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Economic quick take

In our Summer quarterly, we proposed a 50/50 chance of recession arising in the second half of 2024. Since then, services inflation has proven more stubborn, headline US labour data remains strong, and commodities have recently ticked up. This data has resulted in a reduced volume of interest rate cuts priced in by markets and pushed back their expected commencement.

Although this tightening of financial conditions has been partially offset by tightening credit spreads, the probability for a hard landing (recession) occurring in the second half of 2024 has marginally increased, to perhaps 55%. The more material change since last quarter is the 30% probability that inflation (expansion) will re-emerge, showing how challenging and unlikely it is to engineer a durable soft landing.

Economic update

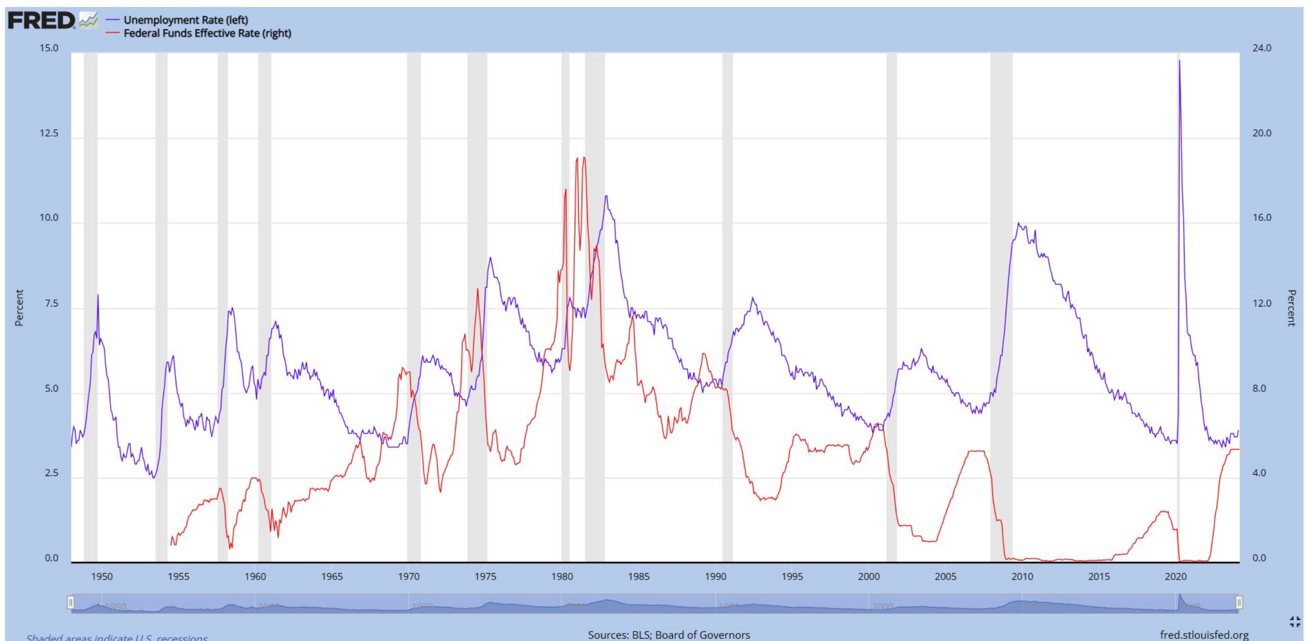
"Those that fail to learn from history are doomed to repeat it" – Winston Churchill, 1948.

A cursory glance at interest rates and unemployment since 1948 shows us the repeatability of the business/economic cycle. The beginning of a 'business cycle' occurs when unemployment is high and interest rates are low, encouraging business investment with ample labour available to meet increasing demand. This leads to an increase in the GDP. This expansion phase is supported by rising levels of employment.

As unemployment approaches its lower bound (i.e. full-employment or NAIRU), a mismatch between available labour supply and employer labour demand arises. This inhibits the productivity of labour through heightened wage pressure and inappropriate hiring practices, as well as exhausting the capacity to grow GDP through additional employment gains.

