CCLA
GOOD INVESTMENT

The year ahead – economic recession, market recovery

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Executive summary

If 2021 was all about inflation and 2022 was all about interest rates, we see 2023 as being all about recession. However, we also see the year ahead as being about markets anticipating the recovery that will surely follow.

Economic recession

- Economic contraction is widely expected and is likely to be especially marked in the UK, where recession could be protracted despite a tight labour market.
- The UK economy looks to be most susceptible among the G7 to a recession that has probably already started, given higher interest rate sensitivity and more hawkish fiscal policy. Nonetheless, inflation should slow to 3–5% range on UK CPI, and the Bank of England is unlikely, we feel, to have to raise interest rates more than another 100bps to 4.5% or so.
- Europe's economy is also set to shrink in the face of energy supply and pricing issues associated with the war in Ukraine, as well as weakening export demand.
- In the US, which dominates the global economy, recession also appears likely, but it will probably take longer to arrive and be relatively short and shallow.
    - An inverted yield curve, historically a very reliable indicator, is among a range of measures clearly signalling that the US is heading towards contraction but the jobs market has yet to respond to tougher conditions.
    - Meanwhile, high levels of personal savings are available to support consumer expenditure; and resilience is further helped by the US mortgage market which does not require homeowners to refinance at higher borrowing rates in the way that we are seeing in the UK.
- US inflation will fall substantially from current levels over the course of the year, but we believe that the days of benign disinflation are firmly behind us and that we are entering an extended period of higher and more volatile inflation than many investors are used to.

Market recovery

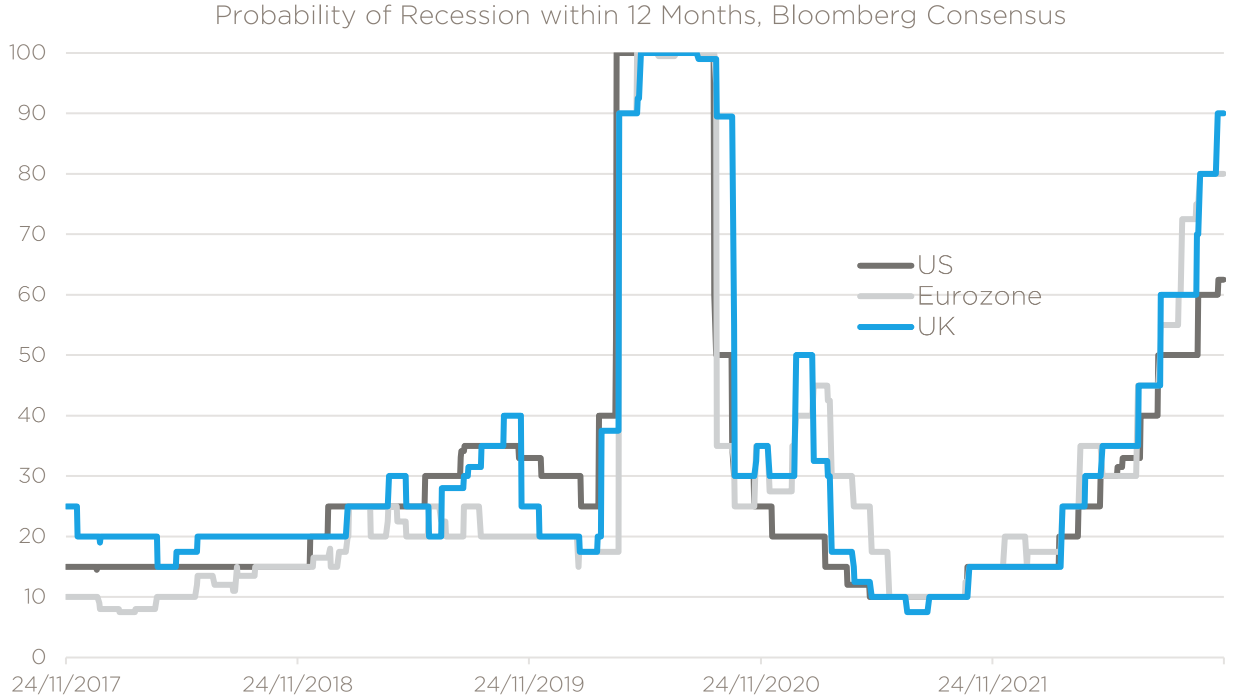
- In the US, equities are much more reasonably priced than at the outset of 2022, and in other major markets they are already looking remarkably cheap. Nevertheless, we see scope for a further downturn in equities in the coming months, as inflation and weakening demand take a toll on corporate earnings which hasn't yet fully been priced into valuations. As we head further into 2023, though, we would expect to see markets begin to move upwards in anticipation of economic recovery.
- Bond yields have risen sufficiently to present some attractive opportunities for the first time in many years. The onset of recession and the policy response of central banks can be expected to push yields lower in due course, bringing the potential for capital gains to add to stronger nominal income in the hands of bond investors. In the corporate bond market, credit spreads are now wide enough to tempt some funding away from equities.
- For alternatives such as commercial property, infrastructure and contractual income assets, valuations will remain challenged by higher bond yields. However, this does not in itself damage the underlying cash flows and fundamental characteristics which make these assets attractive diversifiers for long term portfolios.

