

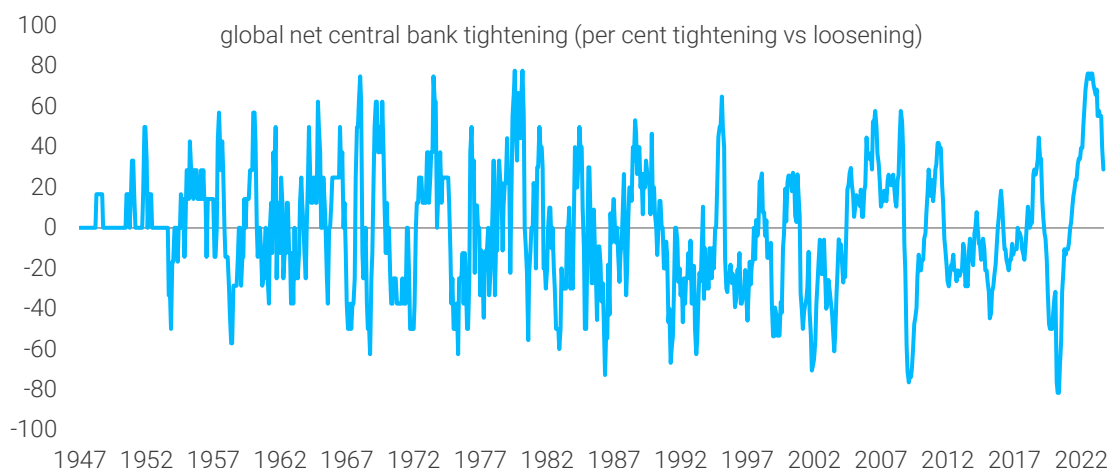
## Macro Picture

# DID WE JUST 'SOFT LAND'?

Dario Perkins

While the global economy remains on the path to a historic soft landing, the journey ahead remains treacherous: it is not yet possible to fully exclude the “hard-landing” scenario (especially outside the US). Central banks are in wait-and-see mode, but the risks are skewed towards policy easing. Whatever happens, we could see big rotations within asset markets.

**Chart 1: The global policy cycle has turned – but what comes next?**



Source: BIS, TS Lombard estimates

## THE RIGHT PATH

When everyone was convinced that recession was the only possible outcome in 2023/24, we outlined three scenarios for the global economy: soft landing (the likeliest), hard landing and “no landing”. So far, the world has stayed on the soft-landing path. Inflation has returned to tolerable levels (albeit above 2%) and we are not yet seeing truly recessionary labour-market dynamics.

## THEN THERE WERE TWO

Unfortunately, the journey ahead remains treacherous and both the hard and no landing scenarios remain in play. We examine the risks, including an inflation rebound that forces central banks to keep raising interest rates and a more serious deterioration in credit/labour markets. On balance, we think the risks are skewed towards a hard landing rather than no landing.

## PRICING PERFECTION?

After suffering the worst bear market in modern history, the next 3-6 months should provide some relief for battered bond investors. The monetary policy cycle is turning. For equities, the big story could be a rotation within the stock market (recession or no recession). Investors believe US growth stocks will provide a safe haven. Past experience suggests this is a dangerous thesis.

## DID WE JUST 'SOFT LAND'?

Twelve months ago, Bloomberg published a memorable article claiming there was a [100% probability of a US recession](#). To be fair to the economists who produced those estimates, they were not alone in thinking a serious downturn was “inevitable”: this thesis set the tone for most sellside 2023 “year ahead” publications. For our part, we were always rather sceptical of those gloomy claims, not least because they were applying classic business-cycle analysis to a highly unusual macroeconomic environment. Instead, at the start of the year, [we framed the discussion in terms of three potential post-COVID “landings” – a soft landing, a hard landing and “no landing”](#). So far, the global economy seems to have stayed on the path to a soft landing. Inflation is trending lower to reach levels that are tolerable for central banks, and this is happening even without any serious collateral damage in labour markets. The demand for workers has cooled, which is what the authorities wanted; but unemployment everywhere has remained close to historical lows, proving that the gloomy prognosis of economists about the amount of pain that would be necessary to restore price stability (based on sacrifice ratios derived from notoriously unreliable Phillips curves) was seriously flawed. Whether by skill or good luck, central banks seem to have delivered a landing that even [Captain Sully would have to applaud](#).

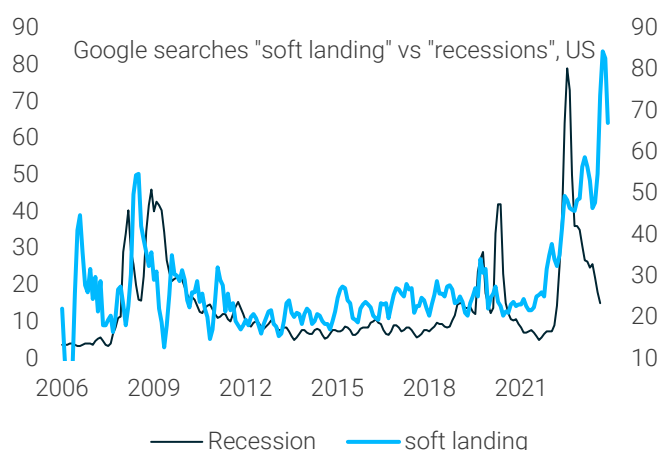
While the prevailing macro trends of the past 12 months have been encouraging, the path to a soft landing remains disturbingly treacherous. On one side, we have the continued threat of a rebound in inflation, from a level that is still above central banks’ targets. While central banks might ignore a supply-induced reacceleration in consumer prices (stemming from tensions in the Middle East, for example), they would need to monitor underlying price dynamics closely. The authorities will be wary of what happened in the 1970s, when a series of large inflation shocks de-anchored inflation expectations. At a minimum, a reacceleration in consumer prices would make it harder for central banks (especially in Europe) to cut interest rates. We see less chance, however, of a strong rebound in economic activity. In the contest between no landing and a hard landing, the risks have become increasingly skewed towards the latter. Not only is the situation in labour markets looking more precarious, but the credit cycle has started to deteriorate. [Outside the US, some central banks have already overtightened monetary policy](#). All central banks were whipsawed by the fake business cycle, but some were whipsawed more than others. Where policy is too tight, recession risk depends on the speed of the monetary reversal.

How should investors position themselves? We are secular bond-market bears; but with the monetary tightening cycle largely complete and the risks now tilted towards recession rather than a powerful rebound in global activity, we should see some short-term relief for battered bond investors ([especially as consensus angst about fiscal sustainability is hugely overdone](#)). The trickier question is how these three landings would play out in equity markets. On some metrics, stock markets have already fully discounted the soft-landing thesis, which would mean they are vulnerable to earnings disappointment. But the real action has been happening below the surface, where there has been a large divergence in performance between the Magnificent Seven (large US tech stocks) and other, broader equity indices (such as the Russell 2000). There appears to have been a flight to quality, based on the belief that the “Mag7” are immune to recession risk and less exposed to the global credit squeeze. But developments over the next 12 months are set to test this thesis, either because the recession *doesn’t* materialize (which should boost small-cap stocks more than the Mag7) or because the recession *does* happen – and it turns out that even “good companies” are not immune to deteriorating macro environment. The Nifty Fifty provide a cautionary tale, which, longer term, points to a secular rotation out of growth stocks.

## 1. THE RIGHT PATH

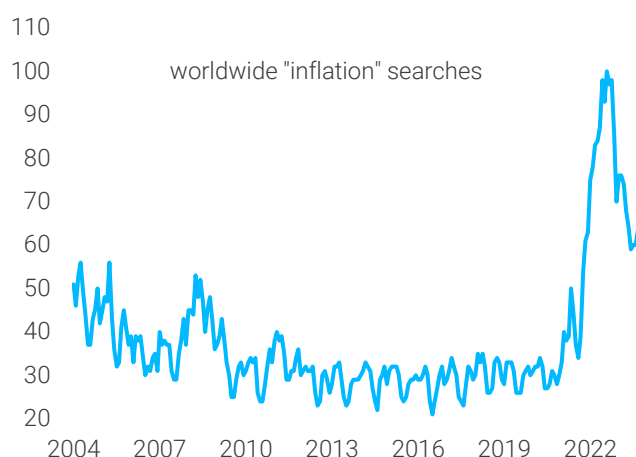
There is only so long you can remain wrong in this industry; and by late summer it was clear that most economists had abandoned their long-standing recession calls and embraced the previously “impossible” soft-landing scenario. Not only was inflation trending lower all over the world, but it was doing so without serious damage to labour or credit markets – so far. This raises important questions. How have central banks restored price stability without inflicting the economic and financial “pain” most pundits (and some policymakers) had expected at the start of the tightening cycle? Should we credit good policy, or would inflation have come down even without such an aggressive policy intervention? (Understanding what has gone “right” in 2023 can shed light on what might go “wrong” in 2024.) What happens next? Is the soft vs hard landing debate genuinely settled or is everything still to play for? And what about that “no landing” scenario? Can we fully discount this idea, or could the global economy rebound even if central banks maintained their “higher for longer” policy stance? What is the hurdle for the next interest-rate move (in either direction)? How will financial markets respond? Below we address all these questions, updating [our framework for this highly unusual business cycle](#).