If we focus on the right-hand side of the below graph (i.e. the present), and looking at the blue unemployment line, it appears we are in the late stage of a business cycle. GDP growth from employing more people has been exhausted. GDP growth can only be durably supported by labour productivity and/or inflation.

Interest rates act as an external disruptor to a late-stage business cycle seeking to subdue inflation emerging as a driving force of GDP growth. This has rarely resulted in a benign outcome, that is a 'soft-landing'. This should make investors more cautious, although so far markets appear complacent about the lessons from history.



To prolong a late-stage business cycle (i.e. a soft-landing), interest rates need to first slow the economy successfully, tamping inflation pressure, then quickly pivot to a neutral setting, without reigniting inflation.

Central Banks probably need to begin pivoting back towards neutral rate settings somewhat pre-emptively before a labour market deterioration became entrenched, which would bring about a phase transition to a hard landing. Nervous central bankers appear unlikely to pre-emptively lower rates, which underwrites our non-consensus view that a phase transition to contraction remains more likely in late 2024 (or early 2025) (i.e. a 55% chance of recession vs 30% chance of inflation re-emerging)

However, a recession might not have to be deep as central banks have ample capacity to cut rates materially to arrest a painful downturn like the GFC.

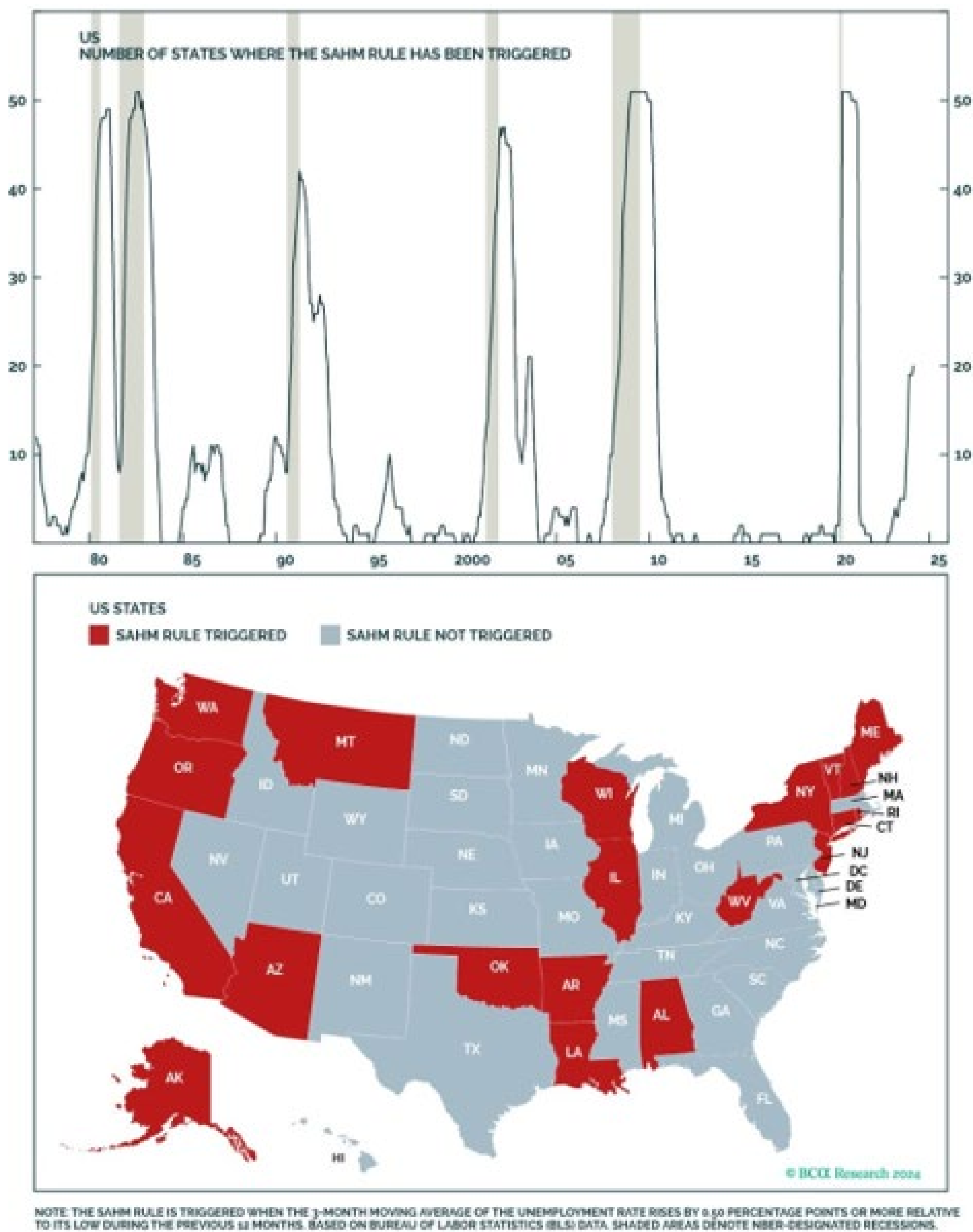
There are no forgone conclusions and there are some reasonable explanations why a recession may not arise:

1. Central bankers grow more tolerant of above-target inflation and that may allow for a soft-landing, or even no-landing, to be achieved. Former PIMCO CEO and Chief Economic Adviser to Allianz, Mohamed A. El-Erian, believes "*Central Banks stepped away from a very strict inflation target to a broader concept of an inflation target*".
   Or
2. Current interest rates might not be particularly restrictive. If current interest rates are closer to neutral than we realise, meaning structural changes have raised the neutral rate materially, the economy may fall into that improbable equilibrium, as engineered in 1995. In 1995 this prolonged the business cycle by nearly five years.

An economy is a complex system and phase transitions are non-linear, making them difficult (if not impossible) to forecast. The business cycle has generally been incompatible with maintaining a neutral state for a prolonged period. The economy appears to exist in either a contraction or expansion phase, and although tipping points between phases look neutral, the probability of an external factor (in this case interest rates) being perfectly calibrated to move an economy from growth to neutral is very low. Similarly, fiscal and monetary support through the pandemic over-stimulated the economy. It is extremely hard to calibrate policy settings.

Recent stickier inflation and weakening leading labour market data also highlight the difficulty of engineering a neutral outcome. Either sticky inflation or weakening labour markets is likely to bring about a state of change. Our view being it's nearly twice as likely to be greater unemployment. In the US, the Sahm rule[1] has being triggered in 20 US states. US full-time employment has decreased for five consecutive months.

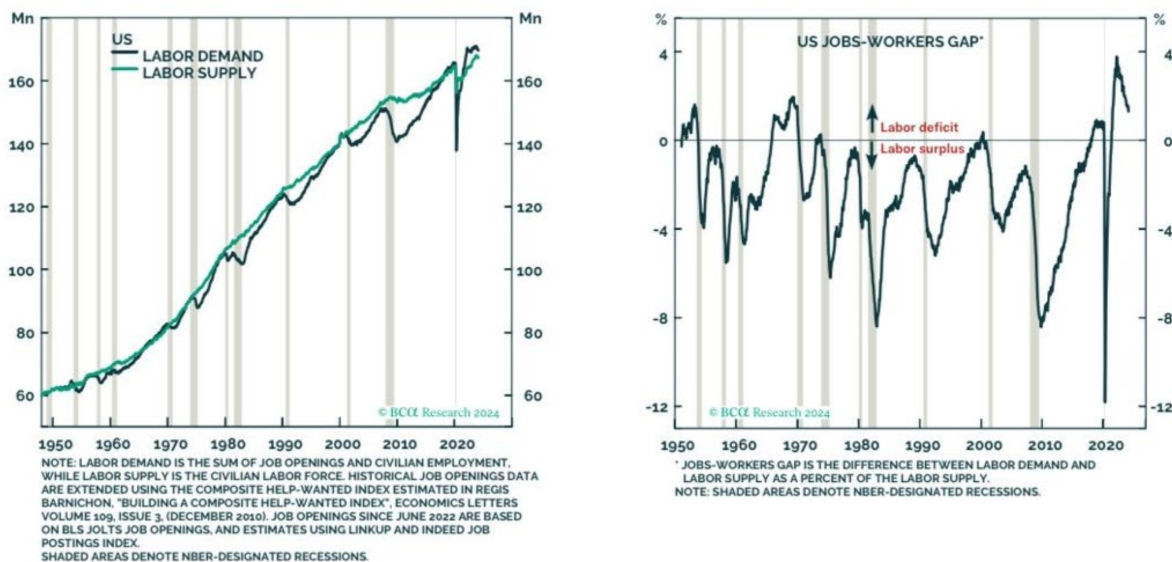
It remains months until the Fed might cut rates, and it is increasingly likely that the labour markets will weaken further.