The markets are not the economy

If 2021 was all about inflation and 2022 was all about interest rates, we see 2023 as being all about recession. However, before we get too despondent, we also see the year ahead as being about markets anticipating the recovery that will surely follow.

As investors, we must differentiate between economic conditions on the ground and what asset markets are pricing in.

Asset markets are forward looking. The economic news may be bad today, but the good news for us as investors is that quite a lot of that is already priced into markets and it wouldn't take much for them to recover their poise in the year ahead, which we expect.



Source: Bloomberg as at 22 November 2022 Note: Probability of Recession derived by Bloomberg from monthly surveys of 54 economists (for US data), 18 for Eurozone and UK.

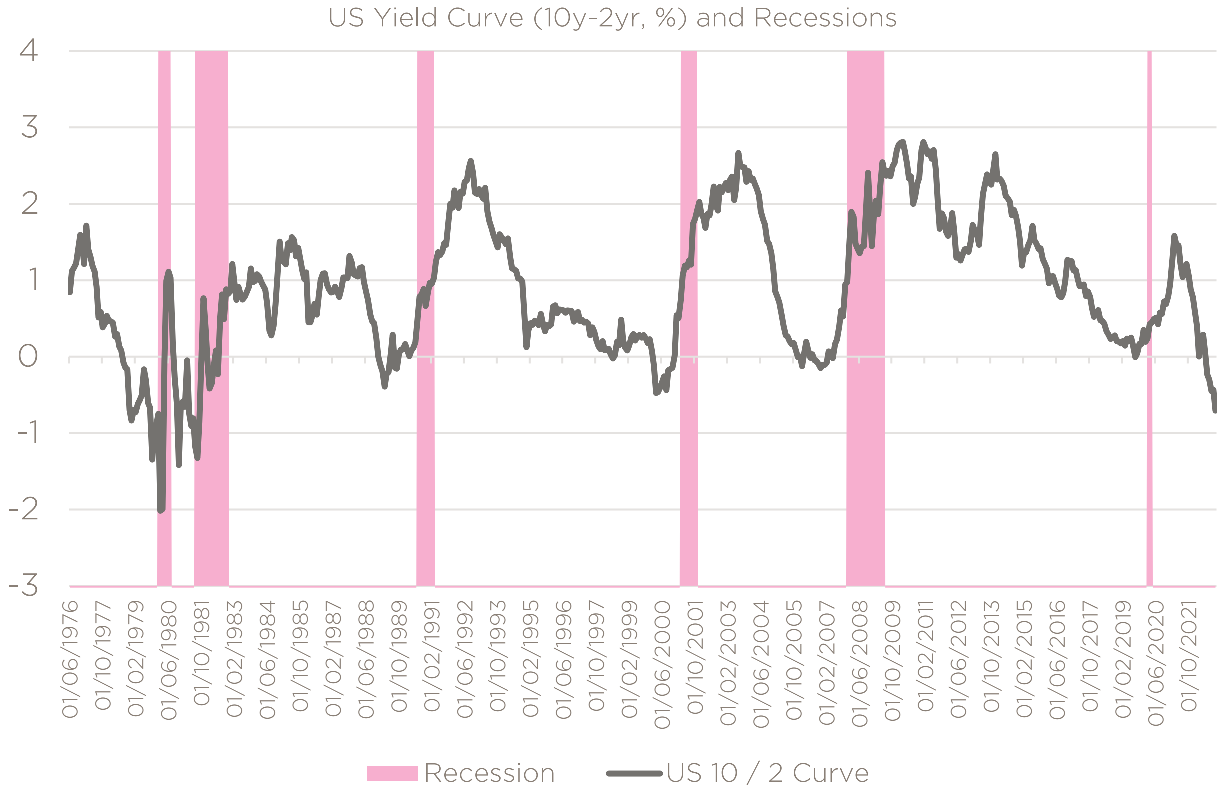
A widely anticipated recession

When it comes to the UK or continental Europe no-one falls off their chair when we say we expect recession. Indeed, one may have already started. Bloomberg's poll of economists puts the odds of recession in the Eurozone at 80% and in the UK at 90%. This must be one of the most widely anticipated recessions ever, but that doesn't mean it won't happen.

We believe UK interest rate sensitivity via the mortgage market will be the critical driver, with 40% of all outstanding mortgages re-setting to much higher interest rates this year. In the Eurozone, the drag on activity from Putin's war lingers on, combined with incipient policy tightening and still sluggish export market demand.

The call of the curve

The tougher call centres on the US economy. A lot of circumstantial evidence is in place suggesting we should brace for recession. The inversion of the yield curve is sounding the loudest alarm.



