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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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Investors Must Remember the Asynchronous Nature of Financial and Business Cycles

Last week, the US recorded a second consecutive quarter of negative growth (-0.9 q/q SAAR), after Q1 1.6% contraction. Traditional economic theory would suggest that the US has entered a technical recession, however prominent economists and policymakers suggest this may not necessarily be the case. Former US Secretary of the Treasury Lawrence Summers said that the US is not in a technical recession because the largest negative contribution to GDP growth came from a drawdown of inventories, which is partly a sign of the economy's strength. In effect, inventory decumulation provided a -2% contribution to Q2 growth, while export and consumer spending provided positive contributions.

Previously, Federal Reserve Chair Jay Powell said that, even in the case of two consecutive quarters of negative growth, the US would not be in a technical recession because the first quarter's negative figure may be due to residual seasonality (and may be revised subsequently), and that the broad-based contraction in economic activity that is typical of a recession is not yet there, in spite of the clear weakening of growth observed by the central bank in Q2 2022.

So, the question remains: are the world's major economies entering a recession at some point this year? If inflationary pressures persist, if the energy crisis intensifies, and central banks continue to increase rates to combat rising prices, *it is almost inevitable that between Q4 2022 and Q1 2023 a recession will begin*. While a vast majority of economists expect that such a recession, if it does occur, will be shallow, Nouriel Roubini expects it to be sharp and prolonged, given the stagflationary global debt crisis that is accompanying it. Even if those conditions mentioned above do not materialise all at once, it will still be very difficult to avoid some form of hard landing, in spite of central banks' best efforts.

Let us assume then that some form of recession will materialise between 2022 and 2023. What would the implications of this be for central banks and markets? Central banks would likely have to stop increasing rates, as the recession will cause the tightening of economic and financial conditions that central banks are pursuing with their current policy actions. Money market futures do predict that the Fed and the BOE, for example, will cut rates in 2023. We expect a deceleration in the pace of tightening from the Fed and the ECB towards the end of 2022.

As far as markets are concerned, investors celebrated Powell's words accompanying the Fed's second consecutive 75bps rate increase in July with a relief rally. Powell said that the Fed will decide its policy meeting by meeting, since it is data dependent; in the past, when central banks become "data dependent", this has generally been seen as anticipating a shift in stance, in this case towards a less aggressive posture. So, is it possible that, even as the economy is about the enter its worst phase, financial markets will hit bottom and start recovering?

Well, yes, it is entirely possible that this will occur, given the asynchronous nature of the financial and business cycle. Financial markets tend to anticipate what happens to the real economy (and even more so the labour market, which is a lagging indicator), as they are able to immediately reflect new information into prices (if one believes in the "efficient market hypothesis"). Over the years, empirical models have been developed to formalise this relationship. For example, an inversion of the yield curve (as is the case in the US currently) is considered to be a predictor of an upcoming recession. Equity markets tend to hit bottom a few quarters before a recession ends (as happened in March 2009 in the US, for example). But even Hyman Minsky's "financial instability hypothesis" suggests that the financial cycle turns well before business cycles do.

In coming months therefore we may observe financial markets bottoming out, while the economy tanks. There is one big *caveat* here, though. If the recession morphs into a systemic crisis, for example by triggering a stagflationary debt crisis – as Nouriel Roubini suggests may happen – then both equity and bond markets may experience another leg down, as commodity prices continue to increase given supply bottlenecks and the impact of the war in Ukraine.

Our Recent Publications

- Flash Preview: BoE To Increase Bank Rate by 50bps in August, *by Brunello Rosa and Nato Balavadze, 29 July 2022*
- Flash Review: Fed Hikes Fed Funds by 75bps, But Ongoing Rate Increases Will be Data Dependent, *by Brunello Rosa and Nato Balavadze, 27 July 2022*
- Preview: For Now The Fed to Continue Its Policy Tightening Undeterred by The Weakening Economy, *by Nouriel Roubini, Brunello Rosa and Nato Balavadze, 25 July 2022*
- **GEOPOLITICAL CORNER:** A Man-Made Crisis: The International Technocracy Is Culpable in the Assisted Suicide of Sri Lanka , *by John C. Hulsman, 19 July 2022*

Looking Ahead

The Week Ahead: Unemployment To Be Unchanged In US And EZ; PMIs To Decrease In DMs, Even To Fall Below 50 In US And EZ

In the US, in July, the unemployment rate is expected to stay unchanged at 3.6% and NFPs are likely to slow down to 250K (*p:* 372K). In July, manufacturing and service PMIs are seen decreasing to 52.3 (*p*: 52.7) and 47 (*p:* 52.7) respectively. Composite PMI is expected to fall to 47.5 (*p:* 52.3).

In the EZ, in June, the unemployment rate is expected to stay unchanged at 6.6%. Also in June, retail sales are likely to shrink by -1.6% y-o-y (*p:* 0.2%). June's PPI is seen rising by 35.7% y-o-y (*p:* 36.3%). July's manufacturing and service PMIs are seen falling to 49.6 (*p*: 52.1) and 50.6 (*p:* 53) respectively. Composite PMI is expected to fall to 49.4 (*p:* 52).

