Investment*Update*

11 August 2022

When the facts change

An American recession is now more likely than not. A broad decline in leading indicators steers us to be yet more defensive, but there are both bullish and bearish arguments to be made

In our last Investment*Update*, from the end of June, we restated our belief that core inflation would fade back to normal levels in the second half of 2023, and that there would be no US or global recession in the next six to 12 months. Yet we also said that we couldn't shy away from the risks and that we were seeing more 'yellow flags' in the data. Our stance had become iteratively more cautious since June 2021 and – particularly from the first quarter of this year – we recommended staying invested yet defensively positioned given the broadening risks, despite a nascent rally in stock markets. If the facts change, we said, we would change our minds, just as we had done over the previous 12 months.

In the six weeks that followed, the facts have changed. Those warning flags in the leading indicators of economic activity have multiplied, while some of the yellow ones have turned conspicuously red. We still believe that inflation will fade considerably next year, but investing is about gauging the validity of the expectations on which today's prices are based. A slow start and broadening risks mean that an awful lot needs to go right with the inflation data for it to fade over the next 15 months to the *extent* that is signalled by both market-based inflation expectations and the aggregation of economists' forecasts.

It is still important to weigh some reasons to be optimistic about market prospects against the more on-the-nose pessimistic ones, as we do below. A US or global recession is not nailed on. What's more, not all recessions are alike: we should focus on how much impact a downturn will have on companies' earnings and long-term sales growth. We're relatively confident that while any coming global slowdown wouldn't be great for businesses' bottom lines, it may not entail very large declines in profit either. And in many cases prices have fallen this year to a point where much – although likely not all – of this may already be factored in.

It is also important to remember that it is easier to buy at the right price than at the right time. So it's helpful that equity and credit market valuations across many sectors are inexpensive relative to history. Tactical asset allocation (short- to medium-term adjustments to portfolios) is an important and valued tool in our box. There is a clear relationship between the macroeconomic environment and the relative performance of many different financial assets, industry sectors and styles, after all, and we make tactical moves particularly to achieve good *risk-adjusted* returns. After the latest turn in the data, we now advocate an even more defensive investment position.

More defensive, yet still invested in stocks, as trying to time with great precision when to be in or out of the market altogether is not something we would recommend. As we said last time, you should consider that equity performance has been positive in 92% and 85% of 10 and five-year periods since 1946 respectively (over 75 years of data covers a lot of different economic and political environments). The exceptions occurred in periods that we believe are unlikely to be repeated: the long-running stagflation debacle of the 1970s; and between 2008 and 2010, when the crash of the global financial crisis came exactly 10 years after the apex of the dotcom bubble.

GDP isn't the final word

It's worth clarifying that we don't believe that the US is currently in any *helpful* definition of recession. As investors we care about recessions because they are defined by falling spending and that usually means falling profits. Although two consecutive quarters of contraction in GDP is a shorthand for recession, to take an accounting construct such as GDP at face value without checking what's going on underneath is like an equity analyst taking earnings-per-share at face value without checking the financial statements for any calculative tricks (rest assured we don't do that at Rathbones!). While US GDP contracted in Q1 and Q2, it was heavily influenced by unusual trade patterns and slowing inventory accumulation. It seems unlikely that the US entered recession according to the broader, and arguably more relevant, official definition set by the National Bureau of Economic Research.

However, that's little comfort when leading indicators of activity suggest that the risk of the US entering an 'official' recession before long has increased considerably. We use some econometrics to combine the signals from a range of economic and market variables with long track records of leading recessions into one probability measure. We compute different models covering different time horizons. As data for June and July were released (and, in the case of June, revised negatively) the model-implied

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Look forward

probabilities have jumped. They are now between 55% and 66% at each time horizon from one to six quarters ahead.