**Chart 2: Summer 2023 consensus pivot**



Source: Google, TS Lombard

**Chart 3: Price stability is being restored**

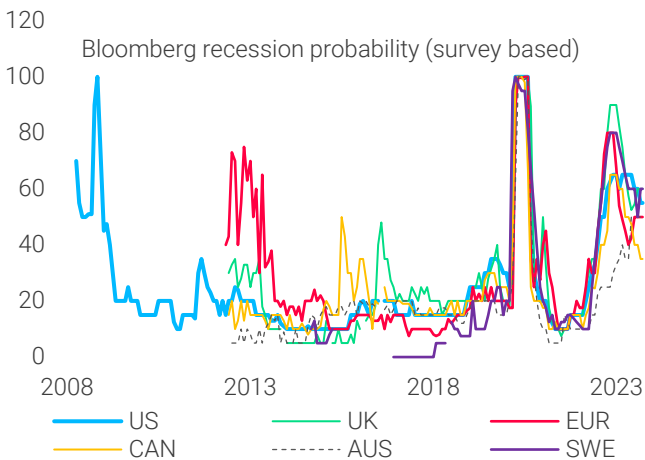


Source: Google, TS Lombard

### Wasn't recession 'inevitable'?

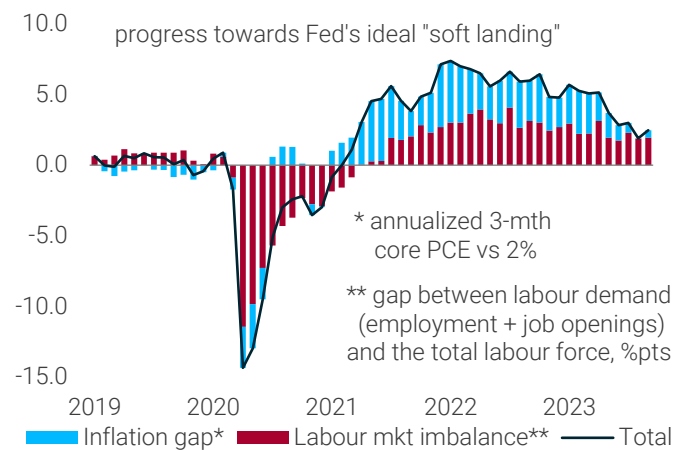
On 17 October 2022, Bloomberg published a highly memorable article saying that its economists had calculated a 12-month US recession probability of 100%. While this take was weird – no econometric model can ever provide such a degree of certainty because its forecasts always come with chunky standard errors – the economics team at Bloomberg wasn't alone in thinking a recession was inevitable. It was also the prevailing tone of the sellside consensus at the start of 2023, when most economists believed that only a serious downturn could restore price stability (and that recession would be the inevitable outcome of central banks' aggressive policy tightening). Our own take was more nuanced. We felt the consensus had an overly deterministic view about where the economy was headed; and since traditional business-cycle analysis was unable to help us understand the post-COVID expansion (a “fake” cycle), we set out three scenarios for how events might unfold: the soft landing, the hard landing and the “no landing”. To return to [what we wrote at the start of 2023](#), those three scenarios were as follows:

Chart 4: Have recession odds really lengthened?



Source: Bloomberg, TS Lombard

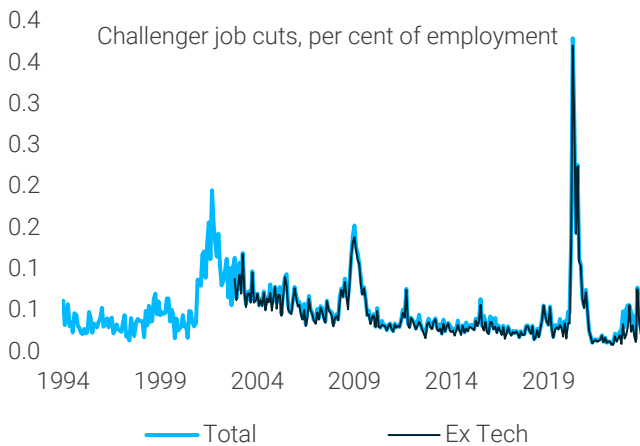
Chart 5: The path to a soft landing continues



Source: BLS, TS Lombard

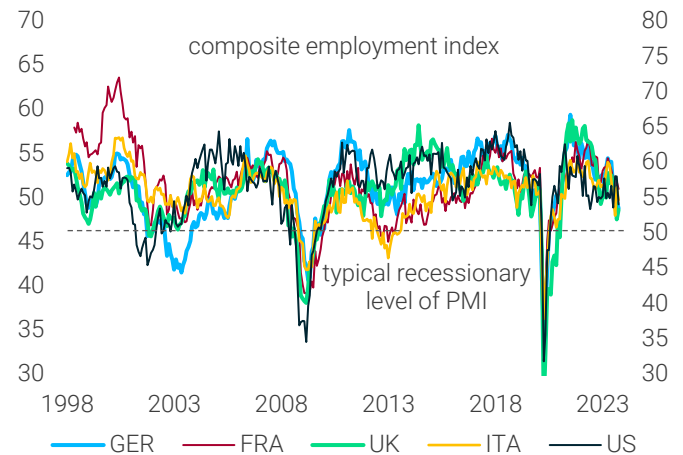
- 1 **Hard landing:** Weak demand causes unemployment to rise and reflexivity kicks in while spending and confidence continue to plunge, which, in turn, damages corporate profits and leads to another round of job cuts. The credit cycle sours, adding another channel for reflexivity. These are the true dynamics of a recession; and when they start, there is massive uncertainty about the ultimate depth and duration of the downturn, which is what kills risk assets. Inflation will eventually ease, especially once there is "slack" in the labour market; but central bank easing will not immediately halt the deterioration in the economy. The danger point for markets is in the interval between serious macro deterioration and the monetary response.
- 2 **Soft landing:** Inflation evaporates despite a generally solid macro environment. Unemployment is steady or increases modestly, without triggering the reflexivity that defines the hard landing. Central banks either keep interest rates unchanged or deliver a 1995-style "midcourse correction", taking monetary policy back to a more neutral setting. Medium-term inflation risks are now roughly balanced, and central banks are in no hurry to return to monetary tightening. Growth resumes and the business cycle continues, after a short interruption. (We later added a credit dimension, which would see a normalization of the credit cycle – after three years of policy-induced hibernation – but no systemic stress or destabilizing rise in defaults.)
- 3 **No landing:** Inflation either fails to decline as rapidly as central banks expect (to levels that they are prepared to tolerate, which is not necessarily 2%!), reverses course or is expected to rebound on the basis of much stronger than anticipated economic data. Far from cutting interest rates, the authorities are forced to continue to tighten monetary policy – perhaps after a brief pause. The recession that everyone expects in 2023 is merely postponed because the economy is still "overheating", with the threat that further policy action will deliver a more sustained (and perhaps more serious) downturn in 2024. Many economists would interpret "no landing" as a "hard landing deferred", possibly by 12 to 18 months.

Chart 6: US labour market survived tech shakeout



Source: Datastream, TS Lombard

Chart 7: Europe on the brink of true recession?

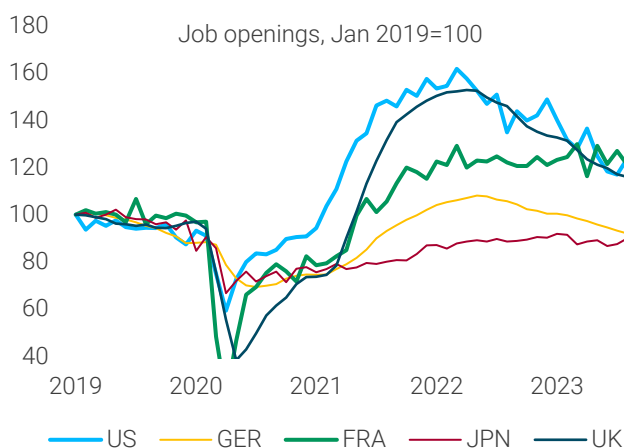


Source: S&P PMIs, TS Lombard

### Conditions for a soft landing

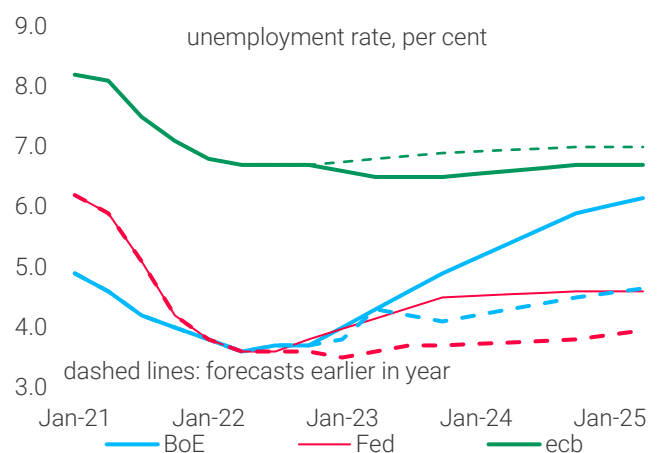
When I shared my thoughts on social media, Mark Dow, a former hedge fund manager and author of the Behavioural Macro blog, [suggested a simpler way to apply the framework to financial markets](#). He put the emphasis firmly on inflation and let the National Bureau of Economic Research determine whether there had been a recession. A soft landing would be “no NBER-defined recession and inflation below 3%”, no landing would be similar but with inflation above 3%, and “anything else would be a hard landing”. The problem with the Mark Dow approach (which, in any case, applies only to the US) is that the NBER can be slow in identifying recessions. In practice, we do not need to wait for the NBER because their recessions are always timed around labour market developments: when employment is contracting, you can be sure that a US recession is under way. But Mark Dow’s focus on inflation does make sense when drawing the distinction between a “soft landing” and “no landing”. While central banks will always say they are totally committed to inflation returning to 2%, we have always felt that they would tolerate prices rising somewhat faster. We can quibble with Mark’s 3% threshold, but the important point is that [inflation must be low enough for central banks to retain a degree of plausible deniability about their acceptance for a sustained overshoot](#).

