for Greenspan's "discontinuities" in macro data – particularly labour markets. US recessions are best defined as periods in which employment is contracting (rather than the "technical" definition of two consecutive declines in GDP). Large job losses bring "reflexivity".

BLAST FROM THE PAST

GDP is contracting in some parts of the world, including the US. But this downturn could have a different "feel" from those of the last 20 years. High inflation and large inventory swings have caused instability in the real economy, trends that were absent during the Great Moderation. But if companies hoard staff, labour markets won't crack and underlying inflation pressures will linger.

BAD NEWS IS GOOD NEWS

Current recession anxiety could be helpful if it prevented central banks from immediate "overtightening". As leading indicators deteriorate, terminal rates will dip lower, which could ease the pain in equity markets – even with earnings set to disappoint. But a genuine "soft landing" requires a quick improvement in inflation, and the monetary squeeze is likely to return in 2023.

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HOW TO SPOT A RECESSION

Everyone is talking about a recession. Output is already contracting in some parts of the world, and, with the BEA set to publish its latest national accounts on 28 July, there are plenty of pundits ready to declare a "technical" US recession. Yet two consecutive quarterly declines in GDP would largely be a distraction at this point. It is better to think about recession risk in more general terms, as a broad decline in activity. Genuine recessions can change the trajectory of an economy for years, especially when they cause a decline in employment. With regard to the US, it makes sense to define a recession in terms of what happens in the labour market (the situation is different elsewhere). When employment contracts, economic weakness becomes "reflexive", leading to further rounds of spending cuts and additional job losses. These dynamics are non-linear, which is why there is always uncertainty about the ultimate depth and duration of any recession. How do we know when the economy is entering such a downturn? We cannot ask the economists because consensus has a horrible record of forecasting recessions. But we can take the advice of Alan Greenspan, who highlighted the importance of "data discontinuities" at cyclical turning points. A decline in payrolls would be a particularly compelling recession marker.

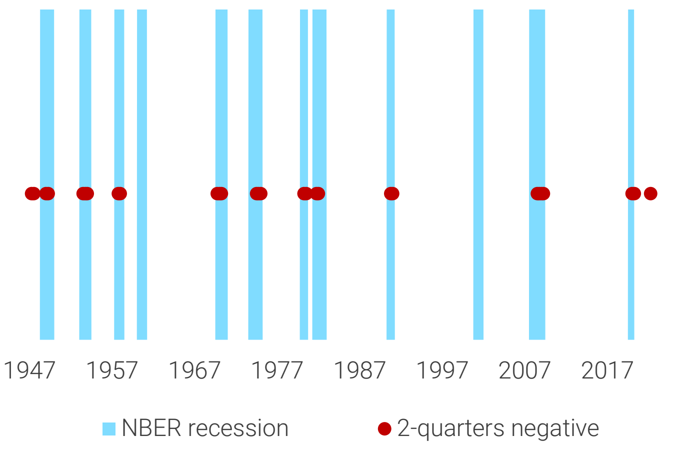
Investors are accustomed to long US expansions, punctuated by a sudden plunge in asset prices alongside sharp declines in employment and output. Excluding the fake COVID-19 downturn, US recessions have had a clear "end of cycle" feel closely tied to developments in financial markets. While we can debate whether these downturns were "necessary", they always resulted from an underlying imbalance in the financial sector (think dotcom in 2000, subprime in 2008). Tighter monetary policy has again exposed various asset bubbles, but today the main recessionary impulse is coming from outside the financial sector – namely, large swings in the inventory cycle, and high inflation (which has reduced consumers' real purchasing power). This is a throwback to an earlier period in history, before the Great Moderation, when inefficient business logistics and extreme CPI volatility produced bouts of instability in the real economy. The good news is that any recession is likely to remain "technical" and mild. Balance sheets are strong and activity should recover as soon as inventories stabilize and the squeeze on real incomes fades. The classic US recession template of the last 30 years may not apply. In fact, given current staff shortages, European-style "labour hoarding" is the more appropriate model.

A mild "technical" recession is not going to restore pre-COVID secular disinflation. If central banks were to cut interest rates in 2023 – which does not seem to be on the cards, despite current market pricing – it would likely be a mid-course adjustment (similar to what happened in 1995), rather than beginning of a full reversal in monetary policy. Labour markets would remain tight, which means underlying inflation pressures would likely linger, albeit not at the extreme levels of the past 18 months. Central banks might even need to resume their policy tightening at some point, causing terminal rates to retrace back to their recent highs. But in the current context, where central banks are on a rapid and dangerous course to "overtightening", there is definitely some truth to the cliché "bad news is good news". Short-term recession anxiety has already pulled bond yields and commodities lower, which has slowed the destruction in equity markets. Naturally, there are risks to corporate earnings – especially given analysts' lofty expectations – but it is possible equity markets will stabilize, even if they are unlikely to rediscover their pre-2022 swagger. The path to a "soft landing" starts with a "soft patch" in the global economy. Now we just need some softer inflation data – at least several months of improvement – which would allow central banks to soften their tone, breathing fresh life into the post-COVID revival. If, in three months, we are still debating the "technicalities" of a recession, that would not be a bad outcome.

1. RECESSION WATCH

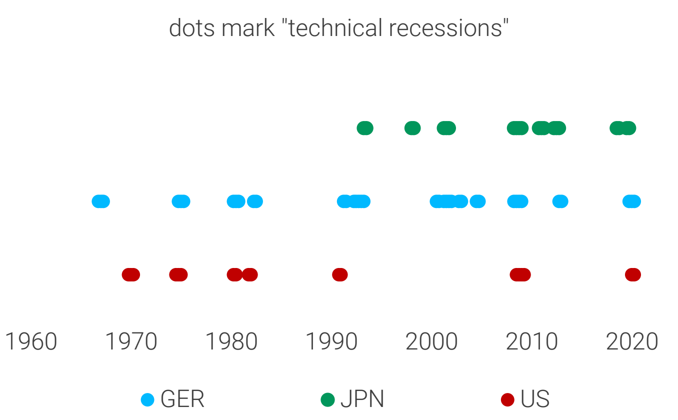
Three months ago, every TS Lombard client meeting started with questions about inflation and policy tightening. Now, investors want to talk only about recession risk. Has the recession already started? How bad can things get? And when will central banks realize what is happening? It does not help, of course, that real output is already declining in many parts of the world, while leading indicators suggest the situation is likely to deteriorate further. In the US, the BEA is due to publish Q2 GDP data on 28 July, which – according to the latest tracking estimates – are likely to show a second consecutive quarterly decline. This would be confirmation, at least according to Wall Street punditry, that the US economy has already entered "technical recession". It would not be surprising if the UK and various euro-area economies achieved this popular recession metric during H2, too, something few investors had anticipated six months ago. When we warned about a "summer recession scare" back in January, even we did not think things would go this far.

Chart 2: US recessions



Sources: NBER, TS Lombard.

Chart 3: Frequent non-US recessions



Sources: National sources, TS Lombard.

