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Europe's recession was ultra-mild, in the US worse is still to come

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- **The US economy is critical to Europe, but while the US faces a deeper recession, Europe looks more positive**
- **Europe has more excess savings from the pandemic than the US, with pent-up demand also higher. This could keep consumers spending longer**
- **Falling US bond yields could be seen as good (inflation is conquered) or bad (recession is coming). The latter is more likely**

Interest rate rises have driven inflation down. We all hope we are close to the pivot point when banks call a halt to hiking and begin to cut rates. Many commentators say victory means inflation getting close to the 2% target; then we can pivot. But the three-year inflation average in the US and Europe is still 5%; possibly even 7% in the UK. For inflation to come down to 2% more permanently, first it needs to undershoot and stabilise at 1% – probably even lower in the UK given recent performance. This is where policymakers failed in the 1970s. Only during the deep recession of the early 1980s did inflation fall below its historic 10-year rate. Of the three regions, the UK needs the deepest recession to get back to the inflation target. It has already used up its 10-year inflation allowance of 20% over the past three years.

Assessing the US

The US Federal Reserve aims to achieve price stability, namely 2% inflation. To reach this it needs to induce deflation. The market realises this, hence the stronger dollar and weaker equities in Asia and Europe – and weaker vulnerable currencies in Turkey, South Africa and Argentina. The Chinese currency has weakened as China seeks to export deflation around the world.

The US uses flawed data for calculating inflation. The consumer price index (CPI) and personal consumption expenditures (PCE) deflator contain large elements of rent: 33% in the case of CPI – and 25 points of this represent owner-occupied rent. CPI services inflation excluding housing costs is 0.4%. But the owner-occupied rent component has risen by 8%, pushing overall CPI for

May up to 4%. Rent and accommodation costs are insensitive to rate hikes, except over longer time periods, and the survey is updated every six months, with the resulting data smoothed.

Headline real rates in the US, excluding the rental component, are 4% rather than 1%. If you were to use current data for rental inflation, rather than data that is six months old, CPI in the US would be closer to 0% and real rates closer to 5%, the highest since the Volcker years of the early 1980s.

All three components of the Fed's preferred inflation measure – goods, shelter and services ex-shelter – are falling. Goods prices are 8% above services prices relative to pre-pandemic. Current rents lead shelter inflation by six-12 months, so shelter inflation most likely will fall from here. Wages are the largest part of services ex-shelter inflation. Average earnings growth has moderated from 8% to 5%. The quits rate, a good indicator of wage growth, is at pre-pandemic levels.

The gap between labour demand and supply opened as we came out of the pandemic: demand exceeded supply by 3.7% in 2022. The only way to recruit workers was to poach from other firms - at higher cost. The combination of interest rate rises and fiscal tightening has helped reduce inflation. The number of businesses planning to raise prices has fallen to levels last seen in 2019.

Usually when labour demand falls but supply rises, unemployment goes up. But with full employment, falling demand leads to slower wage growth and fewer job openings rather than unemployment. As inflation nears the Fed target, a recession becomes more likely. With labour demand falling through the supply curve, further declines will mean lower output and higher unemployment. This might be some months away, depending on what happens to excess savings generated during the pandemic. These peaked at 12% of disposable income in the US, around $2.2 trillion; they are now at 4% or $0.5 trillion[1]. Although still positive, they have unwound three-quarters of the excess, and by October they will be zero. As this happens and the fiscal picture hardens after the debt ceiling extension, the economy will become sensitive to high real interest rates, and then the labour market will crack.

Higher income groups have excess savings compared to pre-pandemic, but not adjusted for inflation. Rising savings rates will hit consumer spending even before the labour market deteriorates. Given excess savings have latterly been spent on services, not on goods as during the pandemic, it will hit the labour-heavy services component.

The US fiscal injection of 4% of GDP over the past year has exacerbated the problems of an overheating economy with excess inflation and no real unemployment. Now the debt ceiling has been raised the deficit will shrink, just as students have to restart loans repayments. This will shift the fiscal impulse from positive to negative. Now the debt ceiling has been resolved, the US will rebuild the Treasury General Account (TGA), depleted in the run-up to the vote. This neutralised all of H1's quantitative tightening (QT). Now the TGA will be rebuilt by $500 billion-$700 billion, just as naked QT continues at the rate of $250 billion a quarter.