Chart 8: Demand destruction in labour markets



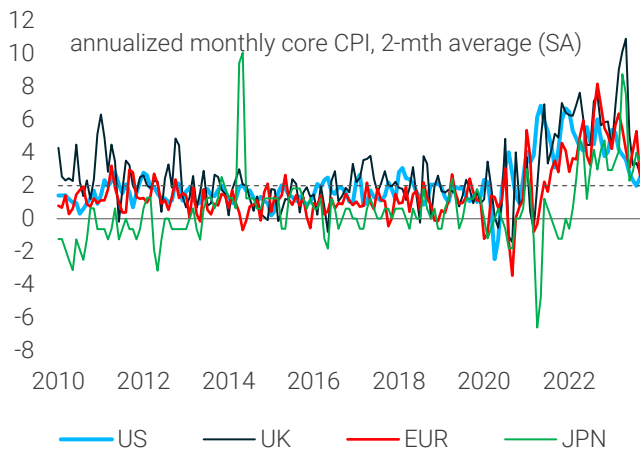
Source: national sources, OECD

Chart 9: Central banks were too bearish!



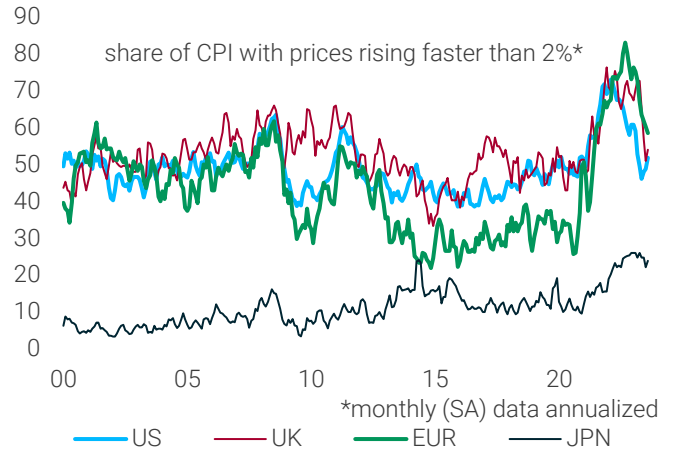
Source: BoE, Fed, ECB, TS Lombard

**Chart 10: Inflation back to tolerable levels**



Source: national sources, TS Lombard

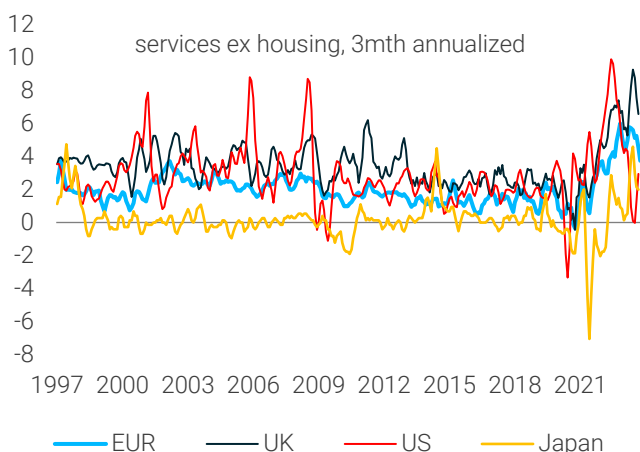
**Chart 11: Entire CPI distribution shifts lower**



Source: national source, TS Lombard

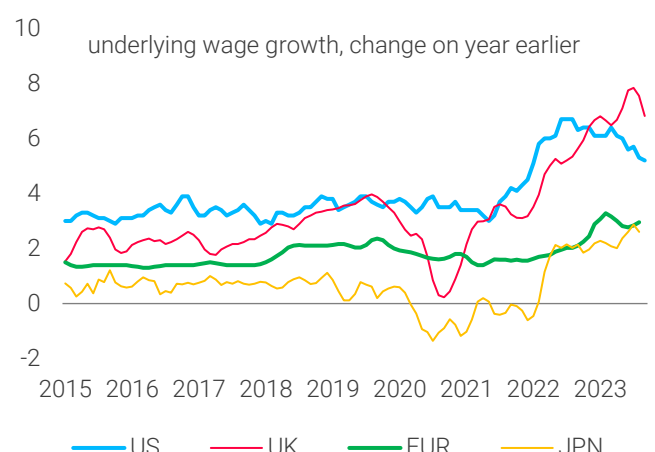
In addition to wanting inflation rates down to tolerable levels, central banks have put a great deal of emphasis on perceived “labour-market imbalances”. Labour demand has been running ahead of supply; and even if this has not really contributed to the inflation the world has experienced since the pandemic, central bankers are strong believers in the Phillips curve. They will worry that continued excess demand for workers will generate sustained wage pressures, making it harder to hit their inflation targets over the longer term. Rightly or wrongly (mostly “wrongly” because the Phillips curve has a terrible record when it comes to forecasting inflation), this adds another criterion for the soft landing. To be confident that inflation is not going to rebound, central banks will want to see a degree of “rebalancing” in labour demand. This can happen either because there is a slowdown in employment, or because there is a decline in vacancies/job openings. And for economies like the US and the UK, where the workforce has shrunk since 2019, there is a third possibility: a recovery in labour supply (the most bullish outcome).

**Chart 12: Even services inflation is normalizing**



Source: OECD, TS Lombard

**Chart 13: Wage pressures have started to ease**



Source: TS Lombard estimates based on national sources

## Where are we now?

In contrast to all the bearish takes at the start of the year, we have always felt there is a plausible (albeit treacherous) path to a soft landing. It would require: (i) inflation back to tolerable levels (ideally below 3-3.5%); (ii) a rebalancing in labour markets without a material increase in unemployment (which would stop the authorities worrying about the Phillips curve); and (iii) economies able to withstand significantly higher interest rates without something “breaking” in the credit system. While progress has been uneven across the various economies, it seems fair to say that much of the developed world has stayed on this narrow path to a soft landing. Not only has inflation fallen significantly, but the entire distribution of price gains in most CPIs has shifted to the left. At the same time, labour demand has cooled: employment has slowed, and job vacancies have declined, yet unemployment rates have barely budged. In fact, all central banks have lowered their unemployment forecasts since the start of the year – the most tangible evidence that their policies have caused less “pain” than expected. And even the credit system has held up better than feared, with most economies proving surprisingly resilient to the highest interest rates in more than a decade. As we explained [in a previous Macro Picture](#), the credit cycle has turned but so far these moves have been consistent with “normalization” rather than a “credit event”. It is not clear if this monetary tightening cycle could have gone any better. But unfortunately, this does not serve as definitive proof that the soft landing is where we will end up.

## 2. THEN THERE WERE TWO

While all central banks have made significant progress towards a soft landing, the path ahead remains uncomfortably treacherous. Nothing has yet been settled, there is still a lot that could go wrong, and progress has been uneven across the major developed economies. On the inflation side, although we are back to price trends that seem more or less acceptable to central banks, the authorities will be mindful of what happened in the 1970s, when prices reaccelerated several times in response to unexpected supply-side shocks. So, it will be important to monitor the situation in the Middle East, where a further escalation in geopolitical tensions could easily spark a new wave of global energy inflation. Higher oil prices are unlikely to trigger additional rate hikes, but they would certainly make it harder for central banks – especially in Europe – to relieve their monetary squeeze with imminent rate cuts. Looking at the alternatives to the soft landing (still the likeliest scenario), the risks are now firmly tilted towards the hard landing rather than no landing. A hard landing could materialize if, for example, tight monetary policy starts to destroy labour demand in sectors that no longer have large staff shortages. And credit markets are another area of vulnerability. The recession risk, which was always about monetary overtightening rather than underlying macro-financial imbalances, [is greater in the euro area and the UK than in the US because there are already signs the ECB and BoE have gone too far](#).

