Global Markets Commentary
Recession Scare

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"A recession is… a significant decline in economic activity that is spread across the economy and that lasts more than a few months… Expansion is the normal state of the economy; most recessions are brief."

National Bureau of Economic Research, the official arbiters of the U.S. business cycle, nber.org

Despite headlines that screamed inflation and recession, in July many capital markets around the globe registered their best monthly performance of 2022. The most beaten-down areas saw the biggest bounce.

In equities, previously battered technology and consumer discretionary sectors outperformed. Leading the upward charge were U.S. equity markets, formerly among the biggest decliners. Longer-dated bonds outperformed shorter-maturity bonds as longer-term interest rates fell more than short-term interest rates.

July's major development was a retreat in bond yields, despite continued high headline inflation and outsized rate hikes by central banks. Bond yields nosedived on rising fears that a recession is imminent, plus the possibility that central banks might pause their rate-hiking, inflation-fighting moves in the next six to nine months. If inflation cools somewhat, and jobless numbers rise, then central bankers could shift away from battling inflation and toward supporting employment and economic growth.

The same major macroeconomic forces continue to drive capital markets: inflation, rising interest rates, recession risks, and geopolitics. Although the news media can be somewhat hysterical when they talk about recession, inflation and rising interest rates, it's important to remember that capital markets are forward-looking. July's numbers confirm that markets have been adjusting their expectations over the last six months. How much is priced into stocks and bonds matters (good news or bad). By mid-June, markets had gone a long way toward pricing in interest rate hikes, slowing growth, and recession risks.

Reacting to rising interest rates, the Canadian 10-year bond yield hit 3.6% in mid-June, marking a near-term high. Reacting to recession fears and higher borrowing costs, stock markets also sunk to year-to-date lows in mid-June.

Since then, and accelerating toward the end of July, equity markets rallied about 7% to 9%, based on indications that worst-case scenarios were not going to play out. In turn, 10-year bond yields retreated below 2.7%, a level not seen since early April. There are good reasons to believe that inflation may be near its peak. The hottest parts of the U.S. economy are cooling quickly, but it's not a broad-based decline. Other areas remain healthy.

We're hearing a lot of talk about recession because U.S. real GDP was negative in two consecutive quarters (Q1 and Q2 of 2022). For some observers, this marks the strict technical definition of a recession. Two main factors caused the U.S. economy to contract on an inflation-adjusted basis. First, there was a large decline in construction and real estate spending (which will help to dampen inflation). Second, there was a modest decline in government spending (less concerning than a pullback in the private sector).

Encouragingly, the almighty U.S. consumer – who drives roughly two-thirds of the U.S. economy – continued to shop, but had to dip into the piggy bank to pay inflated prices. U.S. businesses spent money, U.S. exports surged, and the U.S. continued to buy from the rest of the world. These factors are not typically so positive if the U.S. is in a recession. Although this apparent contradiction led some observers to call the recession a *mere* technicality, it does signal that the U.S. economy could be weaker than previously thought. It also suggests that inflation is likely to simmer down, and central banks may be able to curb their enthusiasm for rate hikes.

Cooling inflation, fewer rate hikes, and substantial and significant parts of the U.S. economy remaining healthy are more aligned with a soft-landing scenario than the uglier alternative of a hard recession. The renewed prospect of a soft landing propelled stocks and bonds to post solid positive performance for July after six months of negative performance. Although this supports the conclusion that both stock and bond markets overreacted to the rapidly unfolding events of the first half of 2022, this tandem snapback isn't likely to last long.

By far the most frequently asked question from clients is when and how this will all end.

For fixed income, our research indicates that the levels we saw in June for bond yields are likely close to the peak for the near term. The recent retreat in bond yields has clawed back some of the 2022 losses in fixed income. However, high volatility is rattling the bond market, so July's downturn for bond yields may be an overreaction. We expect continued volatility, with an upward bias for yields from their current levels.

In our view, the most likely scenario for equity markets is that the June lows have already priced in a multitude of interest rate hikes and a shallow recession. If there is no recession, equity markets should be able to stabilize. If there is a more pronounced, broad-based global recession, equity markets would take a few more quarters to stabilize and downside performance would be back on the table. This latter scenario should see fixed income provide some respite.

There is also another scenario that, in our opinion, is less likely to unfold. Inflation remains high, but the economy recedes (stagflation), creating a difficult period for both stocks and bonds. In this case, investors would need to manage their emotions and rely on a long-term investment time horizon.

Canada — Faring better than most

For July, the S&P/TSX Composite rose 4.4%. Nine of 11 sectors gained, led by industrials, consumer discretionary, and information technology (Shopify surged 11%, despite news of layoffs). Recession fears triggered a retreat in commodity prices – except for natural gas. West Texas Intermediate (WTI) oil fell 6.8% to US$98.62 per barrel.

June's annual Consumer Price Index (CPI) inflation rate accelerated to 8.1%, up from 7.7% in May. The Bank of Canada increased its policy interest rate by a full percentage point to 2.5%, its biggest one-time increase since 1998. Canada, the U.S. and New Zealand now share the developed world's highest rate.