[1] Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to its low during the previous 12 months

Considering how important nominal employment growth is to sustaining a business cycle, without higher unemployment in the short term, meaningful GDP growth (short of a productivity miracle or inflation disaster) seems unlikely in the medium term.

Although the unemployment rate has only marginally edged up, an imbalance remains between demand for labour and labour availability. Labour shortages contributed to supply side inflationary pressures (increased production costs and so increased goods and services prices). As the below graph shows, this imbalance is fast correcting. However, while it remains, premature easing would likely result in a near immediate inflation impulse. The current labour deficit is likely to continue to insulate economies from recession in the immediate future. But once vacancies are absorbed, unemployment is likely to break considerably higher.



BCA Research

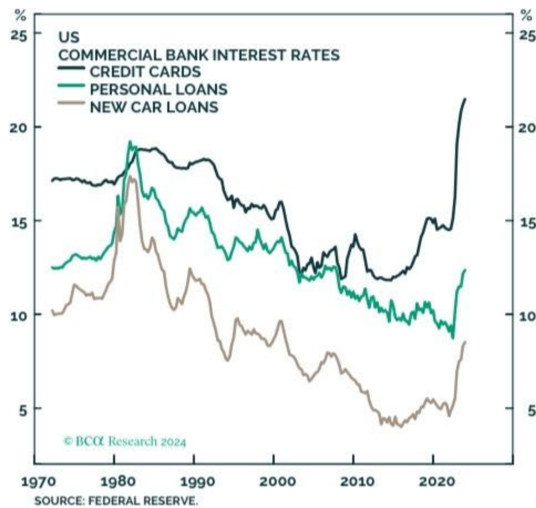
Andrew Norelli, JP Morgan, a month ago, said "*Looking back at 75 years of data, the US economy has never spent more than 24months at full employment. And since the post-Volcker era in the 1980's, the US has never spent more than 18months in full employment. By our estimations, the US economy is at least 22 months in full employment, and this is the 25th month that the unemployment rate has stayed below 4%*". He continued by saying that to stick a soft landing, "*would mean maintaining unemployment rate at around 4% for another year. This would be 36 months of full employment – an unprecedented outcome*".

Leading labour market indicators, which are better indicators of labour market conditions than unemployment, are all weakening. The Quits rate is falling, job vacancies are dropping, and the job-leaver to job-stayer differential has nearly evaporated. This is as expected if monetary settings are restrictive. For a deeper discussion on labour markets, we discuss the 'kinked' Phillips curve framework later in this quarterly.

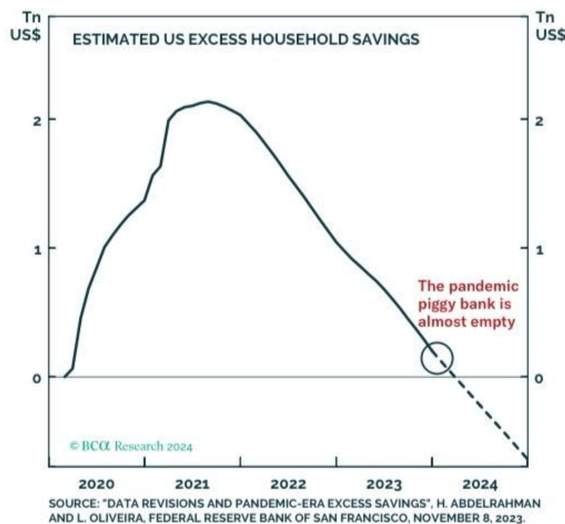
For long term investors, it is not even clear which outcome would be preferred (soft or hard landing). A recession leads to the creative destruction of less productive businesses allowing for more efficient use of labour, eventually leading to more efficient and profitable businesses in the medium and long term; although this is extremely painful (both emotionally and financially) for the workforce who are 'redistributed'.