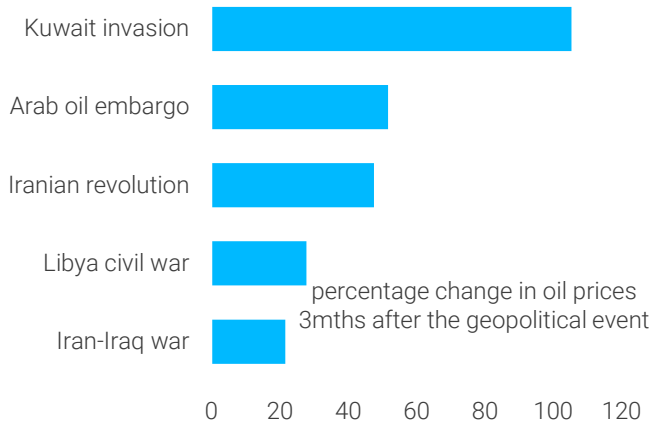
### Too soon to declare victory

If pundits were looking to Jay Powell to declare victory over inflation and celebrate the soft landing, they will have been disappointed by his latest press conference. The Fed chair not only retained the option to raise rates again, but he warned that the central bank still needed to see more progress in two key areas: a further reduction in inflation and an additional rebalancing of the labour market. This was not surprising. Recently, US consumer prices have been a little firmer than the authorities hoped, while job openings have picked up somewhat, ending a period in which the Fed had been making tangible progress on both fronts. Yet given the market’s



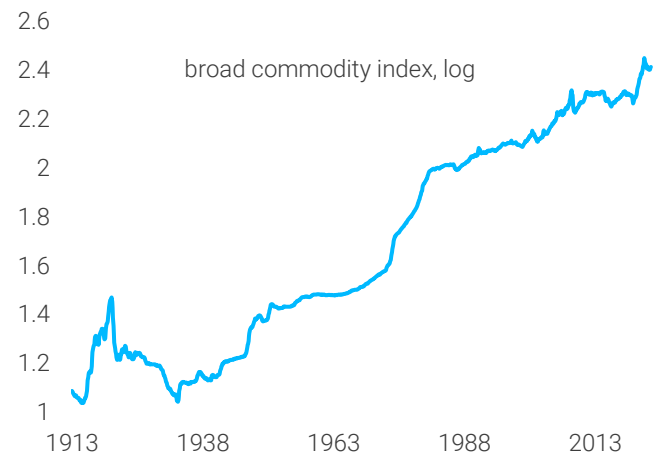
response to Powell's words, it is clear that most investors do not find the Fed's hawkishness credible (particularly after the weaker-than-expected October employment report). We share the market's scepticism. Not only have the odds of "no landing" diminished in recent weeks, but that scenario now seems the least likely outcome. Still, because the consensus has repeatedly underestimated terminal interest rates during this tightening cycle, it is important to think about what sort of developments would force central banks to continue raising rates in 2024.

Chart 14: Past conflicts in the Middle East



Source: World Bank, FT

Chart 15: Return of the 1970s supercycle?



Source: US PPI data, TS Lombard

## One down, two to go

A "no landing" scenario could materialize in one of two ways: either a recovery in activity (which threatened to rekindle inflation) or a rebound in inflation itself. Right now, energy prices are the clearest inflationary threat, not least because of the situation in the Middle East. While, so far, the war between Israel and Hamas had not caused physical disruption to oil supplies, that could change if the conflict broadens to other parts of the region (particularly if Iran gets involved). Recent analysis from the World Bank highlights the risks, pointing out that the region is home to half of proven oil reserves and was responsible for one third of global oil production in 2022. Since 20% of oil trade passes through the Strait of Hormuz, there is an obvious choke point for any further escalation in the crisis. Meanwhile, of course, international energy markets are already in a precarious position, thanks to the loss of some Russian supplies after the war in Ukraine. In some respects, the situation is eerily reminiscent of the 1970s – a point that will not have been lost on central bankers, who were already scared of repeating that experience. Energy intensity is lower today, but another oil shock would confirm the "inflation always comes in waves" thesis.

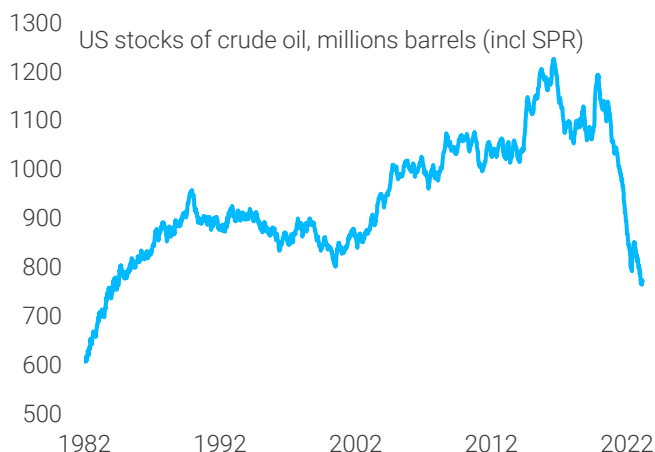
## Response to an energy shock

An energy-induced reacceleration in the CPI would be deeply uncomfortable for central banks, but we should not expect it to trigger further rounds of monetary tightening – at least not immediately. The authorities will be looking at the distribution of price trends, not just the overall level of inflation. Back in 2022, CPI pressures were becoming very broad-based and it was this that made policymakers worried they were repeating the mistakes of the 1970s. We doubt similar trends will emerge this time, mainly because the global economy is in a weaker position, with less pent-up demand and limited scope for consumers to defend their purchasing power by reducing savings. In fact, in contrast to what happened with the post-COVID energy shock, we are likely to see higher utility bills squeeze other areas of spending, providing a disinflationary drag on non-



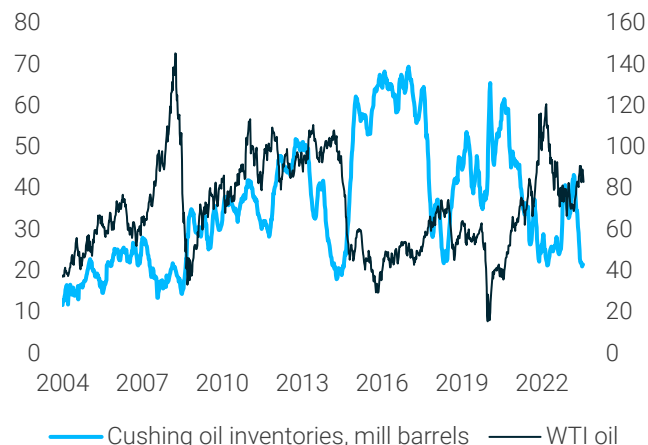
energy components of the CPI. This is not the sort of environment where central banks will feel compelled to intensify the economic squeeze with further rate hikes. That said, another energy shock would make it harder for policymakers to cut interest rates in 2024, especially those that have only inflation targets, not dual mandates. And we know European central banks have a habit of putting too much emphasis on headline CPI, which is often a source of policy mistakes.

**Chart 16: Oil inventories are tight**



Source: IEA, TS Lombard

**Chart 17: Tight markets could mean higher prices**



Source: IEA, TS Lombard

## A rebound in activity

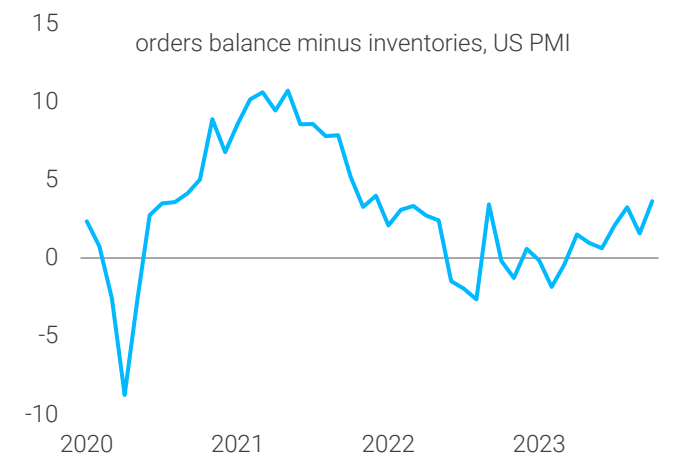
While central banks could “look through” another period of supply-induced inflation, it would be harder to ignore a rebound in economic activity – which would surely extend the tightening cycle. It is difficult, however, to come up with a convincing catalyst for such a rebound. In a [recent Daily Note](#), I examined a number of potential candidates: (i) a recovery in global manufacturing once the post-pandemic inventory drawdown is complete; (ii) a recovery in real incomes; (iii) margin expansion; and (iv) an easing in the drag from monetary policy that could come from a stabilization in interest rates alongside continued growth in nominal income (i.e., a smaller squeeze from “r-g”). While all these forces should prove helpful, it is unlikely any of them would be powerful enough to deliver a strong global economic recovery in 2024 (the sort of rebound that would raise genuine doubts about whether monetary policy is restrictive enough or fuel anxiety about a sudden resurgence of inflation). But these forces will provide a degree of macro resilience, which will be important as the risks start to tilt towards harder landing scenarios. To understand what could go wrong in 2024, we first need to understand what went right in 2023.