In the first half of 2022, Canada's economy outperformed the U.S. economy, which contracted by 1.25% after inflation. Our economy grew at an average pace of roughly 3.75%, a huge 5% swing that reflects Canada's delayed reopening after COVID-19 restrictions. Despite weakness in commodity prices, the loonie ended July at US$0.782 or CAD$1.28, stronger by 0.6%. In the bond market, the Canadian yield curve flattened sharply as 2-year yields fell from 3.09% to 2.96%. A widely held belief that central banks will do whatever it takes to wrestle down inflation prompted longer-term yields to fall more significantly; the 10-year yield slid from 3.22% to 2.61%.

United States — Technical recession

The world's largest economy has now logged two consecutive quarters of negative real GDP growth, the strictly technical, rule-of-thumb definition of a recession that some analysts use. Notably, the National Bureau of Economic Research (NBER) quoted above does not use such a narrow definition. However, the economy appears to be slowing, not crashing. For July, the S&P 500 rose 9.1%, posting its best month of 2022. The U.S. Federal Reserve (the Fed) aggressively raised interest rates (up 0.75%) to combat stubbornly high inflation. Annual U.S. CPI inflation for June hit 9.1%. Faith that the Fed will tame inflation remains solid. Markets are anticipating that, in the longer term, inflation will fall back below 3%. With the U.S. economy showing weakness, market watchers expect the Fed to begin cutting interest rates as early as March 2023.

The U.S. government bond yield curve flattened sharply, and the inversion of the 10-year minus the 2-year yield plumbed new depths at -0.24%. The 2-year yield fell from 2.95% to 2.88%, while the 10-year fell from 3.01% to 2.65%.

Europe — Gas pains

Russia slashed gas flows to Europe through the critical Nord Stream 1 pipeline, further weaponizing essential energy supplies. The Kremlin's goal is to pressure European countries to abandon their support of Ukraine. Surging natural gas prices, inflation, and reduced supply are negatively impacting consumers, businesses, and governments as they scramble to find alternative energy sources.

Returning tourists boosted the eurozone economy in Q2. It enjoyed a surprising, solid 2.8% annualized GDP uptick, despite raging energy costs. After record high inflation readings (8.9% for July), the European Central Bank raised interest rates for the first time in 11 years. The 0.5% increase ends the historic era of negative interest rates, for now. Benchmark German 10-year bund yields followed global bond yields lower, falling from 1.34% to 0.82%. For July, the Euro STOXX 50, German DAX, and Britain's FTSE 100 stock market indices posted strong gains of 7.3%, 5.5%, and 3.5%, respectively.

Asia — Sad news

Shock waves spread around the world following the lone-gunman assassination of former Japanese Prime Minister Shinzo Abe. After his resignation for health reasons, Japan's longest-serving prime minister continued to head the biggest faction within the ruling Liberal Democratic Party.

In June, Japanese core inflation rose 2.2%. Both the government and central bank firmly support higher growth and loose monetary policy, despite negative impacts on the yen. Although a weaker yen constrains the country's collective buying power, it helps Japan's sizeable manufacturing export sector. For July, the benchmark Nikkei 225 rose 5.3%.

China's rebound remains fragile under the cloud of future COVID-19 lockdowns. Although manufacturing activities and exports recovered quickly, the shutdowns impacted all industries. Second-quarter GDP growth sank to 0.4%, threatening Beijing's 5.5% annual growth target. Beijing continues to support growth, recently adding another US$150 billion in infrastructure investment. For July, the MSCI China Equity Index fell 10%.

Our strategy

Our asset allocation remains close to our long-term strategic benchmarks, with some prudent tactical tweaks. Although we are underweight fixed income (bonds), we are maintaining our positions. We believe that bonds will be a risk mitigation tool if a recession unfolds. July's performance supports this view. We continue to reinvest maturing bonds and coupon income at the now-higher level of yields.

We remain slightly overweight to equities, with a bias toward North America – stocks have historically weathered inflation better than other asset classes. Valuations for equities are mildly attractive, especially if corporate earnings growth stays positive. Thus far, globally, corporate earnings growth has been resilient as corporations are passing along price increases. Corporations raising prices is the definition of goods and services inflation.

We continue to monitor portfolios closely for opportunities, yet remain confident that our current positioning is appropriate for these tumultuous times.

The last word

Inflation and recessions are difficult but necessary elements of capitalism. Recessions help cleanse the system of excess. Currently, we have few excesses, which is why we don't anticipate a deep recession.

Higher prices are the cure for higher prices. When prices rise, consumers and businesses change their behaviour. They find cheaper alternatives, or take a pass altogether. When demand falls, prices freeze or decrease. Higher prices also incentivize production and activity. For example, when oil prices go up, oil supply increases; when wages go up, more people want jobs.

While the world is grappling with supply shortages in some areas, these bottlenecks are working themselves out. Even commodity prices (oil, wheat, lumber and corn but not natural gas) have largely retreated to levels seen prior to the outbreak of hostilities in Ukraine. We continue to see robust underlying demand. That supports our prediction that, at worst, we'll have a shallow recession – or likely none at all.

Please contact your Investment Counsellor if you have any questions or would like to discuss your investments.

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