Source: Bloomberg, CCLA as at 30 November 2022. The chart shows the US 10-year bond yield minus the US two-year bond yield. When the two-year yield is higher than the 10-year yield, the yield curve is said to be inverted. Prior yield curve inversions have usually preceded US recessions, and always preceded recession when the inversion was led by two-year yields rising.

The curve's track record in predicting recessions is impressive with no false signals since at least the 1970s. As the chart shows it can be early, but it has not in the last 50 years been wrong. This is the fourth yield curve inversion this analyst has personally experienced. My memory of the other three was that each was dismissed as a technical inversion giving a false signal – 'it's different this time'. It never was different. Recession always followed.

A 20th century cycle

In many ways, after two long and largely inflation-free cycles since the 2000 recession, this economic cycle is a return to the cycles of old. The anatomy of 20th century cycles was shaped by inflation. Late in the cycle unemployment fell below NAIRU, capacity utilisation rose above sustainable levels, and inflation took off. Corporates were unable to pass on cost inflation fully, so margins fell. Central banks responded to inflation by raising interest rates and taking real rates positive. The yield curve inverted. Tougher financing conditions and falling margins pushed investment grade and high yield spreads wider. Companies responded to these signals by deferring investment and laying off workers. Only then did unemployment start to go up, and it only took a tiny (0.5% point) rise in the unemployment rate to confirm that a recession had started.

Tick, tock

Using this checklist for the US economy today is a useful exercise. Low unemployment – tick. Inflation – tick. Falling margins – tick. Central bank policy tightening – tick. Corporate bond spreads wider – tick. Yield curve inversion – tick. Now we wait and watch labour market indicators, the timeliest of which is the weekly initial unemployment claims data. This is the dog that has not yet barked, but it feels as though it's straining at the leash.

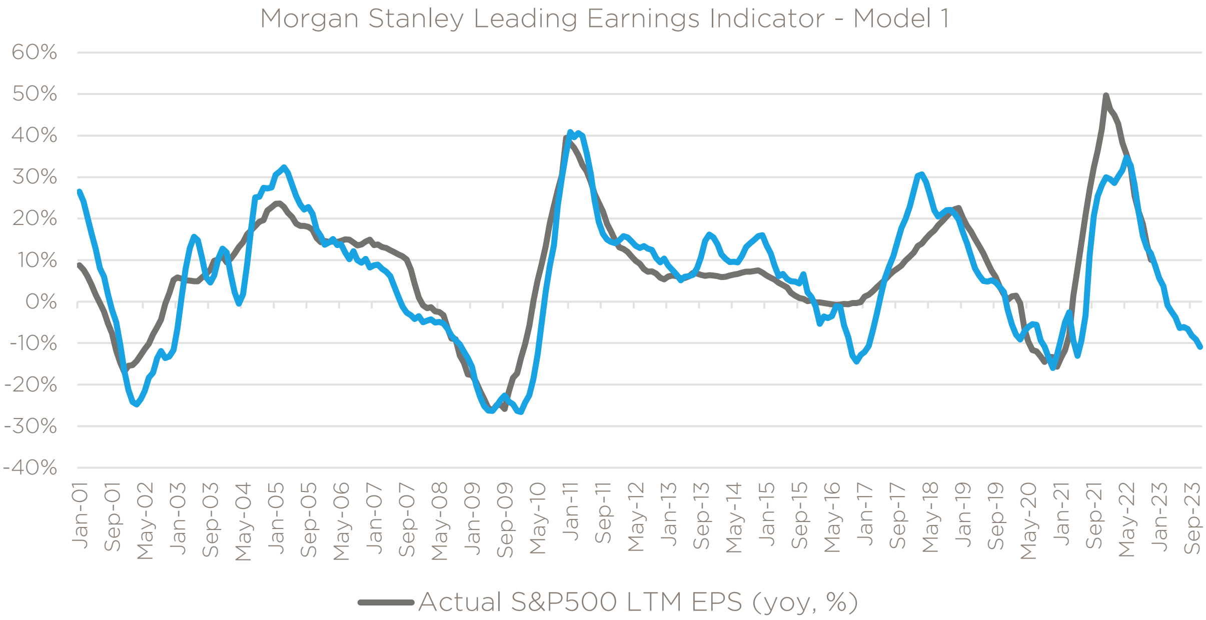
2023 or 2024?

It's a tight call as to whether the US economy goes into recession in 2023, or whether it's deferred into 2024. The US consumer is a fortress with deep protective moats. During the pandemic consumers found it harder to consume and the personal saving rate shot up. It's estimated that there is still around $1.7trn (yes, trillion) in cumulative excess savings. That's nearly 10% of annual consumption, but it's not evenly distributed and much of it sits in the bank accounts of people who are unlikely to adjust their spending. The US mortgage market is also very defensive. Most mortgages are 30-year fixed rates with no prepayment penalty, so refinancing activity can be very strong when rates are low. Borrowers took advantage of 3% interest rates in 2020–21 and refinanced. No resets higher here (unlike in the UK).