[1] Federal Reserve, The Rise and Fall of Pandemic Excess Savings, 8 May 2023

This is compounded by slowing bank lending, which grew in the high teens in 2022 but is now barely 1%. Moves by the Fed and the Treasury mean banks' excess reserves will run out. Banks are faced with unpalatable choices: run out of liquidity and hope for a bail-out (this failed for the regional banks); raise deposit rates (damaging net interest margins); or run-down loans, switching to Treasuries with lower risk weightings. The last option will not shrink balance sheets but does reduce risk; it will not reduce the money supply but will reduce the money multiplier, tightening credit. This reduces the appetite for risk, worsening the liquidity squeeze – as in summer 2000 and November 2007.

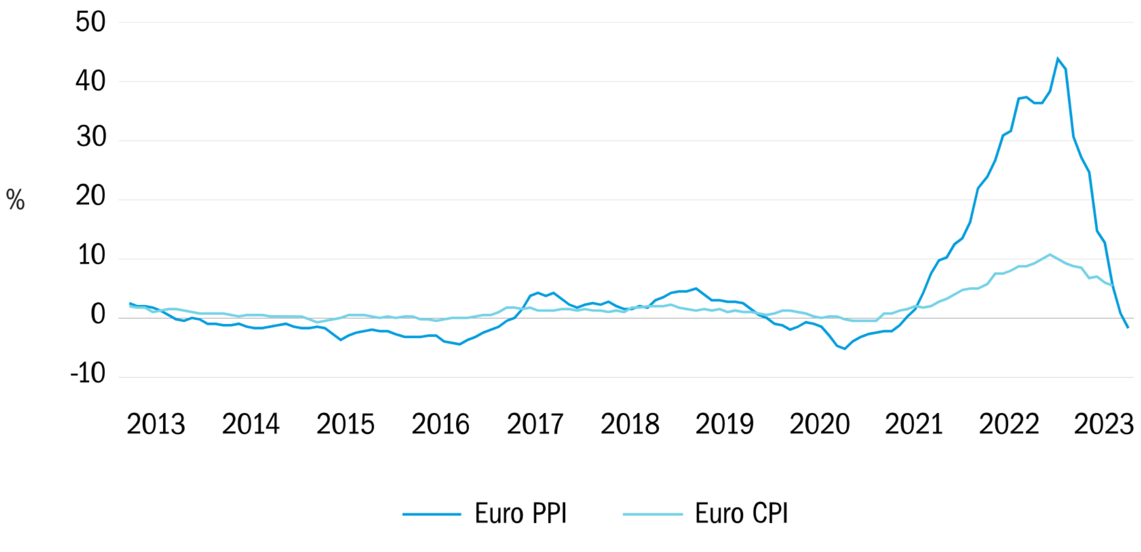
US manufacturing remains weak: the ISM manufacturing index fell to 46.9 in May, the new orders component to 42.6. There has been de-stocking; but capital expenditure may be bottoming, and onshoring will boost manufacturing capex, particularly in technology.

Monetary policy is tight and the jobs/workers gap has declined by 1.6 points since 2022. While restocking adds to demand, lagged effects of tightening will reduce the impact. Credit growth reacts to tighter lending standards with a delay. Credit availability is not a problem now, but that will change as excess savings from the pandemic run out and higher mortgage rates impact housing.

Europe and the rest of the world

Services remain resilient in Europe, but (as in the US) manufacturing is weak and profit warnings abound. Producer price inflation (PPI) leads CPI in Europe by one to two quarters (Figure 1), so recent falls in PPI will put money in pockets later on.