## Why the recession hasn’t happened (yet)

The consensus recession call was based on the idea that high inflation was the result of overheating in labour markets and that there was only one way to restore price stability – namely, create slack in the jobs markets. Higher rates would cause output and employment to decline, resulting in a classic cyclical recession. So far, the thesis has been wrong. Not only was post-pandemic inflation largely unrelated to the level of unemployment (i.e., not caused by the Phillips curve), but we have seen a significant rebalancing of labour demand and supply without people losing their jobs. This rebalancing in labour markets has been particularly important because, [as we explained back in 2022](#), this was always the key to a soft landing. With significant numbers of unfilled job openings, central banks always had a decent shot at reducing labour demand without causing a material rise in unemployment. And curbing the number of job openings in the

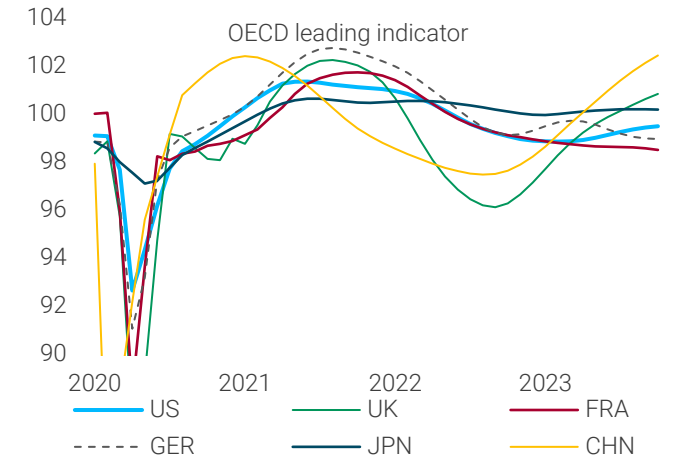
economy has discouraged workers from seeking new positions, which has dampened wages. One interesting question, however, is whether these shifts are the result of monetary tightening or whether they would have happened even if central banks had not raised interest rates aggressively. And the answer is not just academic. It could also have implications for what happens next, including whether we remain on this treacherous soft-landing path.

**Chart 18: Signs of life in global manufacturing?**



Source: S&P PMI data, TS Lombard

**Chart 19: OECD LIIs were flagging a recovery**



Source: OECD, TS Lombard

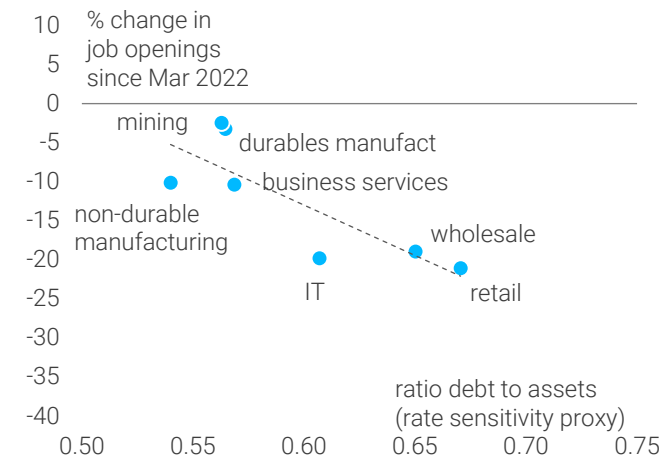
Central banks like to point out that the largest number of reductions in job openings has been in the sectors of the economy that were most sensitive to higher interest rates. [Analysis from the Cleveland Fed](#) shows this was definitely the case in the US: it credited the central bank's decisive action for the labour-market rebalancing that has happened so far. But it is also true that those same interest-rate sensitive sectors – such as the durable-goods industries, tech, real estate and wholesale/online retail – were the source of some of the largest distortions associated with the pandemic. As economies returned to normal and spending patterns shifted back to their pre-COVID norms, there was a good chance we would see sharp declines in labour demand (and wage growth), even in the absence of monetary tightening. One thing is clear, however: because the largest job losses have happened in the areas of the economy that were suffering from the most acute staff shortages, labour matching has improved. Chart 21 confirms this for the UK, showing – at the sectoral level – a clear correlation between vacancy reductions and the vacancy/unemployment ratios (labour market tightness by sector) that prevailed at the start of the tightening cycle. Good policy, COVID distortions or divine coincidence – it is this improvement in job matching that is the reason why aggregate unemployment has stayed so low.

### Paths to a harder landing

There are many market economists who seem to think recessions follow the storyline of the "Final Destination" movies of the early 2000s. The characters in those films could cheat death for a while, but death would ultimately chase them down, often resulting in a much more gruesome end to their lives. Having dodged a recession in 2023, many believe that downturn must now happen in 2024 – and it will probably be much nastier as a result. That view is economists' superstition. We prefer to start with an understanding of what went "right" in 2023 – our analysis of why the world has been on a path to a soft landing – because that can help us to understand what might go wrong in 2024. And starting from this position, there are several ways the soft landing could get a lot bumpier or give way to a genuine hard landing:

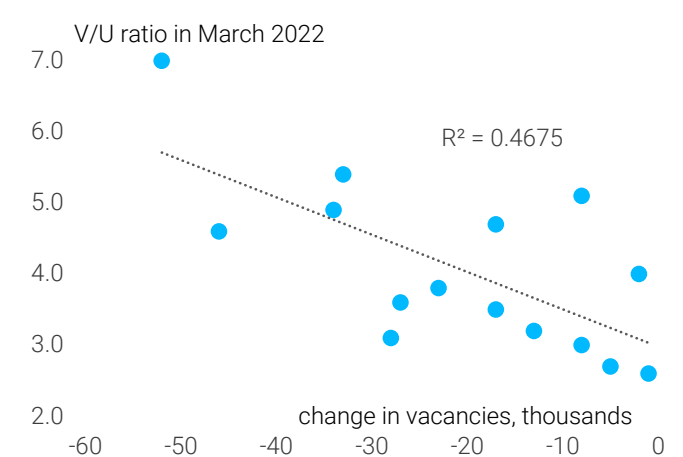
- 1 **Monetary policy is a blunt tool:** As we explained above, demand destruction has typically been concentrated in the sectors of the economy that started out with the most acute labour shortages. It helped that the most interest rate-sensitive activities were those that had boomed most during the pandemic. But there is no guarantee that this will continue to be the case going forward. If high interest rates start to reduce demand in sectors without labour shortages, we are likelier to see aggregate job losses (even if there are still excess vacancies in aggregate – i.e., labour mismatch). One worry we have is that commercial banks are now restricting the availability of credit to the entire economy. This makes the impact of monetary policy even more blunt and is likely to create an even broader monetary squeeze. Sectors that do not have labour shortages and are not particularly sensitive to higher interest rates could suffer policy-induced demand destruction, too.
- 2 **Vacancy data could be wrong:** There is also a risk that as vacancy rates decline and aggregate labour shortages dwindle, additional demand destruction will take place via jobs rather than job openings. It is cause for concern that policymakers are suddenly putting an enormous emphasis on vacancy data, which historically have not been very reliable. Since the cost of publicising vacancies has declined over time – companies can post their job openings online, rather than in a newspaper or with an employment agency – there is no incentive for employers to remove those postings once they are filled. Worse, some companies now post vacancies even when there are no positions available – so-called “ghost vacancies” – just to get a sense of market conditions. The key point here is that if job openings data are overstated, central banks might be chasing a rebalancing of the labour market that is not strictly necessary. And this is likely to lead to policy mistakes and a recession that could have been avoided.
- 3 **Margins squeeze:** Since the pandemic, historically fat profit margins have been another strong incentive for companies not to lay off staff – even as demand conditions have deteriorated. Because companies were making larger profits on each unit of output, they had a stronger incentive to retain staff in an environment where acute labour shortages meant they might struggle to rehire any lost workers if demand subsequently improved (“labour hoarding”). The problem, however, is that margins have already diminished significantly since the end of the pandemic and are now much lower than they were 18 months ago (especially in the US). This does not mean job losses are imminent, but it does reduce the hurdle for companies to start shedding staff, especially in an environment of weak aggregate demand.
- 4 **Souring credit cycle:** As we explained in the previous Macro Picture, the credit cycle has turned, with delinquency, default and bankruptcy rates all on the rise. So far, this is nothing to be alarmed about. Conditions are starting to return to normal after three years of policy-induced hibernation. There may even be a degree of pent-up credit stress. But this is certainly something to monitor in 2024, particularly with smaller companies facing significant refinancing needs. Credit stress could close businesses and put people out of work – another source of classic recession reflexivity. And this could happen even if there are aggregate labour shortages, because it would be a source of mismatch (the Beveridge curve shifts out).

