Recession Fears Grip Markets

The policy meetings of central banks this month have almost uniformly delivered far more hawkish outcomes than markets had been expecting, or indeed, central banks themselves had been guiding. The US Fed had previously indicated that a 75bps hike was not under active consideration for its June meeting, but this is what it delivered. The Swiss National Bank stunned markets with a completely unexpected 50bps hike last week.

Meanwhile, the Bank of England hiked rates as anticipated by 25bps, but hardened its stance on the policy outlook, saying it would act forcefully if necessary to counteract inflationary pressures. The ECB was also more hawkish than expected, indicating that a larger hike than the 25bps it has penciled in for July may be appropriate at its September meeting. Meanwhile, an array of other central banks have announced bigger than expected rate increases at their June policy meetings.

Markets now see rates getting to 3.75% in the US and 3.4% in the UK by early next year, with euro rates hitting 2.25% by end 2023. This represents rapid policy tightening of circa 275-360bps in the major economies. Add to this, the squeeze on household real incomes from near double-digit inflation, a less supportive stance to fiscal policy and marked tightening in conditions on financial markets, and it is reallly testing investors' faith in a soft landing for economies.

Instead, recession fears are taking hold as evidenced by the sharp sell-off in stock markets which has gathered fresh momentum this month. The S&P index has entered bear market territory and is now down almost 25% year-to-date. Meanwhile, bond markets have come under severe pressure also, with ten year German and US yields rising by close to 200bps this year on the back of monetary tightening and spiraling inflation.

Nonetheless, the macro forecasts published by the Fed and ECB this month show that they both expect their economies to comfortably avoid recession. The Fed sees the US economy growing at around a 1.8% rate over the next two years, which is slightly below trend and thus would see unemployment edge up a small bit. The ECB is forecasting growth of circa 2% in both 2023 and 2024, with unemployment stable.

In their recent updates, the World Bank and OECD also projected moderate growth for advanced economies over the next couple of years. Official forecasters believe that the enormous build-up of private sector savings in advanced economies over the past two years combined with strong labour markets will help sustain activity.

Markets, though, are taking little comfort from these forecasts and look set to remain very volatile. They fear that aggressive rate hike will push economies into recession. As such, they are unlikely to reach a turning point until inflation moves on to a clear downward path. However, inflation has not even peaked yet.

Bigger than anticipated rate hikes will continue to be a risk for bonds markets, but they may stabilise before equities, especially if data point to a growing threat of recession. This could bring rate cuts on to the agenda next year. On the other hand, a recession would compound the difficulties facing equities. Corporate earnings would come under severe pressure, prolonging the bear market in stocks.

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