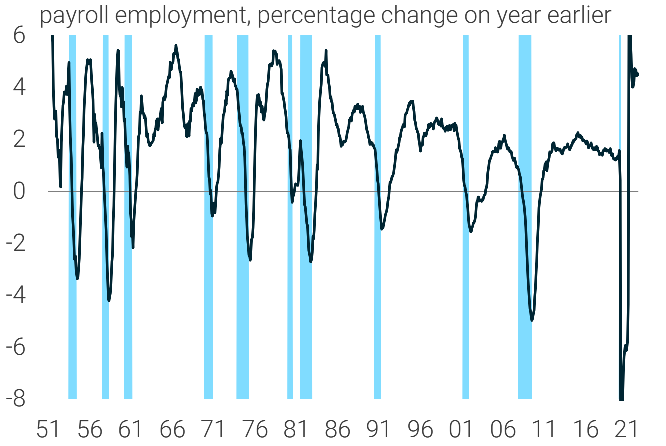
The 'technical' recession

While the "two quarters of contraction" marker is popular among economists, it is important to remember that this recession definition is not particularly useful. The Q1 decline in US GDP, for example, was mostly erratic and included hefty "catch-up" imports as some of the pressures in global supply chains eased. Would the state of the US economy look any better if GDP had recorded a modest rise during the first three months of the year? While it is true that most US recessions, as defined by the NBER, include two quarters of contraction, this is not always the case. The 2001 downturn, for example, did not meet this criteria – there was a quarter of positive growth sandwiched between two declines (Chart 2). And beyond the US, "technical" recessions are, in fact, fairly frequent but have a very different "feel". Germany and Japan, for example, suffer technical recessions all the time, but these do not usually have that classic "end of cycle" vibe that is common during US downturns. For this reason, there is no point worrying about which economies are "technically" in recession or which are not. Only the breadth, depth and persistence of the current downturn matters, not whether specific criteria are met. Labelling is irrelevant.

The only definition that counts

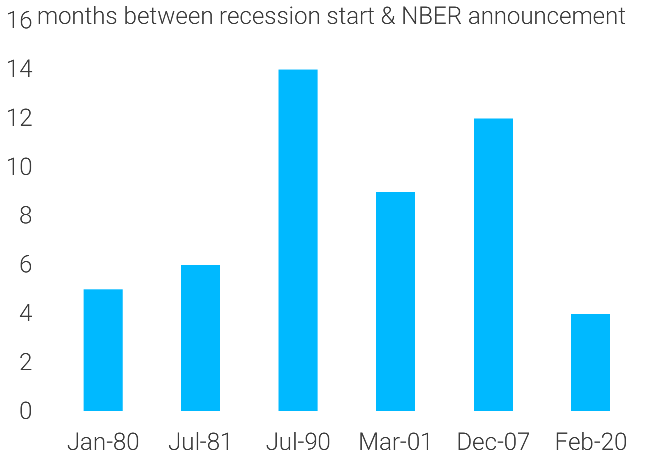
The best definition of a recession is that it involves a broad and persistent decline in national output. Developments in the labour market are particularly important. When weak demand prompts companies to lay off workers, a certain "reflexivity" kicks in. Rising unemployment encourages consumers to reduce their spending (even those who do not lose their jobs), which can lead to further reductions in corporate revenues and additional rounds of job cuts. This reflexivity is naturally non-linear, which is why there is always considerable uncertainty about the depth and likely duration of any recession that involves higher unemployment. Historically, labour market developments have been important in explaining cyclical differences between the US and other developed economies. Facing hefty hiring and firing costs, companies in Europe and Japan are more likely to hoard labour, especially in the early stages of a downturn, which can lead – at least initially – to milder and more frequent "technical recessions". (Naturally, if demand does not return quickly, labour hoarding hurts profits, which can delay the economic recovery.)

Chart 4: Employment defines US recessions



Sources: BLS, NBER, TS Lombard.

Chart 5: NBER announcements usually come late



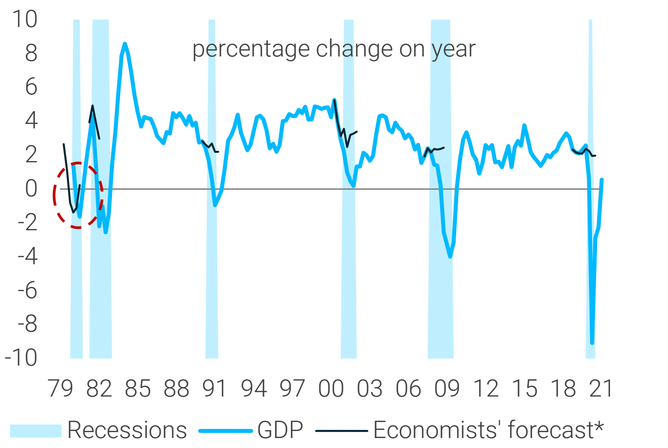
Sources: NBER, TS Lombard.

How to identify recessions

Forecasting the economy at turning points is difficult and demands humility. Our definition of a recession is admittedly broad, which means it does not provide a lot of guidance for investors. So how do you know when we have reached a major turning point? One possibility, of course, is to look at consensus forecasts. But economists have a terrible record when it comes to predicting periods of economic contraction. Of the eight major downturns covered by the Philadelphia Fed's survey of professional economists, the consensus correctly predicted just two recessions – the blindingly obvious one that happened after Paul Volcker raised interest rates to 20% in the early 1980s and the recent COVID-19 downturn (which anyone could see just by looking out of their windows). And this forecasting problem is not confined to the US. The IMF published a comprehensive study based on the experience of 63 DM and EM countries over the period 1992-2014. Based on projections they had made 12 months earlier, economists predicted just five out of 153 recessions. If we reduce the forecast horizon to a few months, performance improves, but it remains woeful overall. The IMF concludes: "The main finding is that, while forecasters are generally aware that recession years will be different from other years, they miss the magnitude of the recession by a wide margin." They highlight a tendency to absorb bad news only slowly.

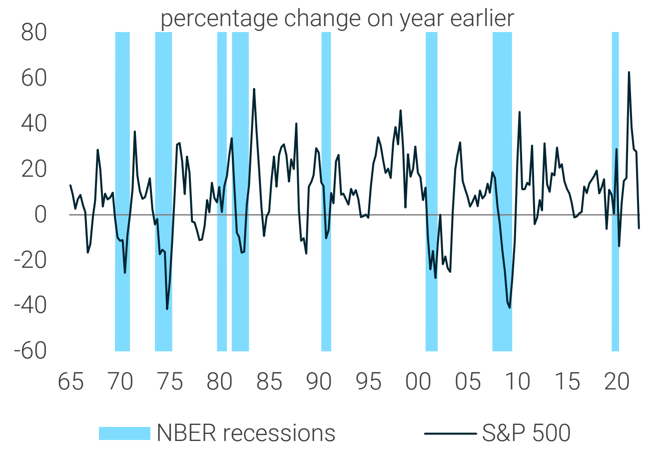
There is no doubt economic models have become more sophisticated over the past 50 years, so why hasn't forecasting improved? Researchers at the George Washington University provide several explanations, such as the nature of economic training (which urges practitioners to assume the status quo in the absence of better information), reputational damage (it is better to forecast continued expansion and be wrong than to erroneously predict a recession) and herding (the desire not to move too far away from the consensus). Another popular explanation is that recessions are entirely random, which means they are – by definition – unforecastable. This is consistent with the "plucking" view of recessions: that is, the idea that GDP will naturally expand until something comes along to "pluck" the growth rate lower. Whatever the cause of this forecasting failure, it is clear GDP projections are unhelpfully sticky, which means they tend to work only in "normal times", when output does not fluctuate by a wide margin. Bearing this in mind, perhaps it is better to look at the probability economists assign to the risk of a recession. Chart 1 (on the front page) shows that economists tend to become more worried about the economy during recessions, but only once the economy has already started to contract.

Chart 6: Economists forecast only one recession



Sources: Survey of Professional forecasts, TS Lombard, *6-mths earlier

Chart 7: 'Nine of the last five recessions' (-ish)



Sources: Datastream, TS Lombard.

