Recession: A price worth paying? House View Q&A (Q4 2022)

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With the release of Aviva Investors' House View Q4 2022, Michael Grady (MG), head of investment strategy and chief economist, discusses the firm's current economic thinking and asset allocation views with Jennie Byun (JB), multi-asset and macro investment director.

JB: Let's start with the overall growth picture. We've moved from slowing growth to recession. What does the growth (or lack thereof) picture look like?

MG: The persistence of upside inflation surprises in 2022 has created a dynamic not seen for decades. Central banks need to see enough of a slowdown in demand to ease underlying inflationary pressures. Too much tightening could push economies into recession, while too little could result in a more persistent inflation problem.

At this stage, we think the risk management decision for central banks will be more likely to result in the first of those two outcomes. As such, we expect growth in developed markets to be weak in 2023, with most experiencing some form of mild recession, characterised by little growth and rising unemployment. Growth in emerging market economies is expected to be a little firmer, reflecting an improving situation in China. Overall, we expect global growth to slow to around three per cent in 2022 and 2.25 per cent in 2023.

JB: As you headlined one of the themes in the publication, this is a monetary policy-induced recession. Where do we see monetary policy moving from here and what are your projections for rate hikes across major developed central banks?

MG: Yes, indeed. As the OECD made clear in its updated September assessment of global prospects, "[a] key factor slowing global growth is the generalised tightening of monetary policy, driven by the greater-than-expected overshoot of inflation targets".

In other words, part of the slowdown can be now attributed to central bank actions that have been – and are expected to remain – more aggressive than previously thought. Arguably, some central banks probably now believe a downturn or recession is almost necessary to address the more fundamental rise in inflation than that driven by energy prices alone.

In the US, we expect the policy rate to peak around 4.5 per cent by early 2023, with the risks tilted to the upside. In the UK, the Bank of England is torn between acting forcefully to tame inflation and adding to the growth headwinds and economic pain; moreover, the recent mini-budget has created greater market volatility due to increased uncertainty. We expect its policy rate to increase materially over the next six months, although not as much as the six per cent currently priced into financial markets.

Elsewhere, the European Central Bank is poised to raise policy rates further as well, to around three per cent through 2023. The Bank of Japan remains the outlier; changes to its yield curve control policy would lead to higher yields, but this may only happen at the end of Kuroda's term in early 2023.

JB: You mention the likelihood is one of a mild recession. What could tilt that balance either way?

MG: Recessions are not inevitable (as they were, for example, during the pandemic). But they now look likely in several parts of the world, with pain reflected in plunging sentiment and retrenchments in discretionary spending.

The mood will be further affected by energy rationing over the winter months, should it be required (and worries about that even if it is not) and sharply higher borrowing costs. This will impact all businesses and households with debts, most notably mortgage borrowers on variable rates or those who have to refinance. The huge uncertainties regarding the conflict in Ukraine, alongside the prospects for inflation and interest rates, are not a backdrop conducive to higher investment spending, while weaker labour markets – an inevitable consequence of slower growth – will hold back consumer spending.

In addition, the more specific and localised worries in China, including the impact of zero-COVID policies, property market strains and possibly misguided policy responses, are adding to those downside risks in a nation of increasing importance and still a hugely significant global exporter and importer.

It is important, however, not to get too gloomy. The next six months or so are going to be tough, but if inflation does start to fall back decisively, if fiscal policy remains sensibly supportive, and – more speculatively – if some sort of resolution to the war in Ukraine becomes more plausible, then any recession could be both shallow and short-lived by historical comparison. In particular, there are far fewer global imbalances (either private or public) which require cathartic and painful adjustments that generally take place during recessions. Both household and corporate balance sheets are in good health by historical standards.

JB: It was only a year ago where we were coming out of the temporary versus structural high inflation debate. Do we run serious risk of a return to the conditions experienced in the 1970s?

MG: Visually at least, the recent inflation experience represents a stark change to previously low and stable inflation and prima facie evidence that something has gone very wrong and/or that policy mistakes have been made.