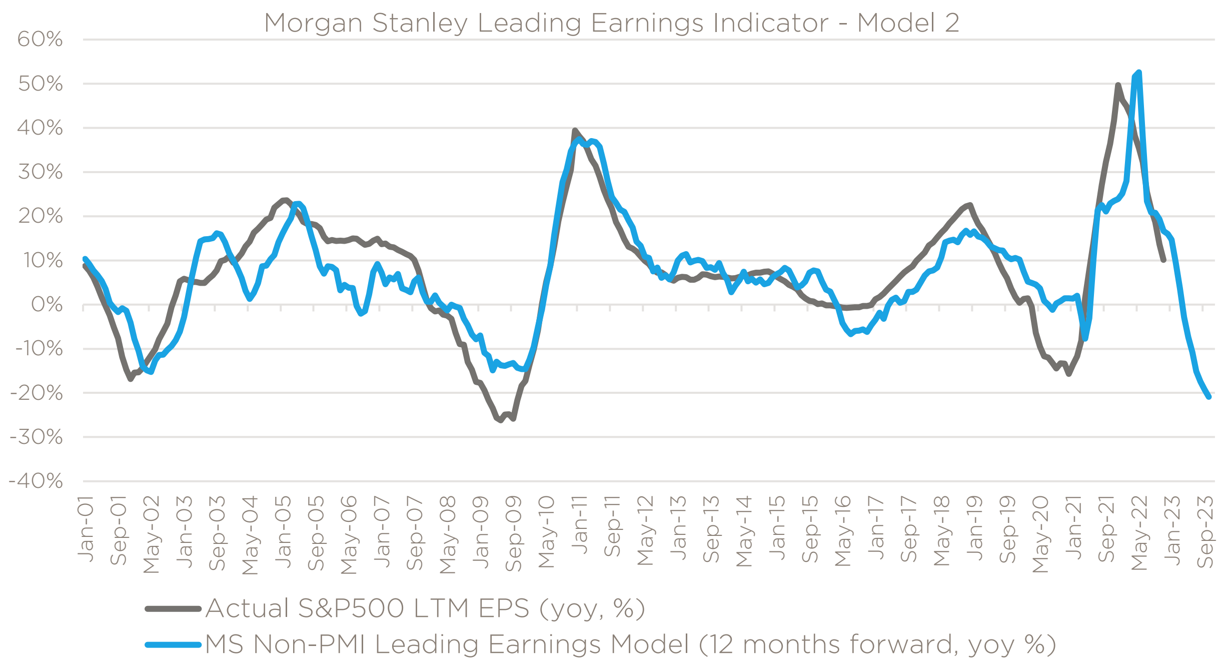
Earnings can still fall anyway

Regardless of whether or not there is a full-blown US recession in the next twelve months, we do think that US earnings estimates will have to be revised lower, and possibly much lower. Morgan Stanley has two models of corporate profit (shown below) which predict US earnings will fall between 10–20% next year with inputs as they are now, i.e. before any eventual recession. The reason for this is that sub-trend growth is enough to turn earnings down, given operating leverage, but in addition to this, margins are already falling given the inflationary backdrop. This anticipated 10-20% fall in earnings stands in contrast to the bottom-up consensus that earnings will grow 7%. If there is a recession then the downgrade to earnings would clearly be larger. This for us is the main risk to markets for one final leg lower before we can really look through to the recovery.

Cross-referencing this with the bottom-up view, consider the high growth AAMMG stocks – Apple, Amazon, Meta (Facebook), Microsoft and Google – which on their own are nearly 20% of the S&P500. We contend there is still a large air pocket for their earnings to fly through, because so much demand was pulled forward during the pandemic as everyone rushed to equip their homes with personal computing essentials. In the five years to February 2020, when the pandemic struck, they compounded their earnings by 20% per year. During the pandemic this accelerated to a 30% annual rate. Now they are suffering from the hangover, much slower growth. As my colleagues James Ayre and Charlotte Ryland point out too, they suffer from the law of large numbers. When you have grown so much that you have almost become the economy, outgrowing it becomes a lot harder.



Source: Morgan Stanley Research, as at 30 November 2022. Inputs – ISM PMI, Conference Board Consumer Confidence, housing starts, credit spreads. Last data point November 2022.



Source: Morgan Stanley Research, as at 31 October 2022. Inputs - Philadelphia Fed economic activity, Creighton University business confidence, Chicago Fed supplier deliveries, Atlanta Fed wage tracker (inverse signal), NFIB small business most important problem inflation (inverse signal), and Brave-Butter-Kelley cycle component.