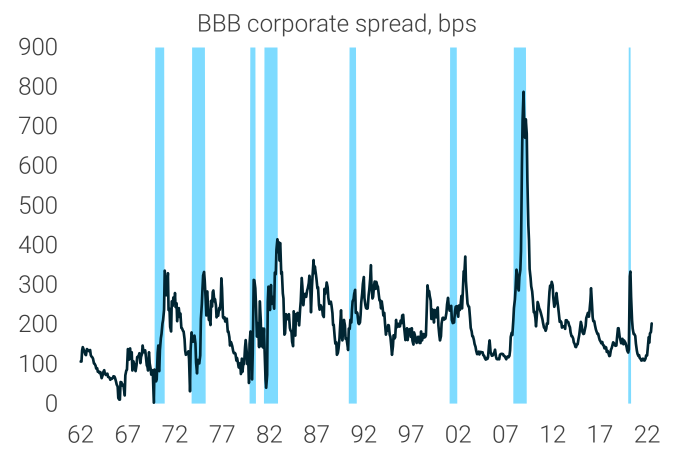
Market-based measures

While it is always entertaining to poke fun at economists, the recession signal from financial markets is not much better. Equities, for example, tend to move in sync with the state of the economy but offer few insights as to the future. Worse, the old adage about the "the stock market predicting nine of the last five recessions" is true, at least in the sense that equity prices are considerably more volatile than output and employment. Every recession usually involves a bear market in stocks, but not every bear market signals a recession. Bonds have a better track record. As every investor knows, the US yield curve has inverted ahead of every major downturn since the 1960s. Yet the lag between technical inversion and recession can be anything from six months to two years, which means observing such a move in bonds does not really provide actionable information for investors. Worse still, even inversion is not a totally fool-proof recession signal because it has occasionally provided false warnings, especially when the Federal Reserve has acted pre-emptively (e.g., 1995 and 1998). So, the recent inversion does not necessarily point to a recession in 2023. Moreover, it is consistent with a soft landing and "mid-cycle" policy easing.

Greenspan's 'discontinuities

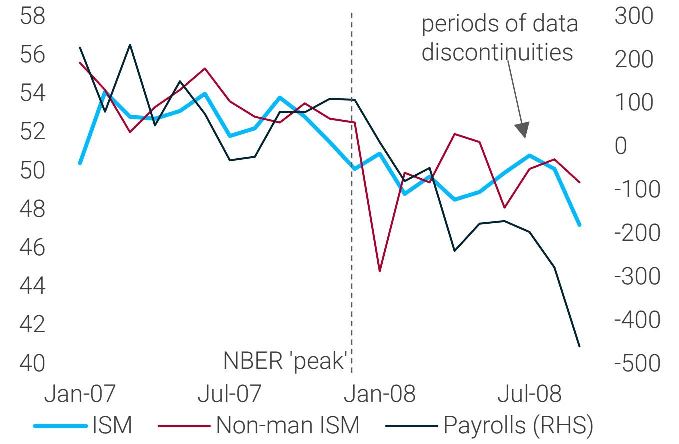
If we cannot forecast recessions, how do we know whether the economy has entered one? Naturally we cannot wait for an institution such as the NBER to tell us, because their "official" announcement comes only once the outcome is already obvious. Yet economic data do take on certain characteristics in the initial stages of a recession, providing important clues for investors hoping to get an early steer. And for once, Alan Greenspan, the former Fed chair, can offer some useful advice. Greenspan has argued on numerous occasions that what he calls "discontinuities" in the data are the classic early sign of a recession. These are sudden, sharp swings that have no readily identifiable cause (such as extreme weather). Speaking to the FT in January 2008, Greenspan identified such discontinuities early in the downturn, even before the full-blown banking crisis and the collapse in global stock markets. While these discontinuities stopped during the spring, they returned in the autumn, consistent with the two main phases of the subprime downturn – a housing recession in 2007-08, following by a banking crisis in 2008.

Chart 8: Credit spreads and US recessions



Sources: FRED, NBER, TS Lombard.

Chart 9: Data discontinuities in 2007-08

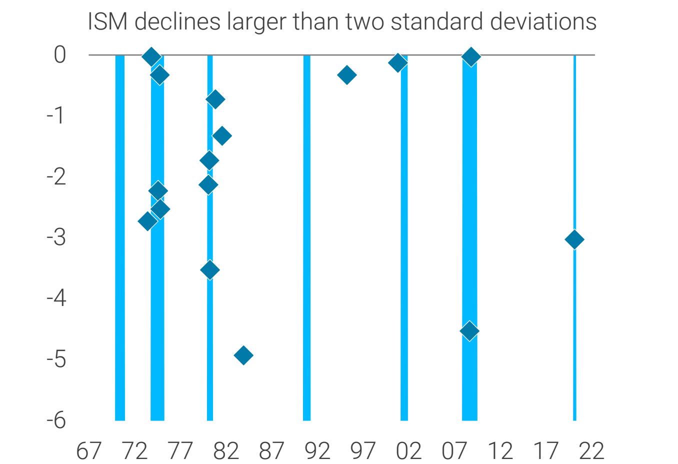


Sources: Datastream, TS Lombard.

Which discontinuities matter?

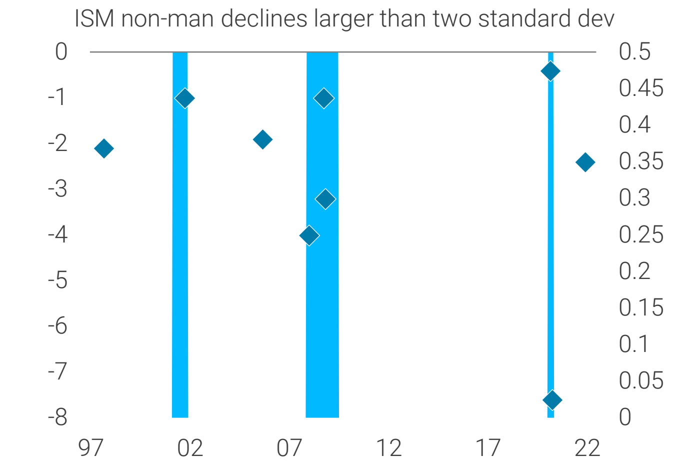
We can formalize Greenspan's recession signal by comparing data outturns with their historical ranges. In Charts 10-13, we show what happened in previous US recessions (excluding COVID, for obvious reasons), identifying discontinuities in some of the most popular data series – the ISM surveys, the monthly change in payrolls (real-time estimate) and consumer sentiment. In this exercise, we define a discontinuity as an outturn one or two standard deviations below its historical average (depending on the exact series). Consistent with Greenspan's view, we find that sudden 'non-linear' moves in the data are common in the early stages of US recessions. A plunge in the ISM or a sudden collapse in consumer confidence – even if only temporary – is a clear warning sign. And in recent months, certain discontinuities have again started to emerge in US data, especially some of the regional manufacturing surveys. So far, this is nothing to be alarmed about – especially given current distortions in the manufacturing sector (the inventory bullwhip). But if we were to see a decline in US payrolls, which has historically been the most important US "marker", this would signal the start of a more serious deterioration in the economic outlook.

Chart 10: Large ISM declines cluster at recessions



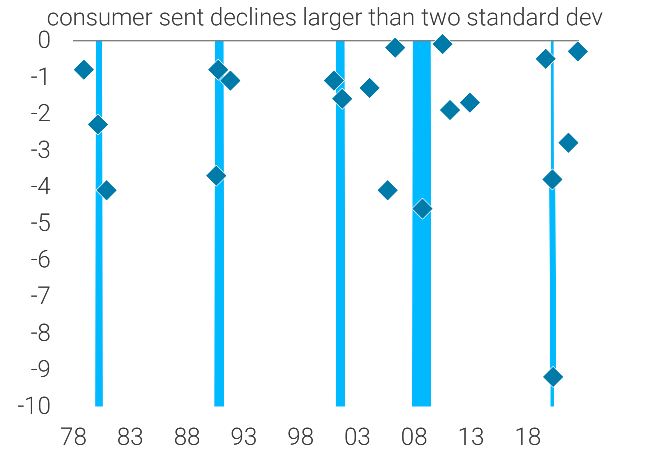
Sources: Datastream, TS Lombard.