Chart 20: Monetary policy reduced job openings



Source: Cleveland Fed

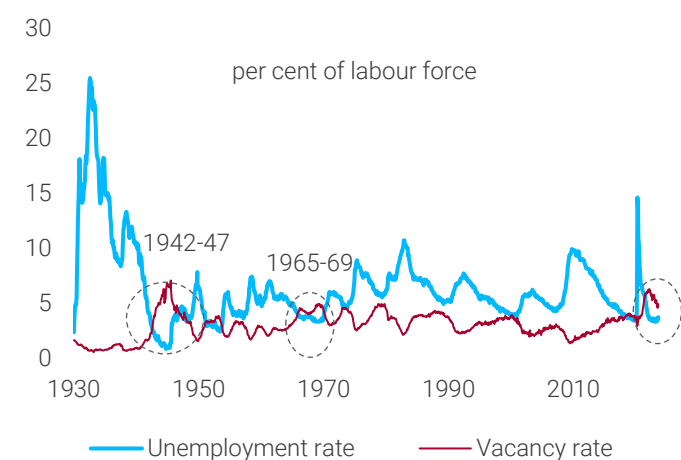
Chart 21: Demand destruction in the right sectors



Source: ONS, TS Lombard

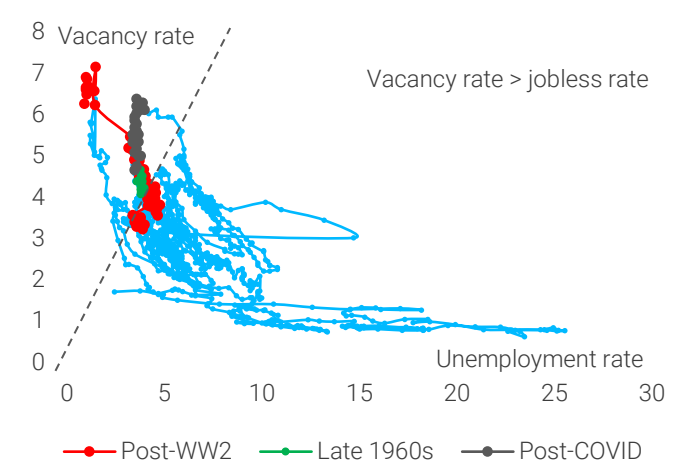
At the start of the monetary tightening cycle, prominent economists claimed there was no historical precedent for a soft landing when inflation was at high levels and unemployment low. They argued that central banks would be unable to rebalance the labour market without putting large numbers of people out of work. Since vacancies and unemployment are inversely correlated – the Beveridge curve – reducing the number of job openings would inevitably trigger a rise in joblessness. Yet this analysis suffered an obvious recency bias. While the situation in labour markets was unusual, it was not unprecedented. Chart 22 shows vacancy and unemployment rates in the US since the 1930s. There are two things to note. First, the Beveridge curve becomes very steep at low levels of unemployment; in practice, this means it should be possible to “move down the curve”, delivering fewer job openings with a similar number of jobs. Second, post-pandemic, the US had more unfilled job openings than people who were out of work. This situation was rare, but it had happened before, in the period immediately after WW2 and again in the late 1960s. To understand what might happen this time, it is useful to look back at those earlier periods and see how the labour market “rebalanced” from a similar situation.

Chart 22: Current job market not unprecedented



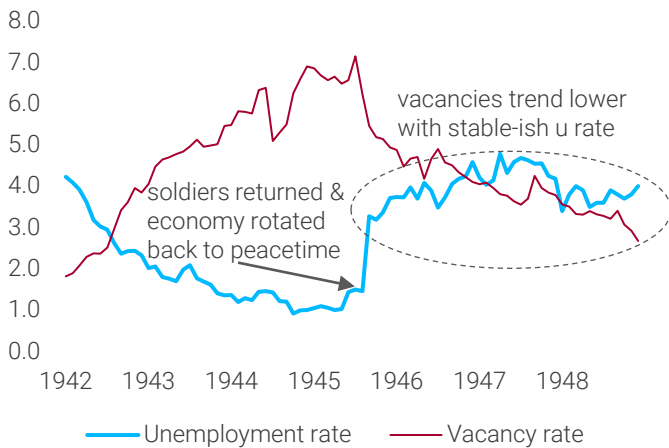
Source: Petrosky-Nadeau and Zhang (2020), TS Lombard

Chart 23: Beveridge curve steep when  $V > U$



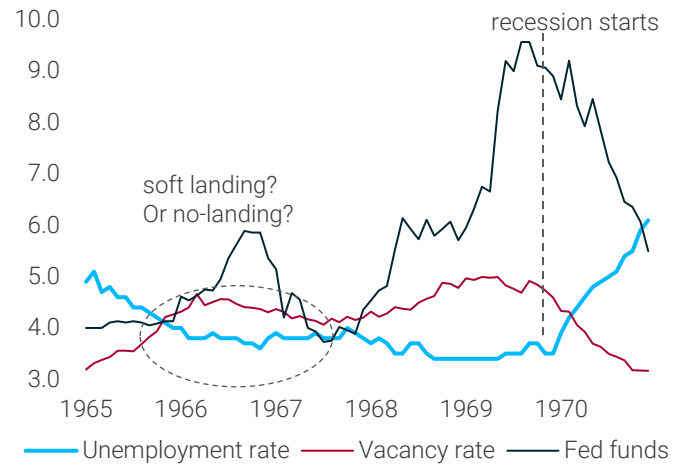
Source: Petrosky-Nadeau and Zhang (2020), TS Lombard

Chart 24: Post-WW2 labour market rebalancing



Source: Petrosky-Nadeau and Zhang (2020), TS Lombard

Chart 25: Soft/no landing in the late 1960s

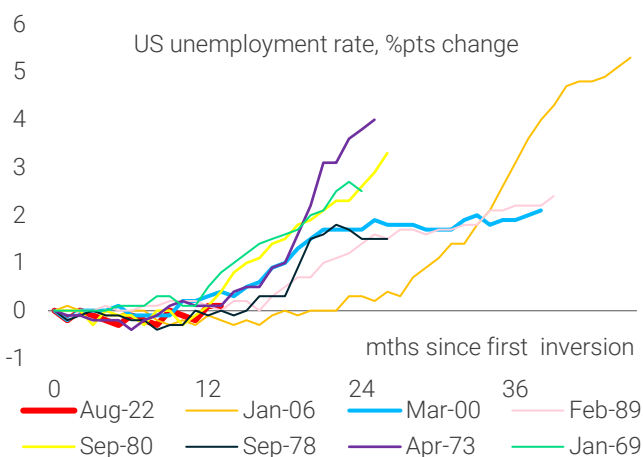


Source: Petrosky-Nadeau and Zhang (2020), TS Lombard

## Past rebalancing episodes

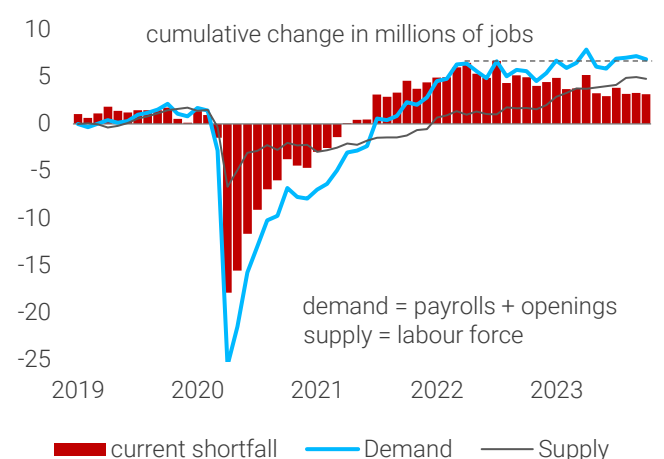
We have always liked the comparison to the period after WW2. Like today, that was a period of pent-up demand, massive supply disruptions and mismatch in labour markets – as the economy rotated back to peacetime activities and returning soldiers were reintegrated into the workforce. Back then, rebalancing happened without monetary tightening. Central banks could not raise interest rates because they had to keep bond yields low to help finance the public debt accumulated during the war. But rebalancing happened anyway. Pent-up demand was eventually exhausted, supply conditions normalized, and there was an increase in the labour force, once military personnel and former government employees found new roles. Demand fell, supply increased and, although overall GDP contracted thanks to a massive decline in the size of the government, the private sector experienced a “soft landing” after the artificial boom associated with WW2. As we wrote at the start of 2023, “fake business cycles can end in unusual ways”.

Chart 26: Favourite chart of the recessionistas



Source: BLS, TS Lombard

Chart 27: Supply response helps US rebalancing



Source: BLS, TS Lombard

In the late 1960s, however, the situation in the US labour market played out rather differently. This time, monetary policy had a much greater role, with the Fed raising interest rates aggressively in an effort to force demand and supply back into realignment. Whether the Fed delivered a “soft

landing” or “no landing” is open for debate. When the central bank was raising interest rates in 1966, vacancy rates fell without any rise in unemployment, which suggests monetary policy was on the right path and that a soft landing was technically possible. Yet, with hindsight, the Fed ended its tightening cycle too soon. By embarking on a series of rapid rate cuts through 1967, monetary easing caused the economy to reaccelerate, with vacancies rebounding and inflation bouncing higher. Some economists believe this “no landing” contributed to the secular inflation problems of the 1970s and serves as a warning for central bankers today. But we draw a broader lesson. Taking the late 1940s and late 1960s together, there are precedents for what central bankers are trying to achieve today. But they will need to proceed carefully. And it would help if they got some help from the supply side. This is where we see encouraging signs, especially in the US. Rapid growth in the workforce means supply is finally catching up (Chart 27).