A new inflation regime

2022 has amply demonstrated that inflation is the enemy of nominal assets such as stocks and bonds. How long is this threat to markets likely to persist? We are believers in (and have been vocal proponents of) the view that last year marked a secular inflection point for the inflation regime – to a higher and more volatile inflation regime over the next ten years or more. There's not space here to fully rehearse the arguments, apart from to say that forty years of benign disinflation is behind us, in our view, because:

1) labour should start to assert itself over capital after a long period of real wage stagnation and growing income and wealth inequality

2) the global supply chain is having to be reformed into a series of national supply chains, building in redundancy and duplication which will raise the cost of supply

3) policymakers will increasingly have to resort to money printing whenever they need to stimulate the economy now they have established beyond a reasonable doubt that Quantitative Easing doesn't much impact the real economy but does have the negative and politically unacceptable consequence of increasing wealth inequality;

4) the global effort to combat climate change should result in what Bill Gates has called a 'Greenium', a green premium which increases the cost of supply as more climate friendly sources are developed.

Disinflation for now

If the longer-term outlook for inflation is much worse than the benign disinflation of the last several decades, though, its near-term outlook we think is much more constructive for risk assets. Focusing on the US, it helps to break the CPI basket down into its main components, which in round numbers are: 20% food & energy, 20% other goods, 35% housing, 25% other services.

Goods deflation is likely

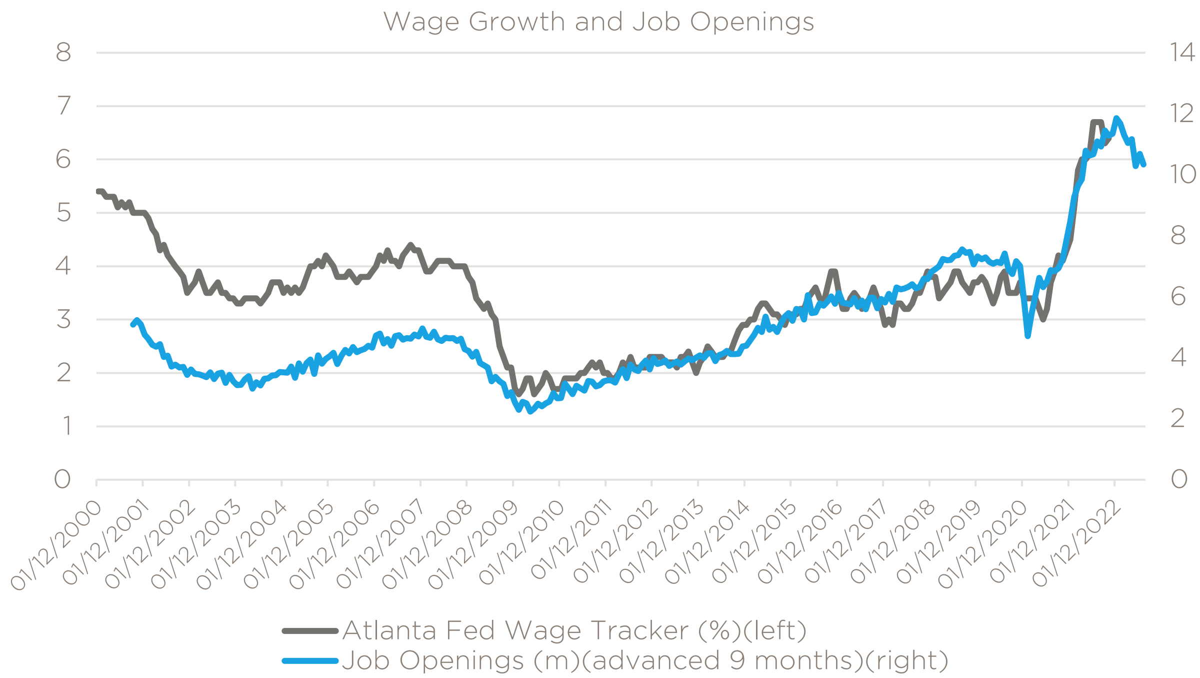
Taking these in turn we can see that they are all either already rolling over or their lead indicators are rolling over. Food CPI peaked at 11% in August, though it was still 10.6% annual rate in November. But all the major agricultural commodities have pulled back sharply from their peak levels in the second quarter of 2022. Since then corn is down 20%, wheat down 41%, soyabeans down 17%, lean hogs down 10%. It's a similar story in energy, with oil down 37% from its June peak. Similar again in other goods, with the cost of shipping a container from Shanghai to Los Angeles down to $2,000 per box now from $12,000 in September. So, for the 40% of the CPI basket that is food, energy and other goods we would expect outright price declines at annual rates. From contributing +2–3% points to the overall CPI reading, that could easily be -2%, meaning a minus 4–5% point impact on overall inflation. On its own this would take the CPI from its 9% year over year peak to somewhere around 4–5% year over year, and this base effect kicks in early in the new year.

Services inflation is stickier

For the 60% of the basket that is services it's a more nuanced story, though still broadly a disinflationary one, albeit with a lag. Housing (which in the US is called 'Shelter') is 35% of the basket and is driven by rental costs and house prices. New asking rents have turned decisively down as judged by the Zillow's All Homes Rent Index, which peaked at a 17% inflation rate in March and had slowed to a 9% rate by November. But there's a nine-month lag before slowing new asking rents translate into slower in force rents, which is what drives the CPI.