Chart 11: Service-sector ISM less reliable



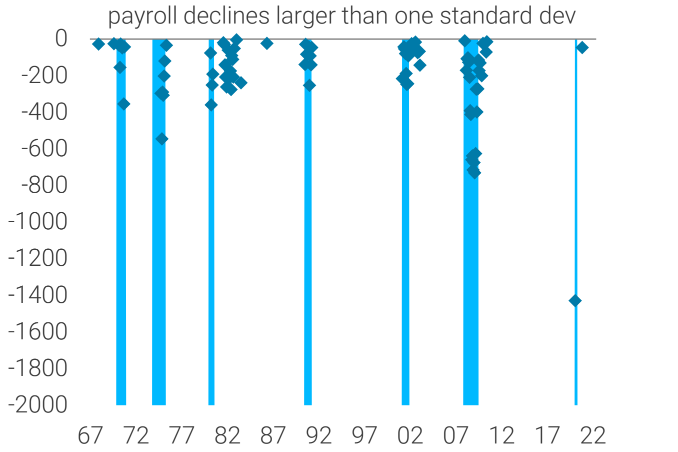
Sources: Datastream, TS Lombard.

Chart 12: Consumer sentiment and recessions



Sources: Datastream, TS Lombard.

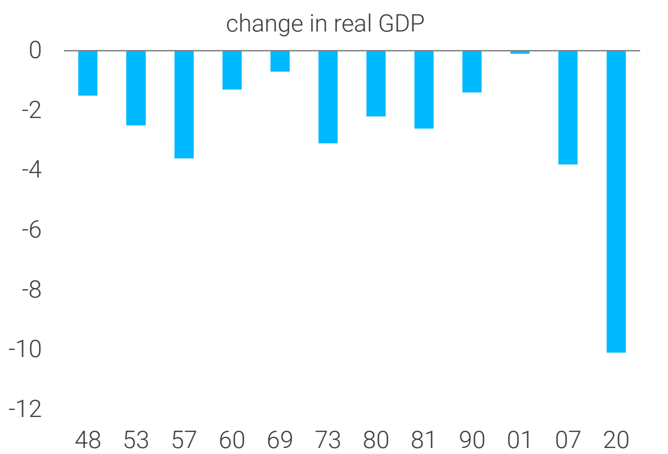
Chart 13: Payrolls decline only around recessions



Sources: BLS, NBER, TS Lombard.

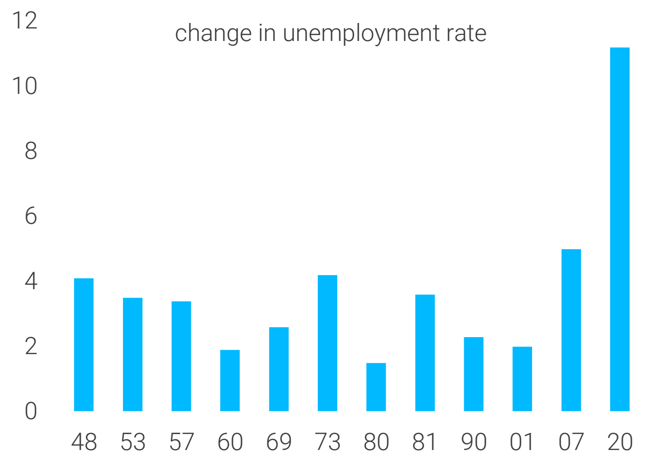
Obviously, it makes sense that a decline in payrolls should offer the clearest indication that the US economy is moving into recession, especially given the reflexivity associated with any deterioration in the labour market. But isn't employment a lagging indicator? And won't it be too late if investors wait for such a clear sign of recession? Our previous analysis suggests not. In past recessions, early weakness in the US labour market triggered a rally in equities, as markets anticipated a more substantial policy response from the Fed (since everyone knows that Fed officials pay close attention to employment trends). This means that even if investors waited for unambiguous evidence of a US recession, they would still have time to exit risk assets before it became clear that easier Fed policy is never enough to halt a downturn once it has started.

Chart 14: GDP during US recessions



Sources: NBER, TS Lombard estimates.

Chart 15: Unemployment during US recessions

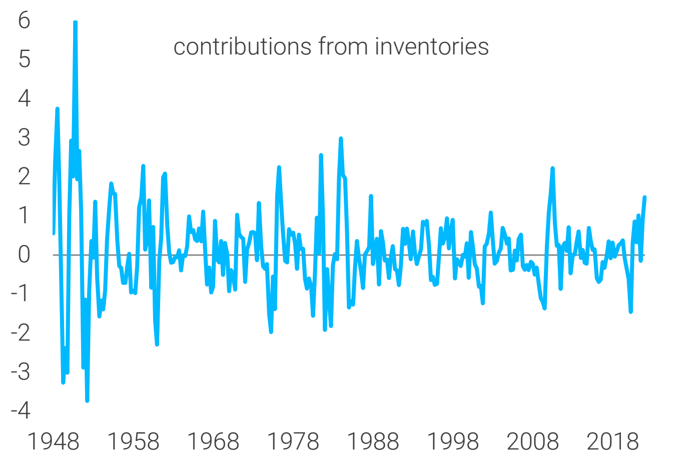


Sources: NBER, TS Lombard estimates.

2. BLAST FROM THE PAST

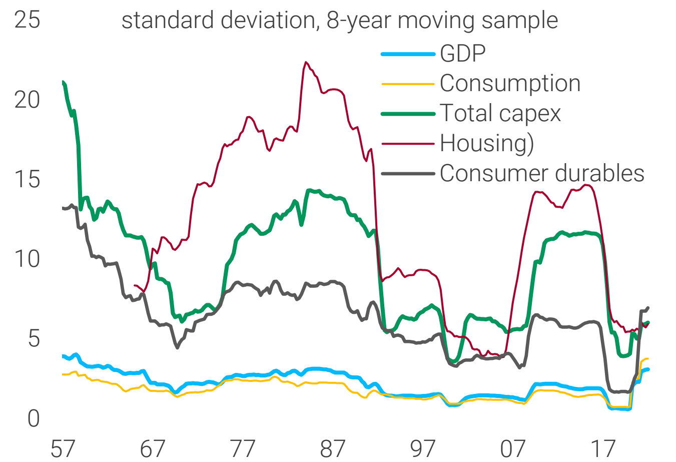
Many parts of the world are likely to experience a "technical recession" in 2022, including the US, where such episodes are relatively rare. This is not necessarily something investors should worry about, unless labour markets start to crack – which could trigger deeper and more protracted economic downturns. Yet the sort of US "recession" we have in mind would look quite different from those of the past 30 years. After all, investors are accustomed to long US economic expansions, punctuated by a sudden plunge in asset prices alongside sharp declines in employment and output. Excluding the artificial COVID-19 downturn, every US recession has had a distinctive "end of cycle" vibe, which was linked to developments in financial markets. What we are experiencing currently – so far, at least – is, in fact, a throwback to an earlier period in history, before the so-called "Great Moderation". Back then, economies were more unstable because volatile swings in inventories and large inflation shocks produced regular periods of contraction. Today's environment is also one in which companies are facing severe staff shortages – in part owing to a decline in the labour force – which means they are more likely to hang onto workers than introduce mass layoffs. This is another reason to think the classic US recession template will not apply. Instead, we could end up with something resembling Euro/Japanese-style labour hoarding. With corporate margins at record highs, this is not necessarily a disaster for earnings.