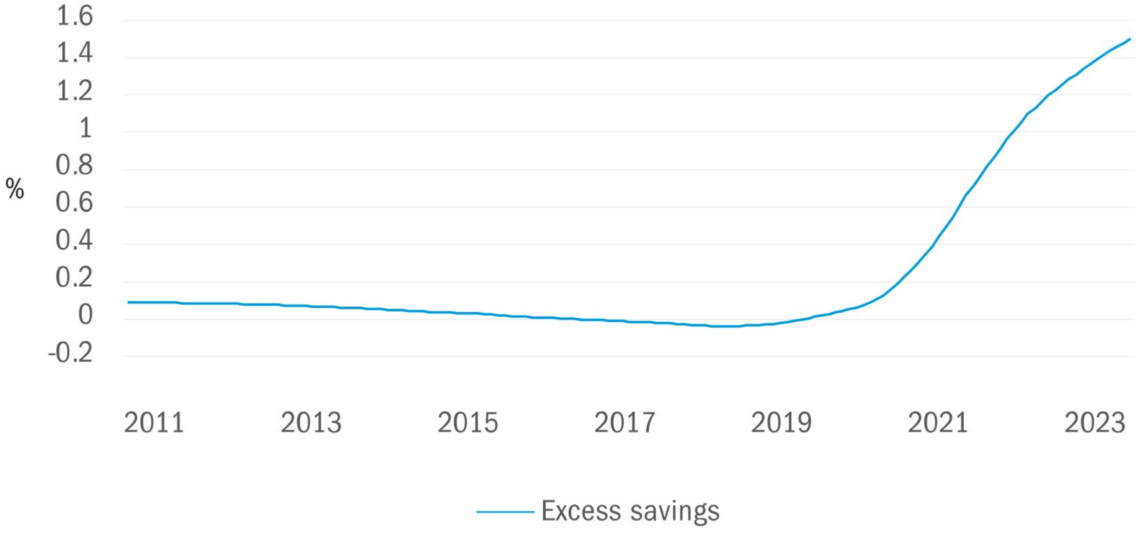
Figure 1: Falling producer price inflation should bring CPI inflation down in Europe



Source: BCA Research, June 2023

With high excess savings in Europe (Figure 2), this means improving consumer spending in late 2023 and into 2024, just as the US consumer tips over the edge.

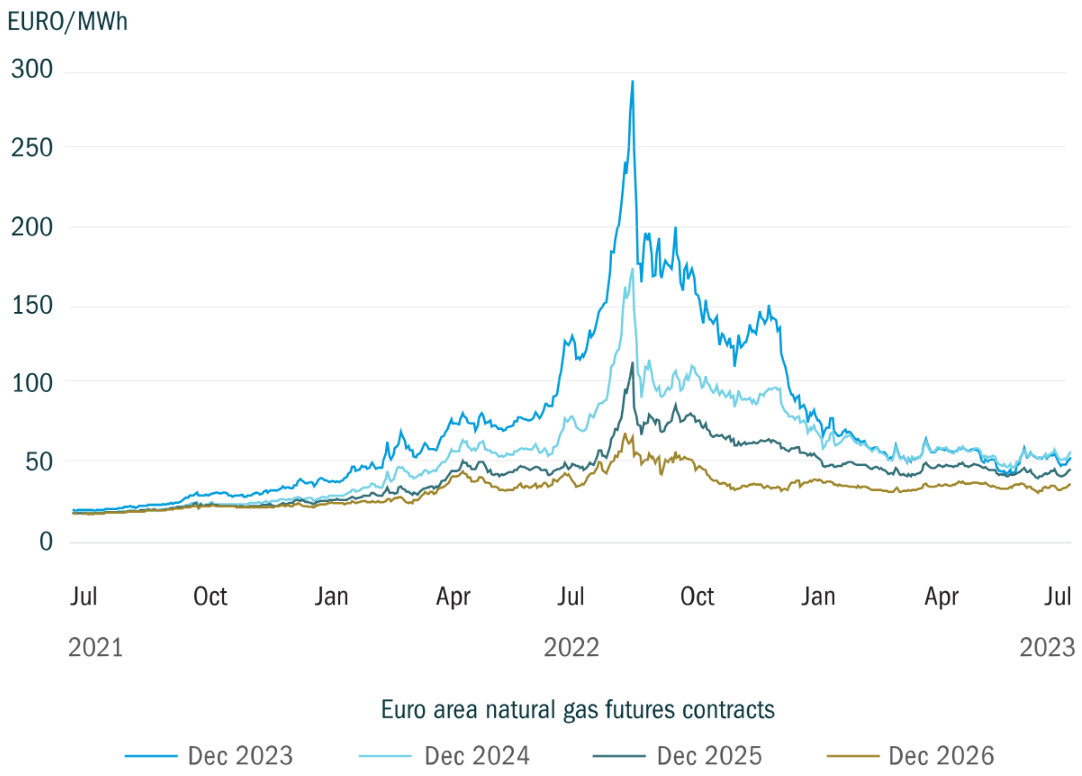
Figure 2: cumulated excess savings relative to pre-pandemic trend



Source: BCA Research, June 2023

Europe is less dependent on Russian energy because of new pipelines, liquefied natural gas (LNG) storage and new sources of supply (Figure 3). Europe's banks are in better shape than in the last recession, and internal devaluations have closed the competitiveness gap between northern and southern Europe.