As for house prices, the bubbly, tech-driven areas such as Seattle, San Jose, Oakland and Austin have already deflated 10-20% from peak and continue to fall precipitously. Nationwide the Case Shiller 20 Cities Average peaked in June and has since fallen by a couple of percent. So – housing inflation should turn down from the first quarter of 2023. Its contribution to headline CPI inflation should therefore diminish, but since it's unlikely to go into deflation (unlike Goods CPI) it won't have as big an impact in reducing the overall inflation rate, we wouldn't think.

Lastly on inflation we come to the 25% of the basket represented by other services. This is driven squarely by wage inflation, which is stickiest of all. Here again there's good news but it will take longer to feed through. The best lead indicator of wage inflation is new job openings as represented by the JOLTS report from the US Bureau of Labor Statistics. Job openings lead wage inflation by nine months, give or take, as the chart below shows. While the pace of new job openings has slowed, though, it is still very strong and indicates wage inflation could remain at about 5–6% most of the way through 2023. This should put a 1.5–2.0% floor under its contribution to the overall CPI, again most of the way through the year.



Source: Federal Reserve Bank of Atlanta, Bureau of Labor Statistics, as at 31 October 2022. Job openings data are lagged by nine months to show the possible direction of wages. The Atlanta Fed Wage Growth Tracker tracks hourly pay for individuals earning between minimum wage and $150,000 pa, so excludes the extremes of the income distribution.

US CPI could slow to a 2–4% range by the end of 2023

Putting all of this together, our expectation would be that US inflation should continue to slow quite markedly from its 7% current rate to end next year somewhere in the 2–4% range. There's starting to be some discussion, though emphatically not at the Fed if we take Jay Powell at his word, that the Fed could consider changing its inflation target. Regardless of the outcome, substantial progress towards that 2–4% CPI range would be enough, we think, for the Fed to go on hold.

What about the UK?

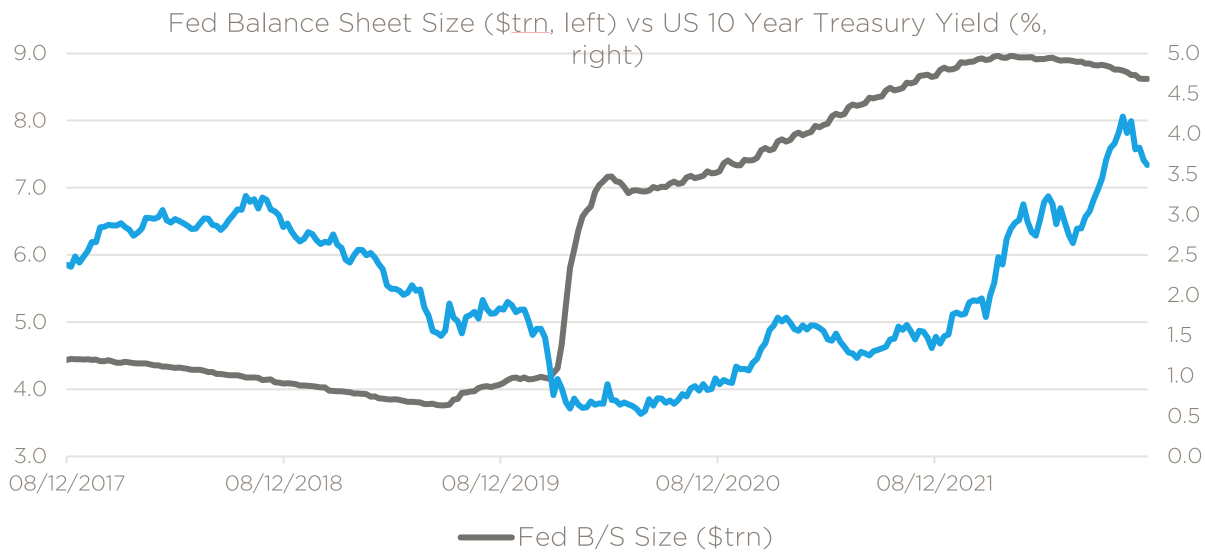
Very similar inflation dynamics should play out in the UK too, but while inflation should slow here too, it might not slow as fast. There are two reasons for this. First, the UK CPI basket is relatively heavier in the sticky services sector (69% vs 60% in the US) and second, sterling's depreciation will take something like 4–6 quarters to fully work through the system. The consensus of the economists polled by Bloomberg has inflation slowing from 11% at the end of 2022 to 4% on the CPI (6% on the RPI) by Q4 2023. This should allow the Bank of England to pause its hiking cycle in the first half of the year. Forward curves have Bank Rate peaking at just over 4.5% by August, so another 100bps of hikes to go.