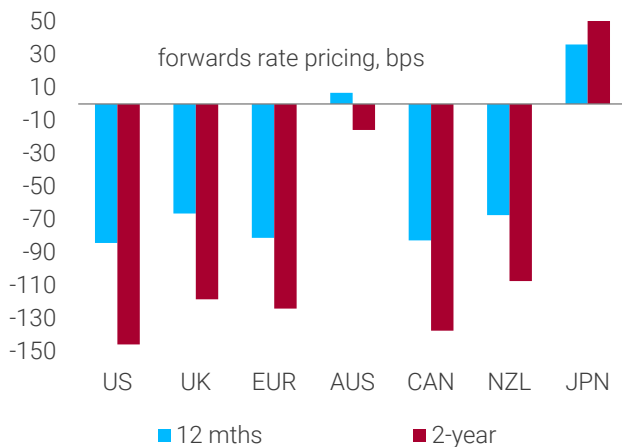
### Bumpier landing outside the US

We think a soft landing is still the likeliest scenario, especially in the US. But if we had to choose between the other two outcomes, the risks now seem tilted towards a “harder” landing rather than “no landing”. This skew is particularly clear outside the US. Remember, the recession risk was always about monetary policy and whether central banks would overreact to post-pandemic inflation. All central banks have been whipsawed by the fake pandemic business cycle, but some have been whipsawed more than others. As we explained [in a previous Macro Picture](#), we worry that the ECB and the BoE have already “overtightened”. Not only were they operating in economies that were always less resilient than the US, but – owing to the structure of debt markets in Europe – they have engineered a much greater monetary squeeze. For the economies of the euro area, the UK and some other smaller European markets, the recession question is now about whether these central banks will realize their error and reverse policy before classic labour-market reflexivity takes hold. The one thing they have working to their advantage is that their labour markets are famously sclerotic, because companies are always loath to lose workers. For now, that means a period of stagnation rather than a nasty crash.

## 3. PRICING PERFECTION?

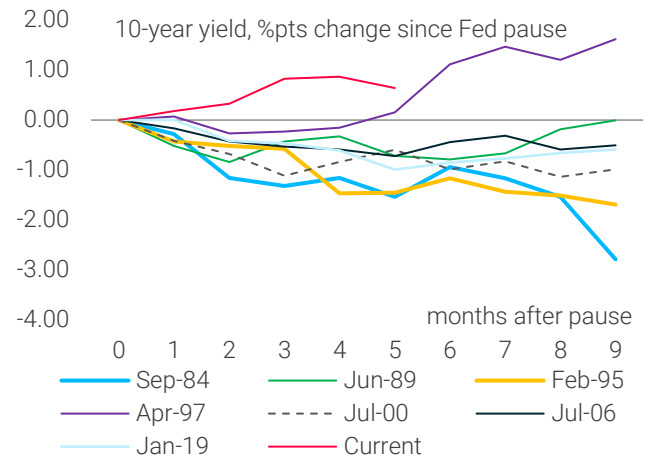
All this talk about “landing” scenarios is not useful unless we compare them with market pricing. What would they mean for markets? How should investors position themselves? Recently we have seen big moves in bond markets, as yields have adjusted to reflect the central bank mantra of “higher for longer”. Although we are secular bears on DM bonds, we think the most acute period of pain for bond investors is over, with yields likely to stabilize or decline (temporarily) from recent highs. The global monetary tightening cycle is over and – barring another surge in energy prices – it is only a matter of time until some central banks reverse course. The outlook for equities is more complicated. The popular cliché is that stock markets are “fully pricing in the soft landing”, leaving them vulnerable to earnings disappointment (especially in a hard landing scenario). Some pundits are also worried about “liquidity”, which is no longer freely available. But the interesting equity market story is hidden below the surface, in the significant divergence between large cap US stocks (especially the “Mag7”) and other DM stock markets. This divergence reflects a widespread belief that large-cap US stocks provide protection from a more challenging macro environment. 2024 is set to test this thesis – recession or no recession.

Chart 28: Rate cuts next year?



Source: Bloomberg, TS Lombard

Chart 29: Yields rose after Fed pause (rare!)



Source: Bloomberg, TS Lombard

## Higher for longer

Bond markets have had a difficult three years. By some metrics, it was their worst bear market in history (in terms of both drawdown and duration). A big part of the post-2022 selloff reflects the expectation that interest rates will remain higher than in the recent past, which is certainly the message central banks have been pushing. Perhaps  $r^*$  (the level of rates consistent with trend GDP growth and stable inflation) has increased, too. But there has recently been a great deal of investor angst about the sustainability of the fiscal situation, which was a clue that perhaps the rise in bond yields had already gone too far. (The fiscal situation is not “unsustainable” and heavy issuance is not a reason for yields to explode higher – except in specific macro circumstances.) Instead, what we had in October was a classic case of what Walter Deemer said: “When it’s time to buy [a security], you won’t want to.” We have been secular bears on bond markets since before the pandemic, but it is now likely we are entering a period of respite for fixed income investors. Since monetary policy is now sufficiently restrictive (*too restrictive* in some parts of the world), it is unlikely yields are going to test new highs in 2024 – not unless the economy rebounds.

## Hurdle for policy moves

The hurdle for interest-rate moves – in either direction – is high, particularly for the Fed, which is in a comfortable position compared with its peers. With the credit cycle starting to sour, only a broad acceleration in activity would force US policymakers to resume their tightening cycle. Watch the US labour market closely. Fed officials believe they need a further rebalancing between demand and supply, so any unexpected rebound in demand – from higher job openings or a reacceleration in employment – could force the central bank to raise rates again. It’s a more difficult call, however, as to whether the Fed will ease monetary policy in 2024. Should we see genuine weakness in employment, especially a contraction in monthly payrolls, there is no doubt the central bank would pivot hard. US officials are always super-responsive to aggregate job losses, and inflation at current levels (close to 3%) is not going to hold them back. Theoretically, the Fed should also be willing to reduce interest rates in a soft-landing scenario, where inflation declines further even with a resilient labour market. Afterall, any further decline in inflation would push real interest rates higher, making policy more restrictive. But, in practice, it usually takes a serious wobble – in financial markets or in the broader economy – to trigger Fed policy easing.



Even in the textbook soft landing of 1995, Greenspan cut rates only in response to a serious recession scare. US payrolls contracted briefly in 1995, a move that the BLS later revised away.

## Reversing the reverse FX war

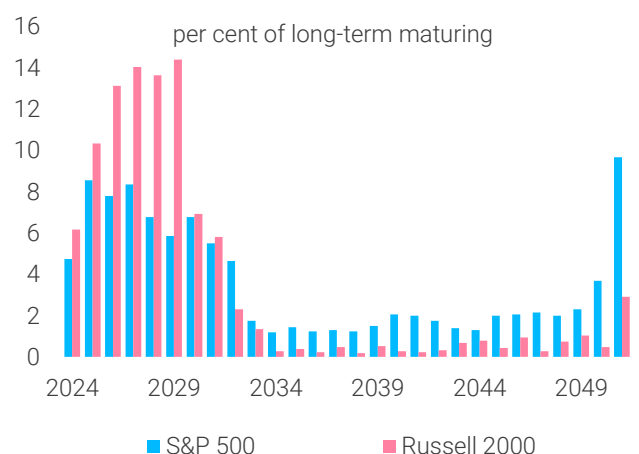
There will soon be a strong case for monetary easing outside the US, particularly in Europe, where central banks have engineered a bigger monetary squeeze. Recent data in Europe have been worrying, especially those showing that weakness in the (systemically important) manufacturing sector is now bleeding into the services sector. Obviously, the ECB and the BoE will want to see a further improvement in inflation before responding to this deteriorating economic situation. But with disinflation now accelerating, that inflation “all-clear” could be just a matter of months away. Our worry is that these central banks – fearful that currency weakness could reignite domestic price pressures – will want to wait for the Fed to pivot first. This would be another instalment of the futile “reverse currency war” that saw the ECB and the BoE chase the Fed to tighten monetary policy in 2022-23. It is to be hoped that central banks in Europe have learned their lesson from that experience – allowing your economy to crash is a terrible way to defend your currency!

Chart 30: Earnings recession already over?



Source: S&P, TS Lombard

Chart 31: Small cap more exposed to higher rates



Source: Factset, BoA via Twitter

## What is the equity market pricing?

You always hear pundits in the financial media say the “equity market is fully priced for a soft landing”. On the surface, this appears to be true. Chart 30 shows earnings expectations for the S&P 500 looking reasonably optimistic. After a brief dip in Q4, US earnings per share are forecast to rise by around 14% in 2024. This is clearly not what we should expect in a hard landing scenario. In fact, the average US recession usually comes with a 15% *decline* in earnings. And, of course, valuations are not cheap: a PE of around 25 on the SPX offers only a modest equity risk premium versus long-term bonds. So, it is easy to imagine an extremely bearish outlook for global stocks in 2024, where earnings disappoint, and the equity risk premium widens. Conversely, there would not appear to be much upside to global equities, particularly if the hurdle for rate cuts is higher than investors think (especially in the US) and central banks are still withdrawing liquidity via QT.