Figure 3: futures suggest European natural gas prices will stay low

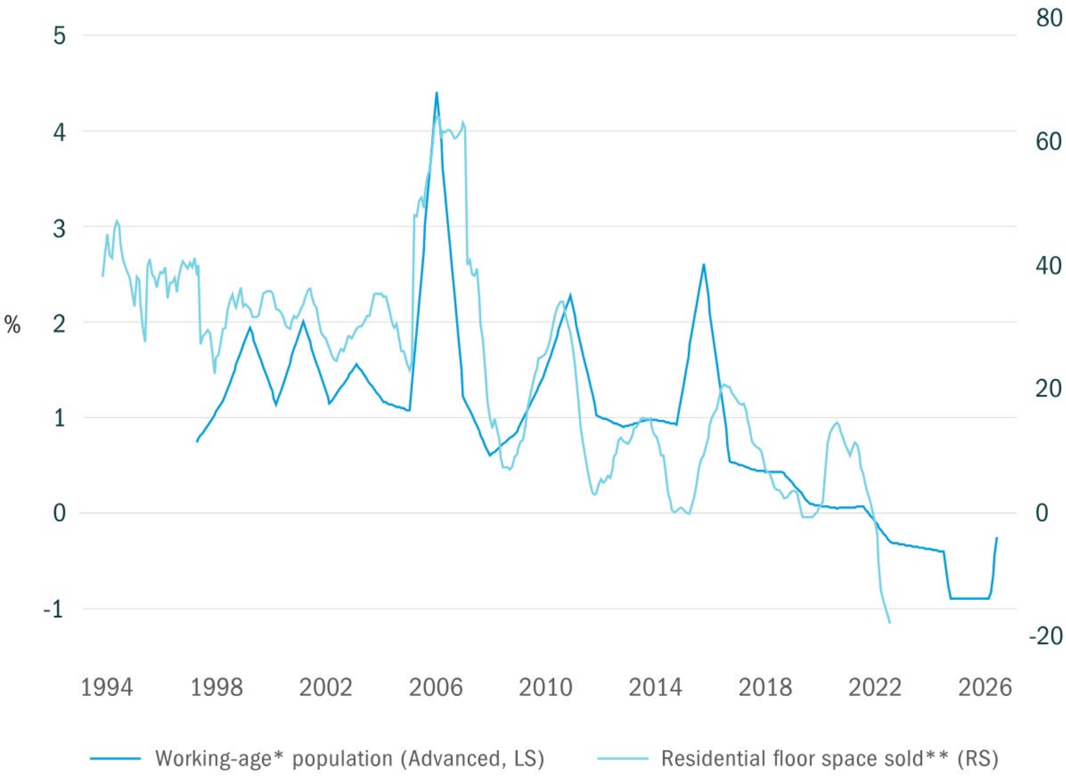


Source: Intercontinental Exchange, ICE Futures Limited/BCA Research, June 2023

China is facing some challenges amid rising rates and deteriorating global liquidity. The misallocation of capital in local governments and overbuilding of housing have been highlighted. This is offsetting some of the benefits of the government's stimulus measures. China faces the choice of domestic deflation or printing money and depreciating the currency, ie exporting deflation. The renminbi devaluation in late 1994 sparked Asia's currency crisis a couple of years later; now the yen devaluation is having the same effect on China.

The global downturn in manufacturing hits Chinese exporters, and although destocking in manufacturing may fade, problems in housing persist. China's housing market looks like Japan's in the 1990s, only worse. This is because of overbuilding, debt and worsening demographics. The UN says China's working-age population will halve by the end of the century[2]. Household formation in China is closely correlated with residential floor space started over the past few decades – and it is negative (Figure 4). The fallout will be unlike that seen in the US between 2006-09. Monetary and fiscal stimulus will help, but only marginally. CPI is 1% and falling, PPI is already negative. Reserve ratios will fall together with other measures to help domestic spending. This sideways-to-slightly-positive move is the best we can hope for from China for the remainder of this year[3].