Chart 16: Inventory methods improved since 50s



Sources: BEA, TS Lombard.

Chart 17: GDP shifted to less volatile output

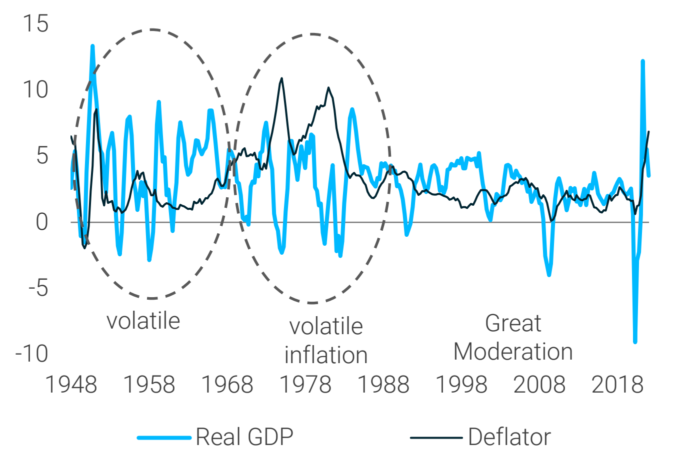


Sources: BEA, TS Lombard.

The Great Moderation

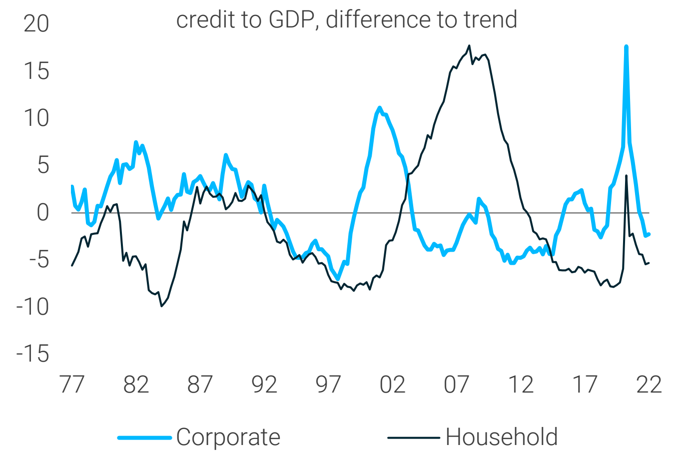
For most developed economies, the nature of the business cycle changed in fundamental ways after the 1980s. Inflation trended lower and became more stable, while GDP posted long periods of continuous growth. When something went wrong, it usually originated in the financial sector. For a while, policymakers called this period the "Great Moderation"; but, of course, below the surface, serious imbalances and vulnerabilities were building up. There was the savings and loans crisis in the late 1980s/early 1990s, the LTCM crash in 1998, reoccurring EM disasters, the dotcom bubble in 2000, and the subprime bust in 2008. There is even an argument, popular among fans of Hyman Minsky, that it was the very stability of the real economy that contributed to the volatility of the financial sector, by encouraging excessive risk taking and over-leverage. In any credit-based modern monetary system, there will be a tendency to loosen credit when times are good and borrow more in the short term than can be sustained in the long term. And it is certainly true that Great Moderation produced a period of low interest rates, which encouraged households and businesses to accumulate debt. Yet it is important to remember that the financialization of the economy is a modern development. Recessions looked very different in the period between WW2 and the early 1980s, typically originating outside the financial sector.

Chart 18: Difference phases of US cycles



Sources: BEA, BLS, TS Lombard.

Chart 19: Financial cycle took over



Sources: BIS, TS Lombard estimates.

Several things happened during the Great Moderation that altered the business cycle:

(i) The shift from manufacturing to services: Manufacturing is inherently more cyclical than the services sector, so it makes sense that overall macro volatility declined as the developed world made this transition. Demand for spinning classes, management consultancy, karaoke and plastic surgery is likely to fluctuate with the overall economy; but unlike steel mills and automobile factories, they have no great cyclical dynamics of their own. We see similar shifts in the composition of consumer spending. The demand for "durables" such as housing and autos, which tend to be the most volatile components of GDP (Chart 17), has diminished, as a result of which the real economy has become more stable over time. And with a smaller share of the workforce employed in the most cyclical industries, recessions have tended to have a smaller impact on employment. This should reduce the reflexivity of the economy during downturns, damping the feedback loop between jobs and spending.

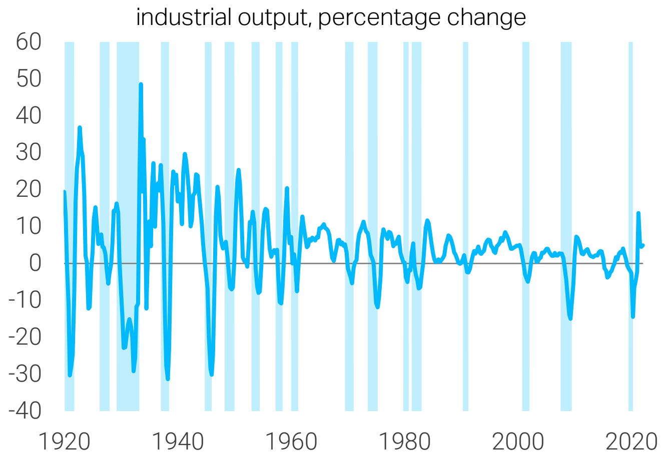
(ii) Better inventory management: Business logistics and inventory management improved during the Great Moderation, too. This was important because large swings in inventories can amplify the business cycle, causing greater cyclical variation in GDP. Before the 1980s, in fact, a shortfall in sales did not typically lead to an immediate reduction in production that prompted the involuntary stockpiling of raw materials and finished goods and eventually led to even larger reductions in orders and output. Things changed with the invention of computers and better, faster communication. Businesses could now track demand and monitor their supply needs in real time, which meant production could respond more quickly and smoothly to changes in demand. This was the era of "just in time" inventory management. Chart 16 shows inventories have been responsible for a much smaller share of US cyclical variation over time, a notable difference from the 1950s and 1960s. But it is also important to remember that most developed economies outsourced their supply chains to the rest of the world, which pushed some of the cyclical variation of the production process into Asia and the EMs (see, for example, semi-conductor activity in Korea – which is far more volatile than global IP).

(iii) Low and stable inflation: Before the Great Moderation, inflation itself was a source of instability in the real economy. Every large inflation shock in the 1970s automatically squeezed consumers' spending power, leading to sharp declines in real output and employment. In a bid to tame these high levels of inflation, central banks often had to tighten forcefully, which itself became a source of wider macro instability. What changed after the 1980s? Naturally, central banks like to take a lot of the credit. They believe their "credibility" anchored expectations, which made inflation more stable – since even large shocks to commodity prices failed to generate the "second-round" effects of the 1970s. But inflation is ultimately about power, and there were big political and structural changes after the 1980s – neoliberalism, globalization, demographics and technology – that were surely more important in delivering an era of "price stability". In any case, when inflation is low, policymakers can move more quickly to stimulate the economy in times of economic crisis and recession.

Sound familiar?