But the interesting story in global equities is hidden below the surface – in the continued divergence between the “Mag7” US stocks and the rest of the market. While the S&P has risen significantly during 2023, the so-called Mag7 stocks (Amazon, Alphabet, Apple, Nvidia, Meta, Microsoft and Tesla) have been responsible for the vast majority of those gains. Whereas the

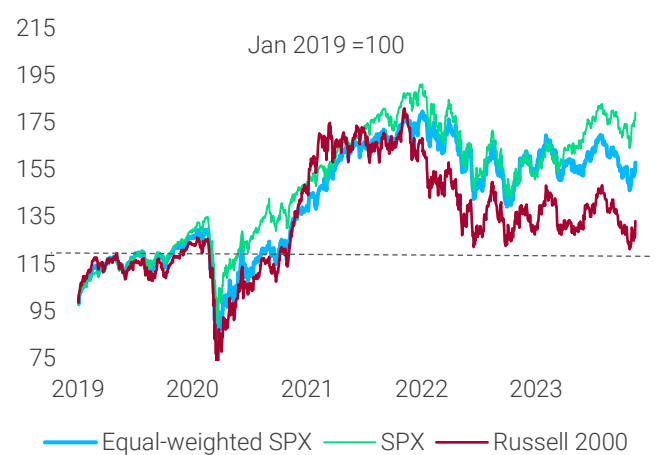
headline SPX is up more than 14% since January, the equal-weighted index is broadly flat. And the divergence is even bigger when we look at small-cap US stocks. Until recently, the Russell 2000 was down on the year and had retraced all the gains it made after the pandemic. Excluding the Mag7, the performance of US stocks would have been much closer to what we have seen in other parts of the world, with 2023 providing a generally tough market environment (especially compared with what stock investors could have earned just by putting their funds into short-term money markets). What explains the strong outperformance of the Mag7? [Optimism about AI is part of the story – particularly what happened to Nvidia after the launch of ChatGPT](#). But it seems these stocks have also benefitted from perceived “safe-haven flows”. With their large cash holdings and low leverage, the Mag7 companies should be less vulnerable to a monetary policy-induced recession. In fact, because of their performance during the pandemic, there are some investors who think these companies are totally “immune” to any economic downturn.

**Chart 32: Rates and rotations post-COVID**



Source: Bloomberg

**Chart 33: Equity rally is mainly a Mag7 thing**

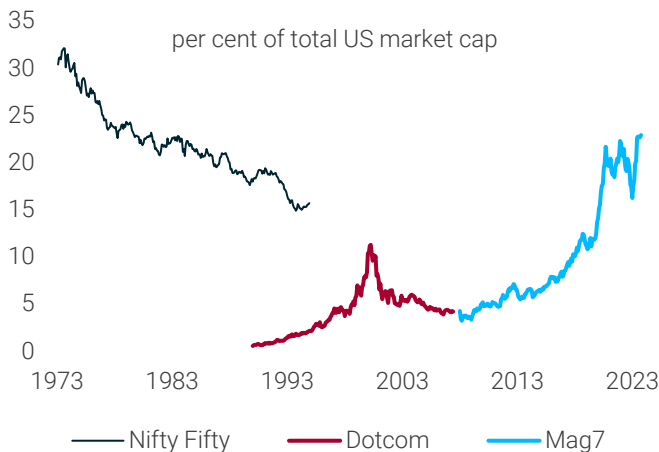


Source: Datastream

## The Nifty Fifty redux?

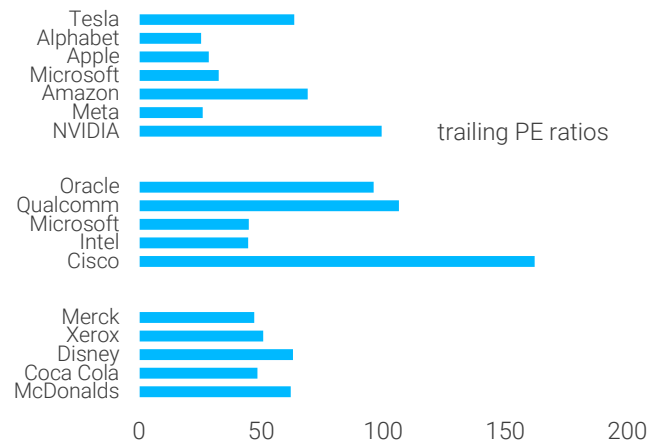
2023 market narratives about the Mag7 are eerily reminiscent of what investors were saying about the Nifty Fifty stocks in the late 1960s. The Nifty Fifty was a group of (roughly 50) large-cap stocks that traded on the New York Stock Exchange. They were widely regarded as solid buy-and-hold growth stocks or “blue-chip” stocks. They were supposed to be “one decision”, in the sense that they would offer extremely stable returns. And the Nifty Fifty accounted for a disproportionately large share of total US market cap, trading on very high PE multiples (typically around 50 or higher). Things get interesting, however, when we look at how the Nifty Fifty traded in the 1970s, when the macro environment became much more challenging. While their perceived safe-haven status boosted their relative valuations ahead of every US recession, this outperformance was never durable. In fact, they suffered more during downturns; and over the decade that followed, they experienced a secular derating compared with cheaper (“value”) parts of the US stock market. The problem was not on the earnings side. Most of the Nifty Fifty were genuinely good companies (like McDonalds and Coca Cola) that delivered solid profits. The problem was the valuations investors had placed on them. They could not live up to the hype.

Chart 34: US themes and market concentration



Source: Bloomberg, TS Lombard estimates

Chart 35: Megacap valuations compared

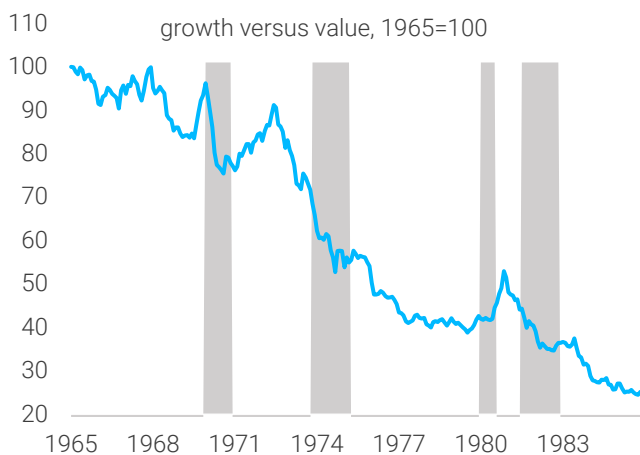


Source: Bloomberg

### Stock market rotation

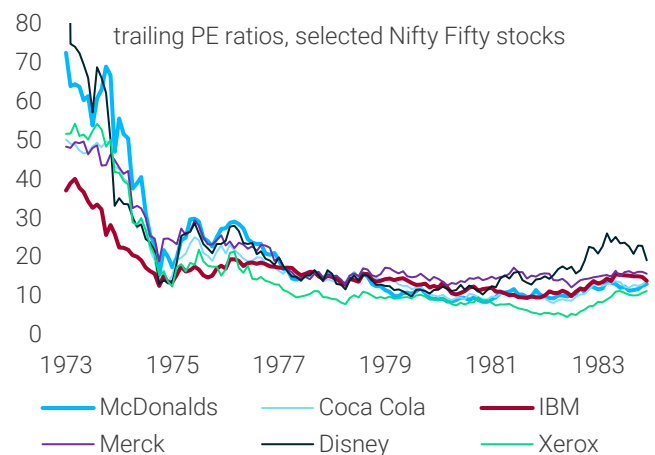
Like the Nifty Fifty in the 1970s, we doubt the Mag7 would be immune to a challenging macro environment. A recession in 2024 would certainly not be a repeat of what happened during the fake COVID downturn, where consumer spending pivoted strongly into consumer goods and tech. But even if the world avoids a hard landing, it is not clear that the Mag7 would be the main beneficiaries. Since these companies are already fully discounting their own soft landing, there would appear to be more upside in other sectors of the equity market – among small cap US companies and in other parts of the world. Put it this way: either we get a US recession, in which case there is more downside to the Mag7 vs other parts of the market, or the soft landing is confirmed, in which case we could see a relief rally among those companies that have struggled most. Even if the kneejerk reaction among investors (and passive funds) is to buy the Mag7, small cap should rally harder. Either way, there will be a rotation out of US “growth” stocks. And [this also supports our long-term thesis about how the new macro supercycle will shift the composition of global stocks markets](#). In a world of secularly higher inflation and rising interest rates, the big investment opportunities are in “value” stocks not “growth” stocks.

Chart 36: Growth stocks are not ‘macro proof’



Source: Fama and French database, TS Lombard

Chart 37: Secular de-rating of the Nifty Fifty



Source: Datastream, TS Lombard

## Bottom line

The world economy remains on the path to a soft landing, with inflation approaching tolerable levels and labour shortages easing, even without a significant rise in unemployment. Given that the consensus thought it would take considerable “pain” to get to this point, policymakers should be delighted with the progress that has been made. Yet, nothing has been decided and the path ahead remains treacherous. On one side, we have the continued threat of a rebound in inflation, not least because of the situation in the Middle East. While central banks would ignore a supply-induced reacceleration in consumer prices, they would be monitoring underlying price dynamics closely – wary about seeing a repeat of what happened during the 1970s. We think there is less chance of a sustained rebound in economic activity. As the main alternative to the soft landing, the “hard landing” is now much likelier than the “no landing” scenario. Not only is the situation in labour markets looking increasingly precarious, but the global credit cycle has turned. The good news is that central banks will not need to raise interest rates further. In fact, some central banks have already overtightened and will need to reverse course. This should provide some relief for bond markets. It is tempting to believe that the equity market has already fully discounted the soft-landing scenario, leaving it vulnerable to any disappointment in earnings. But this thesis ignores the dynamics below the surface. The real risk is concentrated among large cap US stocks, especially the Mag7. This part of the market could struggle (at least on a relative basis...) irrespective of whether there is a recession or not. The better risk-reward surely lies elsewhere.

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