Figure 4: a shrinking working-age population in China implies less demand for housing



Source: China National Bureau of Statistics/BCA Research, June 2023. *population between 15 and 64 years of age, advanced by 5.5 years. **shown as a two-year moving average.

[2] UN World Population Prospects 2022

[3] BCA Research, June 2023

There is positive news on earnings. There is a link between earnings revisions and economic surprises: when economic surprises pick up, analysts upgrade. After falling for months, forecasts are rising as margins (not sales) improve. Margins are high in the US, back to 2019 levels, so the forthcoming recession should be mild. Restocking in Europe and Asia will be helped by a pick-up in manufacturing. On 12x forward earnings Europe looks good value versus the US on close to 20x.

The European Central Bank (ECB) has committed to at least one more rate rise. It forecast inflation of more than 5% this year, 3% in 2024 and 2.3% in 2025[4] – still above target and higher than projected in March. Energy inflation has faded but pressure from a tight labour market and service sector inflation keeps inflation above target. The ECB risks a policy-driven recession to reach the target. Europe has seen a mild recession with two consecutive mild declines in output. Falling inflation will allow bond yields to decline while industrial activity should stabilise.

Tight monetary policy is visible with money supply shrinking, credit demand falling, credit standards tightening and credit flows weakening. Together with the weakness in manufacturing, this will cause inflation to fall. Inflation expectations are already falling, as are labour costs, pushing down service sector inflation. ECB monetary policy is already restrictive enough – rates have tightened from -0.5% to 3.5%, and further hikes risk a policy error.

Ironically, although wage growth is softening, lower inflation will allow real wages to recover ground lost in 2022 when they collapsed due to the inflation spike. Europe has more excess savings from the pandemic than the US. Pent-up demand in Europe is also higher than in the US: durable goods consumption (inflation-adjusted) is 12% below its pre-pandemic trend, while in the US it is 12% above. This combination could keep the consumer spending longer than in the US, but the risk is that it causes the ECB to hike instead of cutting.

Cyclicals have outperformed defensives, despite the worsening economy, as happened in 2007 on hopes of a new cycle starting. The Fed brought rates to 5.25% in 2007, where they are now, and the market thought it could shrug off higher interest rates as a new cycle approached. The more optimistic commentators say things are different this time around, because of Covid, so we should look through the rate hikes to when central banks will cut. The best performing sectors in Europe in the past 12 months were retail, airlines, semis, autos, banks and construction, with defensives at the bottom of the pile. This is similar in the US, with economically sensitive stocks looking through the downturn in macroeconomic momentum. The market has repriced from a PE of 15x in 2022 to 20x now. Money supply is deteriorating. The new orders to inventories ratio is negative. PMIs in every country and region disappointed in June versus May, including services.

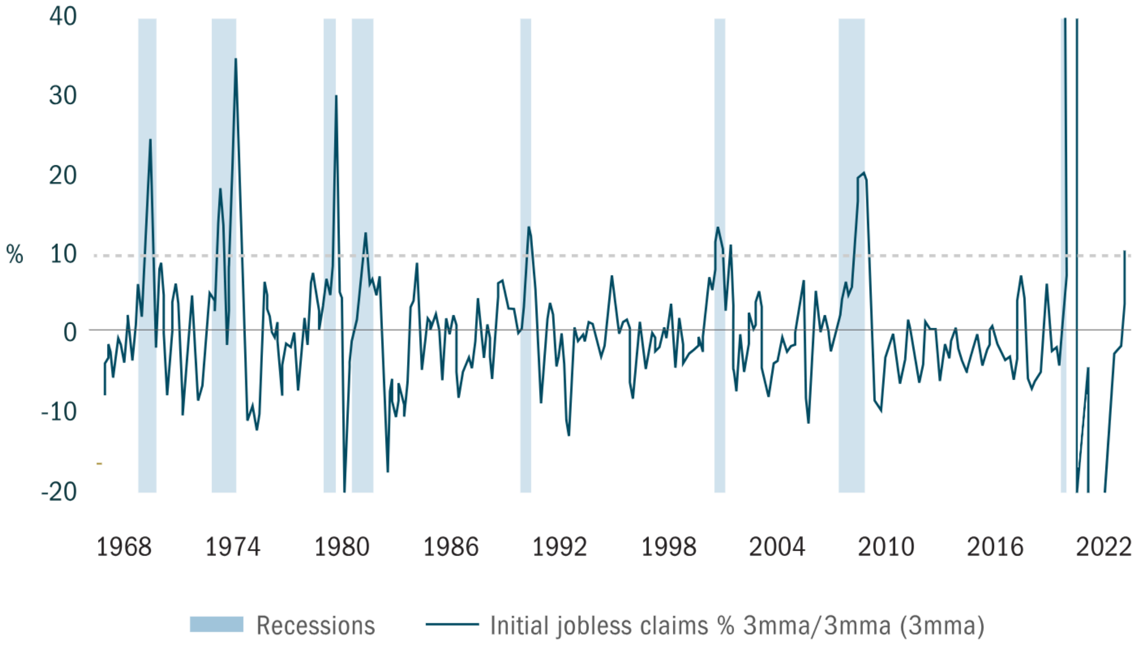
[4] European Central Bank, Macroeconomic projections, June 2023