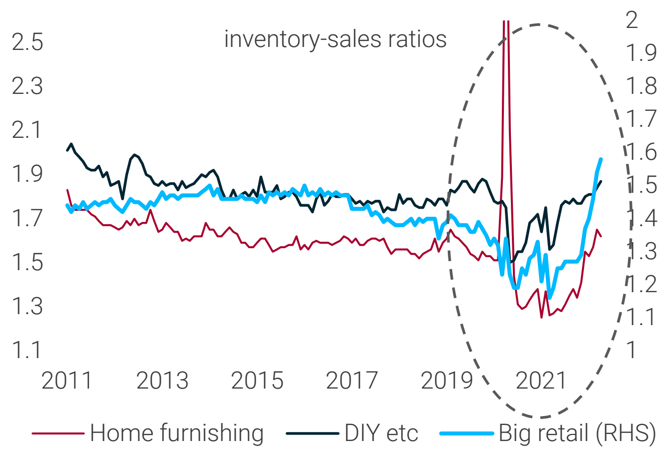
Wild inventory swings (logistical chaos), volatile inflation, excessive reliance on manufacturing and an economy weighted towards durable goods, especially housing and autos – if this sounds familiar, that is because it is a good description of the economy over the past two years. And this is why the "recession" we have today is reminiscent of the downturns we had before the Great Moderation. In fact, we have managed to combine the bullwhip inventory downturns of the 1950s and 1960s with a 1970s-style inflation squeeze. The good news is that the economy today does not seem to exhibit the deep underlying financial imbalances that have proved so deadly in the post-1980s era. Sure, asset prices surged during the pandemic, but without the excessive leverage of the early 2000s, tighter monetary policy has deflated those bubbles without causing serious collateral damage (so far). So, we have a period of instability in the real economy, but this is not necessarily the sort of "Minsky moment" investors usually associate with US recessions. Perhaps, even, it is a taste of "a new macro regime". With inflation likely to remain more volatile in the 2020s and businesses set to reconfigure their supply chains, perhaps the artificial – but ultimately deceptive – macro stability of the Great Moderation has now ended. This could mean more frequent, but less extreme, recessions with fewer underlying imbalances/"bubbles".

Chart 20: Manufacturing leads the US cycle



Sources: Datastream, TS Lombard.

Chart 21: Inventory chaos has returned

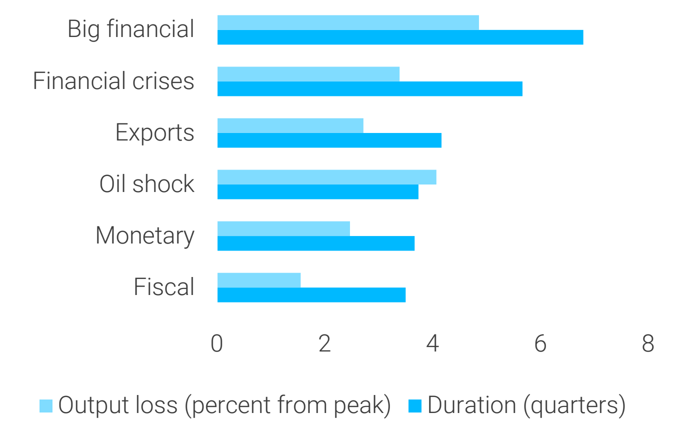


Sources: Datastream, TS Lombard.

Economic imbalances

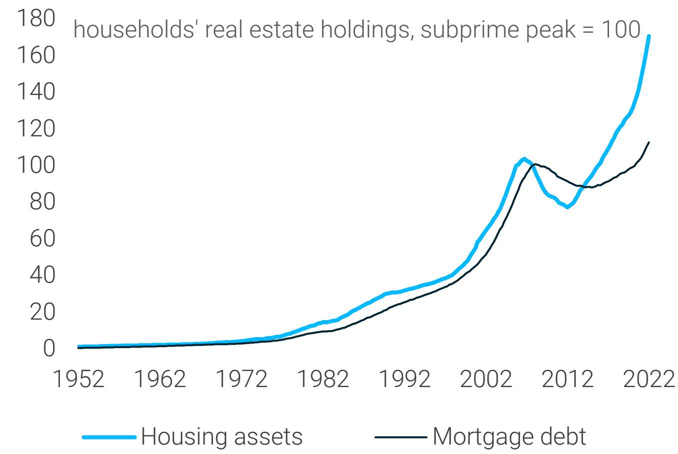
There has been a long a debate in economics about whether recessions are necessary and inevitable. To the extent that there is an underlying "imbalance" in the economy – such as excessive leverage among households and businesses – some believe a downturn can be cathartic because it restores balance and puts the economy on a firmer footing. Today, we see relatively few underlying imbalances, particularly in the financial system. Private-sector indebtedness has declined over the past decade and leverage in the banking system is low. Despite the recent plunge in asset prices, balance sheets remain strong. Households, at least in aggregate, have accumulated substantial liquid assets and savings. Most economies are well placed to withstand a period of mild instability and weakness, especially as the immediate sources of the downturn – extreme inflation and the manufacturing/retail "bullwhip" –will fade. Once commodities stabilize, we will see a strong recovery in real wages. Right now, the only true imbalance – the one thing that might make a recession "necessary" – is that there is excess demand in most labour markets, especially where the labour force has recently shrunk.

Chart 22: Financial recessions are the worst



Sources: IMF, TS Lombard,

Chart 23: Latest bubble lacks leverage of 2000s

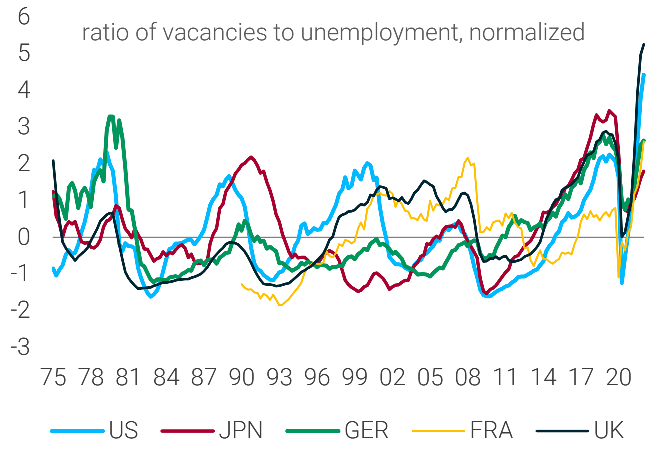


Sources: Federal Reserve, TS Lombard,

Companies will hoard labour

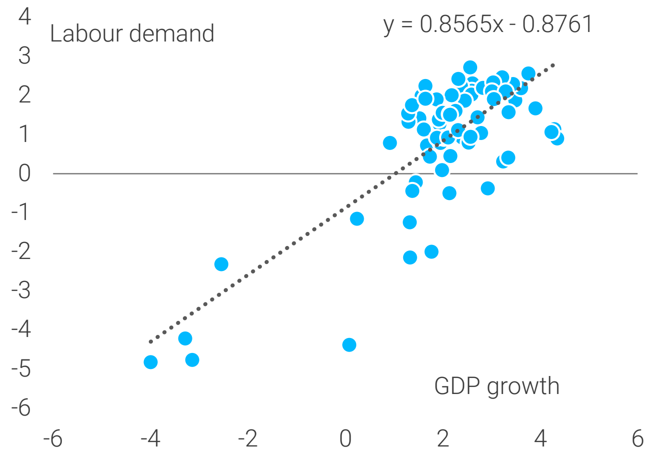
One interpretation of the imbalance in jobs markets is that central banks will need to generate a recession in order to reduce the labour demand. This would ease wage pressures and ensure inflation returns to central banks' targets. But the contraction in the workforce over the past two years – which is particularly extreme in the US and the UK – makes this unfeasible. In the US, for example, the shortfall is equivalent to around 5 million workers, which, based on the traditional relationship between labour demand and GDP, would require a decline in output of around 4-5% - i.e., similar in magnitude to what happened after the subprime crash. There is no way the Federal Reserve, or any central bank for that matter, would tolerate such a deep recession. In any case, this is the wrong way to think about the problem. The better interpretation is that – given the labour shortages – companies will want to hang onto their workers even if the economy stagnates over the next three to six months. Since labour hoarding is unusual in the US, this is another reason to think any near-term "recession" is going to have a very different "feel" from those of the modern era. The European/Japanese recession template seems more appropriate.

