Research Note

Recession fears ramp up as rates move higher

- Last week's higher-than-expected US inflation have dampened hopes of milder rate rises
- Europe and China are also grappling with slowing economic growth
- This has triggered extreme investor pessimism, increasing the scope for short term bounces amid range bound markets

US markets braced for higher-for-longer rates

The US's inflation numbers, released last week, caught many by surprise. Given the consensus that inflation had peaked in June, market watchers were looking forward to softer August inflation data as further evidence of this.

Instead, many were sorely disappointed. While the trend is downwards – from 9.1 percent in June to 8.5 percent in July to 8.3 percent in August – this pace is far too slow. At this rate, US inflation is unlikely to reach the Fed's 2.0 percent inflation target for several years, by which time the US economy may have become irreparably damaged.

The market expectation now is for the Fed to keep its foot on the pedal, and raise rates by a steep 0.75 percent or even 1.0 percent when it meets later this month. Based on current data, this step-up in US interest rates is expected to continue into 2023 and only halt when it has hit around 3.75 percent.

Eurozone recession looking more likely

The news was no better on the other side of the pond. The Euro Area's annual inflation rate in August accelerated to 9.1 percent from 8.9 percent in July, a new high and above market forecasts of 9.0 percent. This prompted the European Central Bank (ECB) to raise rates this month by an unprecedented 0.75 percent and to increase its average inflation forecasts for 2022 to 8.1 percent.

However, unlike in the US, economists here point out the forces driving up Eurozone inflation is not high demand and wage growth. The problem instead is one of supply, given its dependence on shrinking gas and other commodity exports from Russia and Ukraine. This supply shock has pushed up prices in the region, and is not something that higher interest rates can directly address.

The ECB appears therefore to be relatively powerless in preventing further inflationary pressures and a steep slowdown in economic growth. This has prompted Fitch Ratings[1] to forecast a recession for the Eurozone and UK later this year, compared to a "mild recession" in the US starting in mid-2023. For the full year 2023, Fitch expects the Eurozone to continue to contract by 0.1 percent, while the US is expected to eke out a small positive growth of 0.5 percent.

China cannot come to the rescue

In the past, China might have been expected to pick up the slack in terms of global growth. However, the country is facing its own growth constraints as a result of on-going Covid restrictions and the property market shake-up. Most economists now expect China's economic growth this year to close at around 2.0 to 3.0 percent.

The prospects for growth look better in 2023. At 2.5 percent in August, China's year-on-year inflation rate is less than a third of its western counterparts. This gives China the flexibility to continue to cut its lending rates, although so far it has opted to do so in only a measured way. Current economic weakness may see its 1-year and 5-year Loan Prime Rate (LPR) fall further.

Over the medium term, China faces a slew of opportunities and challenges. On the plus side, it is cementing its leadership position in high value yet low-cost manufacturing across a range of new age products including electric vehicles, telco and infrastructure. On the other hand, China looks likely to become increasingly enmeshed in geo-political and trade conflicts. These looks set to keep Chinese markets relatively volatile.

Extended period of poor investor sentiment

Given recent negative inflation surprises and revised growth expectations, it is perhaps unsurprising that current investor sentiment is poor. However, some sentiment indices are indicating extreme pessimism.

For example, the AAII (American Association of Individual Investors) Sentiment Survey[2] notes that only 26.1 percent of investors surveyed as of 14 September were bullish about the direction of markets in the next six months. This is well below the long-term average for bullish investors of 37.7, a level not reached since the start of the year.

Another common sentiment indicator, the 125-day rolling average of the S&P500 index also shows a declining momentum since April 2022. Meanwhile, the ratio of put options (that is, the option to sell stock) and call options (that is, the option to buy stocks) is hovering at about 1. Both are indications of extreme investor bearishness and could be signalling a temporary market bottom.

Markets look likely to stabilise, for now

There are other reasons to suggest that markets may find cheer in the near term. Leading indicators of inflation, including the global supply chain pressure index, container freight rates, used vehicle car prices, food prices, and sales of existing homes, all point to potential improvements in the US inflation outlook. The other major culprits for August's high inflation number - rent and wages – are high but appear to be rolling over. These indicators suggest that inflationary pressures are easing, but this is not yet reflected in actual prices.

A further reason to be hopeful is that unlike in the high inflation scenarios of the 1970s, central banks are now much better at providing forward guidance to markets. As such, even though interest rates are still "behind

[1] Fitch Ratings, "Fitch Ratings Slashes Global GDP Forecasts on Supply Shocks, Faster Rate Rises", 14 September 2022.
[2] AAII Sentiment Survey, "The AAII Investor Sentiment Survey", 14 September 2022.

the curve” in terms of what they should be to curb inflation, the US Fed has been successful at messaging its intentions to “do whatever it takes”. This better alignment between the Fed’s intentions and the market’s expectation could help to stabilise bond yields, and with it, equity markets.

This is not to say however that the current market crisis is over. Following a near term market bounce will be more periods of uncertainty about inflation and economic growth. As such, we do not see the markets moving higher in a sustained way. Rather, markets are expected to trade within a broad range, thereby providing opportunities for long term investors to pick up good quality investments via dollar cost averaging, or take some profit where appropriate.

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