In the UK, in July, manufacturing and service PMIs are seen falling to 52.2 (*p*: 52.8) and 53.3 (*p:* 54.3) respectively. Composite PMI is expected to fall to 52.8 (*p:* 53.7).

Still in the UK, the BoE is expected to increase its Bank Rate by 50bps 1.75%.

The Quarter Ahead: EU-wide Plan on Gas Rationing Is Reached; The US Imposes Sanctions; IMF Cuts Global Growth Outlook

EU Energy ministers reach a deal on a 15% gas reduction plan. Voluntary savings of 15% from now until next spring could amount to 45 ml cubic meters of gas. The European Council noted that there could be 'some exemptions' from a mandatory reduction target in the event of an emergency. Meanwhile, Russian Gazprom suspended gas supplies to Latvia.

The US announced a new package of sanctions against Russia. The US unveiled new sanctions on two Russians individuals and four Russian entities accusing them of supporting Moscow's global malign influence and election interference operations. According to US authorities, the sanctioned individuals and entities raised funds and spread false information to derange the American electoral process. As reported, the measures need to be taken separately from war-related sanctions.

In its updated World Economic Outlook, the IMF slashed economic forecasts again. The IMF warned *of 'an increasingly gloomy and uncertain outlook'*. Higher-than-expected inflation, China's lockdown, and negative spillovers from the war weigh on the global economy and could push it to the brink of recession. World growth is seen slowing from 3.2% in 2022 to 2.9% in 2023.

Last Week's Review

Real Economy: QoQ GDP Shrank In US And Rose In EZ; EZ Inflation Accelerated; US PCE Increased; Fed Hiked Rates

In the US, in Q2, according to advance estimates, GDP shrank by -0.9% q-o-q (*c:* 0.5%; *p:* -1.6%). PCE and Core PCE rose to 6.8% y-o-y (*p:* 6.3%) and 4.8% y-o-y (*p:* 4.7%). July's Michigan Consumer Sentiment increased to 51.5 (*c:* 51.1; *p:* 50).

Also in the US, the Fed increased its target Fed funds range by 75 bps to 2.25% - 2.5%.

In the EZ, in Q2, according to flash estimates, the economy expanded by 0.7% q-o-q (*c:* 0.2%; *p:* 0.5%) and slowed down to 4.0% y-o-y (*c:* 3.4%; *p:* 5.4%). In July, headline and core inflation rose to 8.9% y-o-y (*c:* 8.6%; *p:* 8.6%) and 4.0% y-o-y (*c:* 3.8%; *p:* 3.7%). July's economic sentiment decreased to 99 (*c:* 102; *p:* 103.5) and consumer confidence deteriorated further to -27 (*p:* -23.8) as expected.

Among the largest EZ economies, in Q2, *i)* France's GDP advanced by 0.5% q-o-q (*c:* 0.2%; *p*: -0.2%) and grew by 4.2% y-o-y (*p:* 4.8%) *ii)* German economy reports 0% q-o-q growth (*c:* 0.1%; *p:* 0.2%) and 1.4% y-o-y (*c:* 1.7%; *p:* 3.8%); and *iii)* In Italy, GDP rose by 1.0% q-o-q (*c:* 0.3%; *p*: 0.1%), whereas it slowed down to 4.6% (*c:* 3.7%; *p:* 6.2%). July's annual harmonized inflation rate: *i)* rose in France to 6.8% (*c:* 6.7%; *p:* 6.5%); *ii)* surged in Germany to 8.5% (*c:* 8.1%; *p:* 8.2%); and *iii)* decreased in Italy to 7.9% (*c:* 8.1%; *p:* 8.0%).

Financial Markets: US And EZ Stocks Post Gains; Yields Fell; Dollar Slides, While Oil And Gold Prices Rose

Market Drivers: Investors worry more about the recession than inflation, even though the U.S. annual PCE inflation posts the largest increase since 1982. It is believed that the economic downturn would cause the Fed to soften its aggressive hiking campaign. As a result, the dollar weakened versus the EUR and equities rallied.

Global Equities: Increased *w-o-w* (MSCI ACWI, +3.3%, to 637.7). The US S&P 500 index increased (+4.3% w-o-w, to 4,130.3). In the EZ, share prices were up (Eurostoxx 50, +3.1% w-o-w, to 3,708.1). In EMs, equity prices increased (MSCI EMs, +0.7%, to 993.8). Volatility fell to 23.4 (VIX S&P 500, 52w avg.: 23.4; 10y avg.: 18.1).

Fixed Income: *w-o-w*, 10-year US treasury yields fell (-9.6 bps to 2.66%). The 2-year US Treasury yields decreased too (-8.2 bps to 2.89%). The German 10-year bund yield also fell (-20 bps to 0.83%).

FX: *w-o-w,* the US Dollar Index was down (DXY, -0.9%, to 105.7; EUR/USD +0.1%, to 1.02). In EMs, currencies strengthened (MSCI EM Currency Index, +0.7% w-o-w, to 1,661.11).

Commodities: *w-o-w,* oil prices rose (Brent, +5.7% to 104 USD/b). Gold prices also increased w-o-w (+2.1% to 1,764 USD/Oz).

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The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*

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