Chart 24: Tight labour markets



Sources: OECD, national sources, TS Lombard.

Chart 25: Big GDP fall needed to restore balance

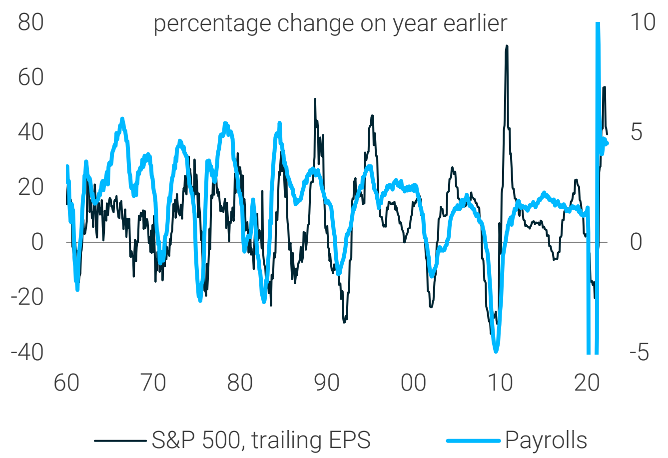


Sources: BLS, BEA, TS Lombard.

3. BAD NEWS IS GOOD NEWS

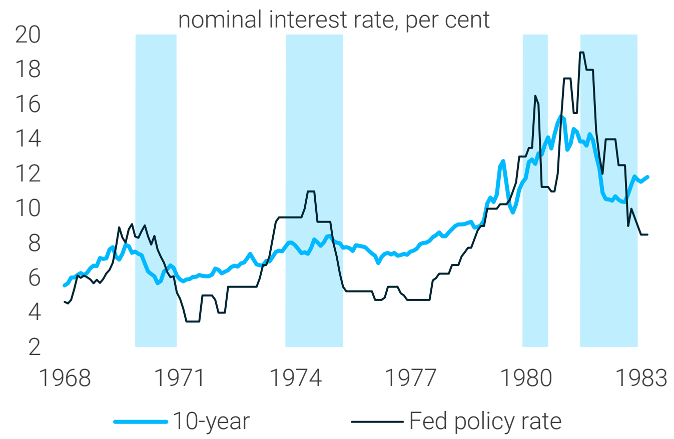
What does the current period of economic weakness, “technical recession” or not, mean for financial markets? Anxiety about the outlook has already caused bond yields and commodities to plunge. While it is premature to think about central banks cutting interest rates in 2023 – despite current market pricing – it makes sense that “terminal rates” should dip, at least temporarily. The more difficult question is what this means for equities. In principle, lower bond yields should offer some relief to global stock markets, especially given the pain they experienced in the first half of the year. But this has to be balanced against the threat to corporate earnings. And unless we get some better news on the inflation front, meaning at least several months of sequential improvement, the much anticipated “dovish pivot” will be further away than investors realize. After all, a mild recession with labour hoarding is not going to generate underlying disinflation. This means we are still reliant on there being a large “transitory” component to recent CPI data.

Chart 26: Profits plunge during recessions



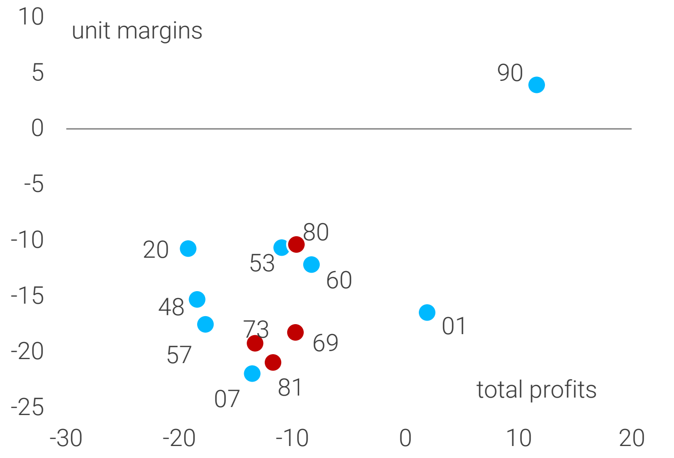
Sources: S&P, BLS, TS Lombard.

Chart 27: Fed pivoted even in the 1970s



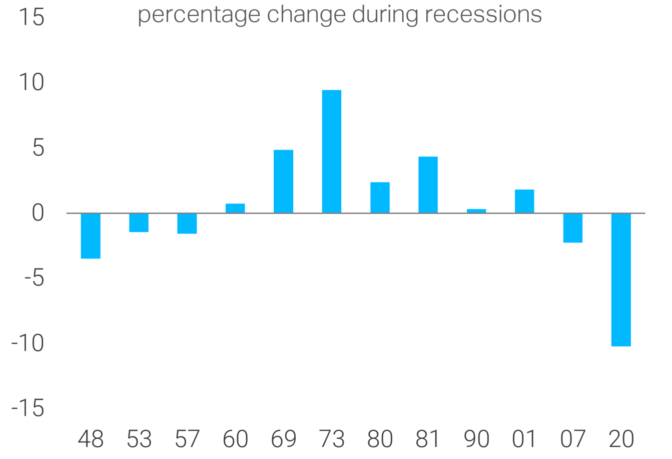
Sources: Datastream, TS Lombard.

Chart 28: Double hit to profits during recessions



Sources: BLS, BEA, NBER, TS Lombard.

Chart 29: Nominal GDP did not decline in 70s

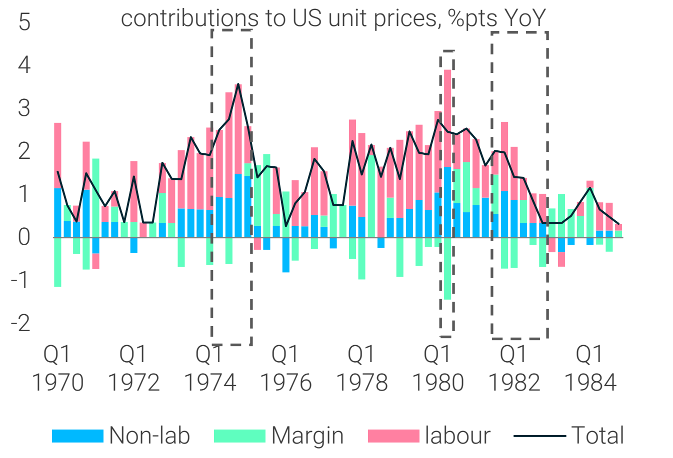


Sources: BEA, TS Lombard.