The policy implications are quite benign

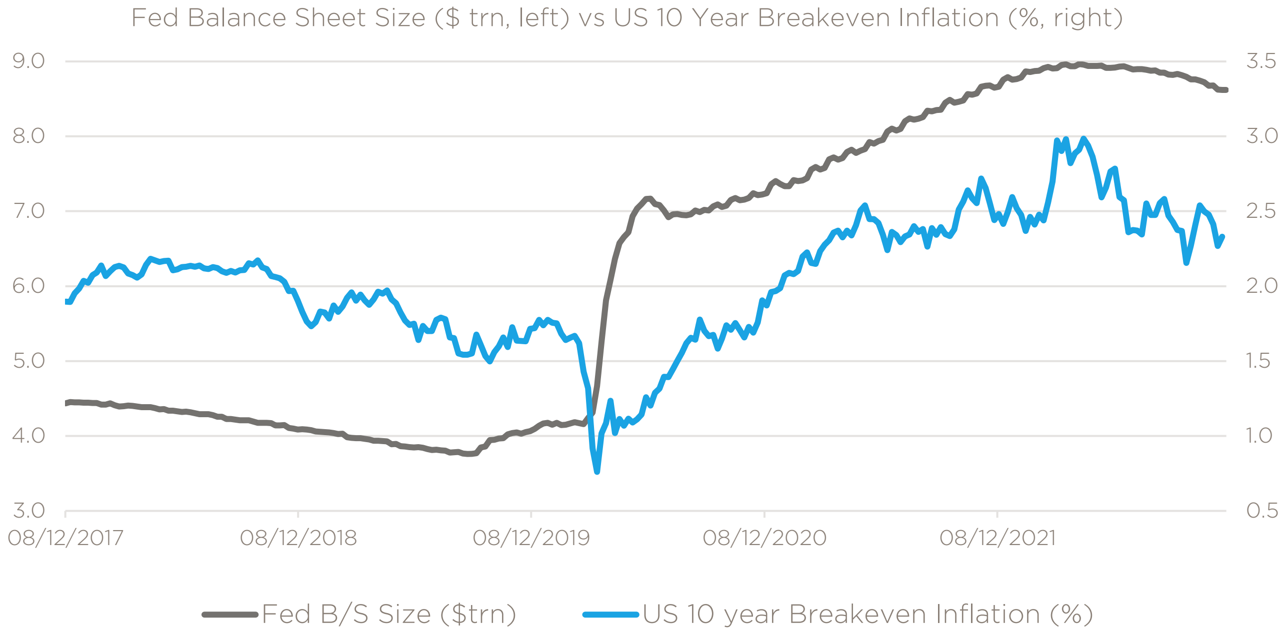
Looking again at the US, if this inflation forecast come to pass, it should lead to a benign policy outcome. The Federal Reserve is expected to take its Fed Funds rate up to 4.85% by May, where it is expected to peak before nearly 50bps of cuts in the second half of the year to end at 4.45%. While that may be the market expectation today, 2022 has taught us too that forecasts of the Fed Funds rate in particular are very prone to revision. (This time last year no rate hikes were priced in for 2022 – but we ended up with 425bps of them!) But if the Fed is able to end its tightening cycle after another 25–50bps of hikes as markets expect, the relief should be manifest. This said, it will also be important to know why the Fed pauses. If it's because of slowing inflation and slowing growth but no recession, markets would love it. If instead it's because of a recession in 2023, then the champagne may have to stay on ice a while longer. Either way, we won't really know until the middle of the year which it is, if it's either. There's lots of uncertainty here. Markets hate uncertainty.

Quantitative tightening (QT) lowers bond yields

How much of a threat is QT? The truth is, it's very hard to form any kind of view because even the Fed doesn't know! It does know it wants to reduce the size of its balance sheet, which is already down to $8.6trn from its peak at $9trn. It may have another $3–4trn to go, but it doesn't know what the tipping point where the impact of their actions shifts from 'removing excess liquidity' (good) to 'removing required liquidity' (very bad). The rather grim analogy is that of a surgeon cutting out a brain tumour while the patient is still conscious and talking – when the patient starts to slur their words, the surgeon knows they've gone far enough and maybe too far. This is the risk the Fed faces. We will be watching access to the discount window, reverse repo balances and the cross-currency basis swaps to judge whether they are going too far. The discount window shows stressed borrowers paying up for dollar liquidity. Reverse repo is where money market funds park excess liquidity at the Fed. The basis swap is the cost of swapping other currencies into dollars. All will give signals of any looming liquidity crunch.



Source: US Federal Reserve, as at 30 November 2022.



Source: US Federal Reserve, as at 30 November 2022.

One thing we can say, though, is that QT is not on its own likely to raise bond yields, or at least that hasn't been the experience, as the charts below show. We see that when the Fed last tried QT, in 2018–2019, far from bond yields blowing up, they actually fell. The second chart shows why this was. Tightening liquidity lowered expected inflation as evidenced by the 10-year breakeven inflation rate. Conversely, when the Fed re-started QE during the pandemic, bond yields rose, and again this was driven by rising breakeven inflation.