For real estate, as in the last cycle (from the peak in 2005 to the trough in 2009), adjustment is slow: homebuyer affordability is being hit, house prices are yet to react. More and more homeowners are becoming saddled with expensive mortgages – UK two-year fixed mortgage costs have gone from 1.5% to 6.3% – but given cheap mortgage rates during the pandemic, effective mortgage rates are still below 2019 levels.

What next?

The gap between the best labour market and recession is typically less than six months. Unemployment reached a low of 3.4% in June. When initial jobless claims rise by 10% over a three-month period, it heralds a recession. This signal has never failed – and we just got that signal. PMIs are peaking and jobless claims moving higher.

Figure 5: recessions and jobless claims



Source: Bloomberg Finance LP/JP Morgan, 2023

Last year, many believed we would have a recession in the first half of 2023 and improve in H2. We said the opposite. Now the hope is for a soft landing. Last year sentiment was negative, evidenced by short positioning in index futures. Earlier this year positioning was neutral to short; now it's near the top.

Volatility is at a record low. Complacency is all around. US bond yields have peaked. The stock market has been led by technology. Falling yields could be seen as good (inflation is conquered) or bad (recession is coming), but the latter is more likely. If US payrolls turn negative, the best performing sectors are likely to be healthcare, technology, and consumer staples.

The US yield curve inverted in July last year. US credit demand is the weakest since the global financial crisis. The same is true in Europe: bank lending to households is falling. The Fed grew its balance sheet by $300 billion during the regional bank crisis. That's over now: it's shrinking again.

Margins are also falling. Earnings revisions are stabilising having been negative since last June, but jobless claims are about to get worse. There is now a disconnect between equity prices and real yields. Europe outperformed the US for six months by 30%, but a third of that has unwound. Job openings are falling, house prices have peaked and are now falling.

Europe is affected by activity in the rest of the world as much as the US. Global recessions are rare – only three in the past 100 years: 1930-31, 2008-09, and 2020's pandemic. Typically global recessions mean sub-par growth, as in the 1970s, 80s, 90s and 2000s. If that is how you define a "normal" recession, then we are already in one: China slowing, Europe in recession, the US growing less than 2%, so export-led economies like Germany are suffering.

Unemployment has yet to rise significantly, either in Europe or the US, but in China youth unemployment is over 20% – double pre-pandemic levels. This summer, 12 million new graduates will add to this pile. Germany's unemployment is rising, with the US to follow.

Commodities are in a bear market, high yield credit drifting, economically sensitive sectors like chemicals publish almost daily profit warnings. Apart from a few US tech behemoths, the stock market is moving sideways and rotating within sectors.

China is slowing and its government is expected to increase stimulus. Developed world economies are being tipped into recession by their aggressive central banks. After a rebound in late 2022, Chinese stocks have been weak this year. We might see some respite as emerging markets begin to perform better than developed markets, lifting European consumer stocks which have underperformed technology.

Note: all data contained within the article is sourced from Bloomberg unless stated otherwise, July 2023.

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