We believe any judgement on policy error is more likely to be applied to the long period of exceptionally loose monetary settings between 2008 and 2020 than to the current episode of aggressive tightening. And that includes not just very low – even below-zero – policy rates, but also the array of unconventional policy instruments, collectively known as QE.

The clear lessons from the past are that the alternative would be worse. By not addressing the issue now, inflation would become even more ingrained in behaviours and the eventual demand and output adjustment needed to bring it back to target would be even more painful. We believe central bank efforts – and a reduction in those supply-side shocks – mean inflation will fall back in 2023. But even if it does, it will be some time before policymakers can relax and consider first a pause and then a reduction in policy rates.

JB: Sticking with comparisons to the 1970s, the energy crisis caused by the Russia-Ukraine conflict has parallels with that era. Are there any gleanings we can take from that period?

MG: Comparisons can be made with the transition to green energy. The current energy shock bears some comparison to the twin crises in the 1970s. Those events inflicted short-term pain but led to far-reaching changes to the energy industry that were in the end beneficial.

Longer-term aspirations for green energy are appealing and, we hope, realistic. But they will not inevitably be achieved. Governments are being pulled both ways – ease and speed the transition but keep prices low. They will not all do the right thing. Some may prioritise short-term relief through increased fossil fuel production or distorting subsidies, potentially exacerbating the climate crisis.

The green transition remains a laudable ambition. Recent events may both help and hinder, but care needs to be taken to ensure macroeconomic policy adapts dynamically to present circumstances and continues to smooth the path to cleaner energy and less pollution.

JB: How much leeway do governments have with fiscal policy?

MG: Fiscal policy was already moving into the ascendency before the pandemic, but the COVID-19 experience accelerated that journey. The reaction to it reveals very different attitudes to issues of fiscal sustainability than those that prevailed for decades.

However, there is still a danger the high regard in which fast and flexible fiscal programmes are held now obscures some of the realities of their longer-term consequences. Bluntly, the rules of fiscal sustainability have not been rewritten.

The key relationship is between the real rate of interest which governments pay on their debt and the growth rate of the economy. Growth is slowing, inflation may have peaked and should fall significantly next year and beyond and interest rates are rising quite rapidly. Public sector debt is now more than 100 per cent of GDP in most G7 nations.

The IMF recently acknowledged that while fiscal support in the face of the energy shock was warranted, it "should be temporary, concentrated on the most vulnerable, preserve incentives to reduce energy consumption and be withdrawn as energy price pressures wane".

JB: How does this translate into asset allocation?

MG: The deteriorating macro environment creates a challenging outlook for credit and equity markets, with outcomes skewed toward downside scenarios. Bear market rallies may occur, but for as long as central banks are actively tightening to slow economies, the market will struggle to sustainably price an improving outlook for growth and the current risk-off environment for growth-sensitive assets will persist.

We further reduced our equity exposure, which now stands at neutral across most markets except Europe, where we have a slight underweight, and the UK, where we have a slight overweight.

Given current yields in major economies, the outlook for fixed income over the longer term is likely positive. However, timing the entry will be tricky and highly sensitive to the depth and breadth of inflationary pressures. We remain underweight government bonds and high yield, with investment grade and higher-grade emerging-market debt preferred alongside a heavy long dollar overlay.

JB: Lastly, do you see any interesting opportunities to generate returns in this very challenging environment?

MG: With so much of the outlook determined by inflation and the subsequent policy response, it is unsurprising that market volatility has been elevated. As we have seen in the UK in late September, fiscal policy can have sizable ramifications for market pricing and monetary policy decisions. Divergences in fiscal policy could create opportunities for relative-value plays going forward. Playing these divergences will also help reduce the need to perfectly time the rotation from short to long bonds.

For example, currencies with less hawkish central banks and deteriorating terms-of-trade have been more at risk – such as sterling, yen, won and yuan. A handful of emerging markets also have wide trade deficits and problematic fiscal metrics. However, many EM currencies benefit from high commodity prices, and have raised interest rates to quell inflation and stabilise exchange rates. As such, EM FX may outperform many G10 currencies, especially when carry is considered, even as the US dollar remains 'king'.

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