Econometrics are only ever a starting point. We can think of reasons why some of the indicators individually may be giving misleading signals. The relationship between consumer confidence and actual spending has become very distorted since the pandemic, for instance. While the rise in initial jobless claims may indicate not broad-based cyclical unemployment, but instead the shorter-term, frictional sort driven by consumer goods companies over-hiring during outsized demand in the pandemic and now shedding workers that may soon be employed in the labour-short services sector. But the deterioration in the data is just too broad-based to be ignored. It encompasses the consumer, the jobs market, private investment, residential construction, and energy costs. To say they are all sending misleading signals is pushing it. The monetary and financial data, such as the change in bond yields or the real money supply, are also signalling a two-thirds likelihood of recession in 12-18 months' time.

However, it's important to stress that while the chance of a US recession is high, it is not a foregone conclusion. And if one does arrive, it's highly likely to be a relatively mild one by past standards. This is important when we come to analyse potential changes to profits and market reaction (as we do below). We take some comfort from the lack of obvious major financial imbalances and the relative strength of the banking system. Anchoring your expectations for what a recession would mean for investors to what happened in 2008 could be misguided.

Risks elsewhere

The risk of a deeper recession is much more pronounced in Europe, however, where we've been flagging a greater than 50% probability of contraction for some months now. Q2 GDP growth was remarkably resilient in the Eurozone, thanks to a very strong tourist season in the south and a long-awaited rebound in spending on socialising in the north. However, the price of energy and attendant cost-of-living crisis make that unlikely to continue. We went into more detail in the last update, but since then the situation has worsened. Russia has further reduced gas deliveries via the key Nord Stream pipeline. Startlingly high imports of gas from elsewhere have helped to plug the gap, allowing storage levels to keep rising ahead of winter to an extent that could avert the need for rationing. However, this has only happened at considerable cost. Gas and power prices have surged again. The additional cost to Germany of maintaining electricity consumption at current power prices (versus last year's average) is roughly equivalent to 4% of GDP.

The situation in the UK is a little better, but not much. Another rise in household fuel bills is likely to push inflation up to over 13% by the start of winter, far eclipsing the growth in average take-home pay. Pledges made by the two candidates racing to be the new Prime Minister are unlikely to do much to avert households' pain, and Liz Truss's tax cuts risk making inflation worse.

For an economy with a dismal record on business investment relative to its peers since 2016 (both before and since the pandemic), and one which today has a lower standard of living (as measured by the average inflation-adjusted wage) than before 2008, it is disappointing that the Conservative leadership contest has been so devoid of new ideas. The notion that cutting already-competitive tax rates (particularly income taxes) provides a boost to growth *beyond the short term* was popular in the 1970s when there was little else to go on other than the leading abstract theories of neoclassical economists. But since then, economics has undergone an empirical revolution that has revealed economies are rather more complex. We need policies that take account of the real world. Of course, finding any party in the UK with learned, new ideas is rather a tall order and we certainly don't want to single out this government! We will be exploring the interaction between investment, entrepreneurship and the state in our series of private client conferences towards the end of the year – an opportunity for all of us long-term investors to look beyond the gyrations of the business cycle.

The path of inflation

As we write, the monthly increase in US core prices (excluding energy and food) has just printed below expectations. We're confident that core inflation will fade rapidly across the globe next year. The San Francisco branch of the US Federal Reserve estimates that between half and two-thirds of headline American inflation is driven by supply constraints. Similarly, we calculate that two-thirds of US inflation is coming from energy, food or categories of goods that had outsized demand during lockdowns and supply chains that failed to keep up. In the Eurozone it's over 80%. Crucially, these forces are abating as the demand for consumer goods is falling sharply to more normal levels, and supply chains are becoming unblocked. Just look at the extraordinary plunge in the gauges of input costs in the headline ISM survey of US businesses this month. Order backlogs are no longer growing, while suppliers' delivery times are now in the normal range. Citi's global supply chain indicator stands at its lowest (best) level since January 2021. The prices of many agricultural commodities, such as wheat, which had soared after the invasion of Ukraine, are now back to where they were at the start of the year.

However, inflation pressures in consumer services are broad. Nominal wage growth may need to slow from 5-6% now to 3-4% to give inflation a good chance of getting back to normal next year. The labour market indicators with the most predictive power over wage growth point to it only *edging* down in the next few months, so more progress is required. This fall in wage growth could take time and the longer inflation remains elevated (as it will in the UK due to energy prices) the greater the risk that wage growth remains high. While the fact that wage inflation is lagging so far behind price inflation means a repeat of the 1970s is unlikely, we are concerned that the market has become too complacent about how quickly inflation could fade, as we set out earlier.