This shouldn't be a surprise. Central banks engage in QE and QT specifically to raise or lower inflation expectations. So far, it's worked. If it continues to work in this way, we should expect QT next year to lower bond yields, not raise them, counterintuitive as that may seem.

If it's a recession, it's probably not that deep

So, the near-term US macro picture seems mixed rather than genuinely terrible. Growth is slowing to stall speed and may well tip into recession. But that recession is unlikely to be very deep if only because there are not the sectoral imbalances that have been present in prior recessions. US consumers have not borrowed heavily against home equity, their balance sheets have been rebuilt since the Global Financial Crisis (GFC), and they are still sitting on substantial excess savings. The banking system has substantially de-geared too, with large banks' core equity Tier 1 ratios in the 10–12% range rather than the 5–6% range back then. Government debt is much higher, but that is also much more manageable when you happen to be the global reserve currency.

Risks

The risk to this somewhat benign view is that great unknowable, liquidity. We read somewhere that there have been 284 rate hikes around the world in 2022. The Fed has raised rates by 425bps since March, or nearly 50bps per month. This is more than twice the pace of policy tightening you'd see in a normal tightening cycle. You have to go back to the 1970s to find a faster-paced tightening – and that ended badly for the economy and for the stock market. Given this, the risk of "something going bump in the night" is clearly much higher than it has been for many years. Central banks have done a very good job of containing longer term inflation expectations, but at the cost of this rapid tightening. Some obvious areas that have benefited from super-abundant liquidity have already paid the price. The crypto universe has been under intense pressure. Concept-stock style valuations in hyper-growth areas of Tech have been heavily discounted. Anything relying on cheap leverage and possibly sub-par due diligence is likely to continue to be punished – areas within private equity, levered loans, anywhere there's been (dread words) financial innovation – and we would not be at all surprised if more bodies floated up to the surface. But will this prove a systemic shock in the way the sub-prime crisis or the

Eurozone government bond crisis were systemic, requiring a 'whatever it takes' policy response and a further shock adjustment downwards to all risk asset valuations? We do not believe so. Famous last words.

Asset allocation

All of which brings us to asset markets and what's already in the price. Here we would say our view is very much more benign. A lot of the bad economic news is already reflected in the price, we think. As we've said, the yield curve is heavily inverted, indicating that the bond market structure is already pricing in a recession, even if we still think there is room for the absolute level of yields to fall as recession bites. Credit spreads have already widened out to levels that we find increasingly compelling as hold-to-maturity investments that could meet our CPI+4% (net) targets. Non-US equity markets are standalone cheap, we would say. Consider the table below. Price/earnings ratios have fallen by 25–40% from their 2021 peaks (far right column). Outside the US, P/E ratios are in line with their Covid lows, which is really quite a statement. A P/E of 10–12 such as we see everywhere apart from the US, with bond yields in the 2–4% range, implies a risk premium of 4–8%, i.e. a real return of that order of magnitude. Again, we can achieve our targets with starting valuations like these, subject to returns on invested capital at least partially closing the gap with the US.

		P/E at prior market troughs						
		GFC	Euro Crisis	Covid 19				
Index	Region	2008 low	2011 low	2020 low	Current Dec 2022	Current vs Avg low	P/E at peak 2021 high	Current vs Peak (%)
FTSE 100	UK	6.5	8.3	10.1	9.9	19%	15.6	-37%
Euro STOXX	Europe ex UK	6.9	7.7	11.8	11.8	34%	18.3	-36%
Topix	Japan	9.3	10.9	10.4	11.8	16%	18.4	-36%
S&P 500	US	9.5	10.4	13.7	16.7	49%	23.0	-27%
MSCI World	World Developed	8.5	9.9	12.7	15.0	45%	19.5	-23%
Shanghai A	China	10.4	7.4	9.9	10.4	13%	14.3	-27%
MSCI EM	World Emerging	6.1	8.4	10.2	11.3	37%	16.2	-30%
MSCI All Country	All Country World	8.5	9.6	12.2	14.5	44%	18.8	-23%

Source: Bloomberg and CCLA, as at 30 November 2022.

Outside stocks and bonds, we see good valuation opportunities in many of our other holdings too. Our Alternatives book now has expected Internal Rates of Return of around 9% we think. UK property has had the sharpest NAV downgrade in living memory during the second half of 2022, down 25% between July and December. Our external valuers Knight Frank tell us that transactions are starting to flow again, albeit slowly, and they are not expecting NAV's to be downgraded substantially further outside a renewed panic in the UK gilt-edged bond market – something that we do not expect, but you never know. Reversion yield on MSCI All Category UK Property we estimate is now 6.4% as of December, meaning that the spread to UK gilts has widened out again to more acceptable levels than was the case shortly after the Truss-Kwarteng budget imbroglio.

With that, it's time to put away our smudged and cracked crystal ball for another year, and to wish any long-suffering reader to have made it this far a very happy 2023!

Important information