Recessions and earnings

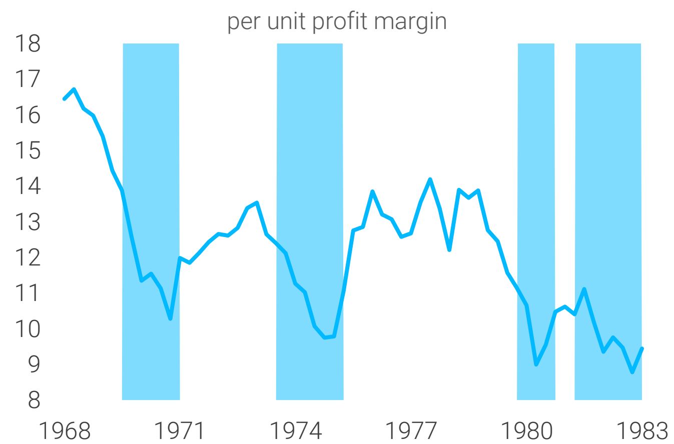
Genuine recessions are invariably a disaster for corporate earnings. On average, EPS declines by around 15% in a US recession, which is far deeper than the decline in GDP. Intuitively, the hyper-cyclicality of corporate profits makes sense. In a recession, companies experience a double hit to earnings – output declines, and margins shrink (since wages are sticky while productivity deteriorates). Today there are some analysts who believe “pricing power” will protect corporate revenues. They point out that nominal GDP will continue to grow even if volumes are down. Yet the experience of the 1970s shows this is unlikely. While the 1970s were unusual in the sense that nominal activity continued to expand even during several recessions, corporate earnings still suffered several large contractions. Chart 30, which decomposes US inflation into contributions from labour costs, non-wage costs and margins, shows why. Even in the 1970s, every US recession brought that same toxic combination of falling output and a contraction in margins. The only encouraging thing about this period, in fact, is that profits recovered quickly once the recessions ended. Real output bounced as commodity prices declined, and companies rebuilt their margins by raising their prices even as the pressure on their costs diminished.

Chart 30: Recessions in the 1970s



Sources: BEA, TS Lombard.

Chart 31: Margins shrunk, then rebounded

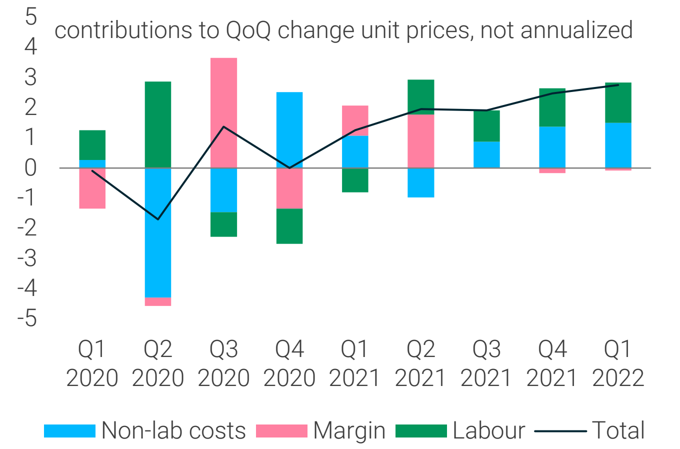


Sources: BEA, TS Lombard.

The profits outlook today

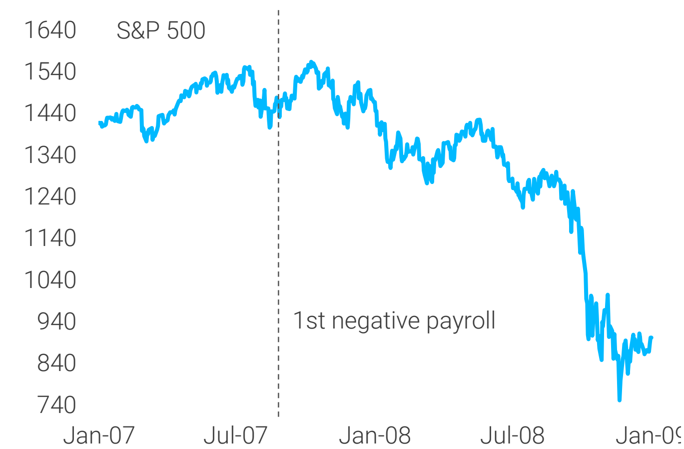
Technical recession or not, equity analysts seem to have wildly optimistic expectations for corporate earnings over the next 12 months. To the extent that it was valuations – not earnings downgrades – that have driven the bear market in stocks, this is a major problem when thinking about the outlook for equities during the second half of 2022. If profits miss these bullish expectations, we might even expect another leg down in global stock markets. But there are two reasons why the outlook is not as dire as it seems. First, it is not clear anyone actually believes EPS forecasts, except perhaps the analysts who made them. Certainly, most institutional investors do not expect such a strong performance. Second, although profits are likely to struggle – perhaps even contract – we are unlikely to see the typical recessionary plunge. Stagnant output and a modest margin squeeze would point more to a mild contraction than a classic "earnings recession". Right now, it is labour costs that are biggest problem for corporate margins. While unit labour costs are likely to remain problematic in the second half of the year, especially with companies set to hoard labour, lower commodity prices will provide an offset. Like in the 1970s, companies will not reduce their margins as non-labour costs sink, supporting margins.

Chart 32: Falling commodities could help margins



Sources: BEA, TS Lombard estimates.

Chart 33: US stocks rallied as labour mkt cracked



Sources: Datastream, TS Lombard

A dovish pivot?

If the weakness in the economy is mild and corporate earnings hold up better than many investors fear, it is likely that equity markets will stabilize in the second half of the year. In fact, given what has happened in the past, it would be foolish to rule out a more bullish reaction. Consider, for example, what occurred in 2006. The Fed had been on autopilot for two years, raising interest rates at every FOMC meeting. Even with officials worried about inflation and signalling the possibility of future rate hikes, its decision to end this automatic phase of policy tightening triggered a powerful rally in financial markets. Investors did not care about the FOMC's policy guidance; they cared about what they was actually doing. Actions speak louder than words. Even two years later, when the US labour market started to crack, stocks rallied in anticipation of Fed rate cuts, which were supposed to limit the fallout from the housing crash. Perhaps we will see something similar again, especially if there is some relief from the CPI.

'Recession' buys time, if…

The problem for the "dovish policy pivot" is that a mild technical recession during which companies hoard labour is not going to generate any genuine (underlying) disinflation. Even if central banks slow the pace of policy tightening, there is a good chance they will eventually have to resume raising interest rates. The important point, however, is that a period of economic weakness could at least buy some time, especially if it coincides with a plunge in commodity prices. Even if companies are not shedding staff, uncertainty about the outlook should discourage hiring – which is something central banks are keen to see. Right now, the authorities are following a rapid course of monetary tightening, which – if unchecked – will inevitably lead to a deeper downturn than the one we are seeing right now. Anything that diverts them from this course is surely a good thing, especially as there is still a significant "transitory" component to their current inflation anxiety and "credibility" fear. But it is also clear that weak economic activity alone is not enough. If there is any hope of a "soft landing", we are going to need to see a moderation in the CPI over the next three to four months. That is why last week's US reading was rather ominous.

Bottom line

The global economy has slowed significantly, with some parts of the world now contracting. Whether we see "technical" recessions – two consecutive quarters of decline – is largely irrelevant at this point. It makes more sense to define a recession according to what happens in the labour market, which is what typically causes nasty reflexivity. When companies shrink their staffing levels, new rounds of spending cuts and further job losses follow. Even with most economies now under pressure, there are good reasons to think labour markets will remain resilient. Uncertainty about the outlook might discourage hiring; but amid massive worker shortages, most companies will want to retain their staff. For this reason, this latest US downturn is likely to have a very different vibe from those of the last 30 years. Labour hoarding is generally something we associate with Europe and Japan, not the US. And with inventories and high inflation driving much of the weakness in the economy, we even have a throwback to an earlier period in history – before the so-called Great Moderation – when instability came from within the real economy rather than from asset bubbles and imbalances in the financial sector. The good news is that a "soft patch" is still the most plausible route to a "soft landing". But at the same time it is going to take several months of softer inflation data for central banks to soften their tone. With an improvement in the CPI in H2, global equities might even stage an unexpected recovery.

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