Central bankers' agenda

This means that there is a concomitant risk that investors are wrong to have revised down expectations for central bank policy rates during 2023. Particularly given that policymakers have remained emphatic that bringing down inflation is the number one priority, even at the sacrifice of growth.

Given that changes in government bond yields have been very strongly correlated with what central bankers have done relative to market expectations, the risk of a delay to the first rate cut (which in the US is expected from around March 2023) means that bonds could fall in value (as yields move inversely to price). This risk also means that the technology and other so-called 'growth' stocks that have led the equity rally in July may not continue to outperform. This isn't what usually occurs as we enter recession. If the recession is deeper or longer than anticipated, we expect disinflationary forces to dominate, making bonds a better investment to defend against this scenario.

We are less certain about the risks around the path of UK interest rates. The Bank of England has made some serious communication errors during the past year. The rhetoric from Governor Andrew Bailey has been notably more inflation-busting of late. But the projections made within the latest Monetary Policy Report somewhat belies the chief's speeches: the medium-term inflation forecasts are among some of the weakest ever made. Even if they assume interest rates rise no further, the Bank suggests inflation could fall well below forecast on a three-year horizon.

What's priced into markets?

Equity markets have bounced strongly from their June lows, but we believe that the deterioration in the growth outlook discussed above is not being fully discounted. There has still been no major downgrade to earnings expectations, with the consensus continuing to anticipate solid growth this year and next in most major markets and across most sectors. The analyst consensus for 2023 earnings growth is still 8% in the US and 3% in Europe.

Of course, we think the US and global recessions would be mild, and therefore it may only require a few percentage points to be shaved from these expectations. It's important to remember that earnings are nominal and nominal economic activity is unlikely to contract. Note the continued resilience displayed by company results during the Q2 earnings season where the number of large positive surprises was yet again above the historic average. Nevertheless, the risks to earnings are skewed to the downside in our opinion.

While earnings downgrades are likely to come, it's possible that equity prices may have already adjusted to some degree. Historically, changes in stock prices lead changes in earnings expectations by circa six months. Equity valuation multiples tend to trough in the first month of recession and have even been known to trough before the start of one. There's considerable evidence that institutional investors have already sold a lot on prior pessimism. Bank of America's Global Fund Manager Survey, in which we participate, shows the lowest allocation to equities since October 2008 and the highest allocation to cash since 2001. Futures positioning data shows extremely large net shorts. However, some of this positioning reversed in July. Retail investors do not appear to have adjusted their positioning by anything like as much yet and it is here that the risk of further capitulation is most acute if a recession begins and inflation stays sticky.

We recognise both upside and downside risks, but place more emphasis on the down at present and recommend continuing with a substantial bias towards defensive, diversifying assets and defensive, inflation-resilient companies. This leads us to American and British investments, and some parts of the Japanese market, and away from cyclical European, Chinese and emerging market investments. We prefer cash to government bonds, given the potential overestimation of the rate at which inflation will fade, and look to our strong track record in identifying alternative diversifying assets.

As we set out earlier, we are long-term investors and think it's important to continue to look for well-priced opportunities, particularly those linked to multi-year shifts in how people live and work. Companies with sales growth tied to these opportunities may be more resilient to a downturn if they are able to take market share from their competitors to compensate. The next in our new series of thematic investment reports will focus on the role of construction and building materials in the fight against climate change. Look out for it soon.

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Contact us

If you would like further information or to arrange an initial meeting, please contact us on 020 7399 0000

Head Office
8 Finsbury Circus, London, EC2M 7AZ

For ethical investment services:
Rathbone Greenbank Investments
0117 930 3000
rathbonegreenbank.com

For offshore investment management services:
Rathbone Investment Management International
01534 740 500
rathboneimi.com

@Rathbones1742
Rathbones Group Plc
Rathbones Group Plc