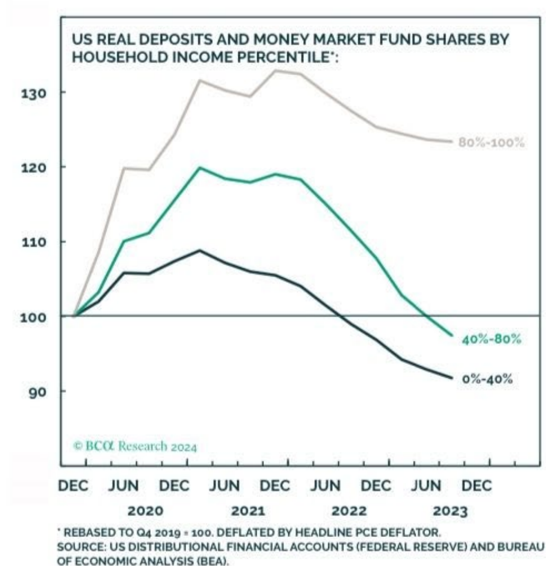
One common argument as to why the US economy may avoid recession is the strength of the US consumer, where consumption is c.70% of the US economy. This view assumes the US consumer is strong and will continue to be supported by wage growth through 2024, which sustains consumption momentum and GDP.

However, the US consumer does not look strong. Banks are less willing to lend to consumers (below right) and consumer credit interest rates have risen sharply (below left).

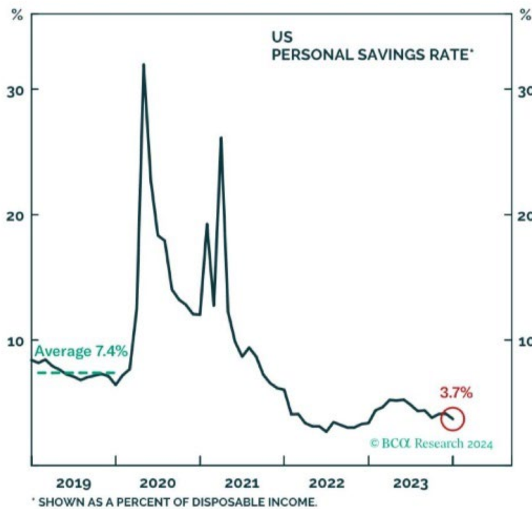


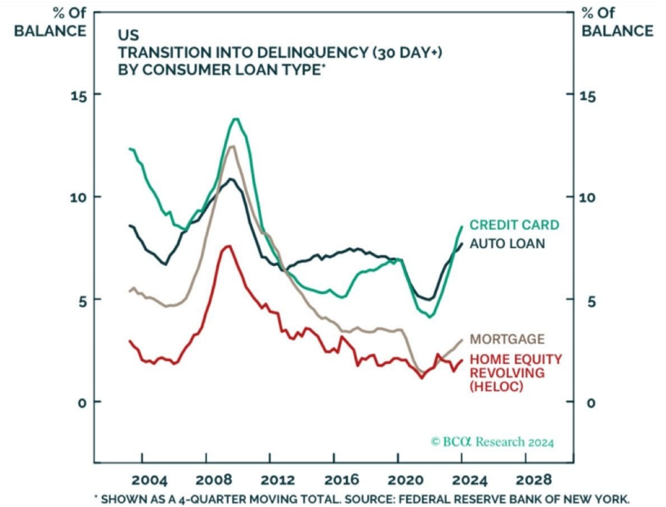
Pandemic savings are nearly empty (below left). In particular, the bottom 80% of households are worse off than before the pandemic (below right).



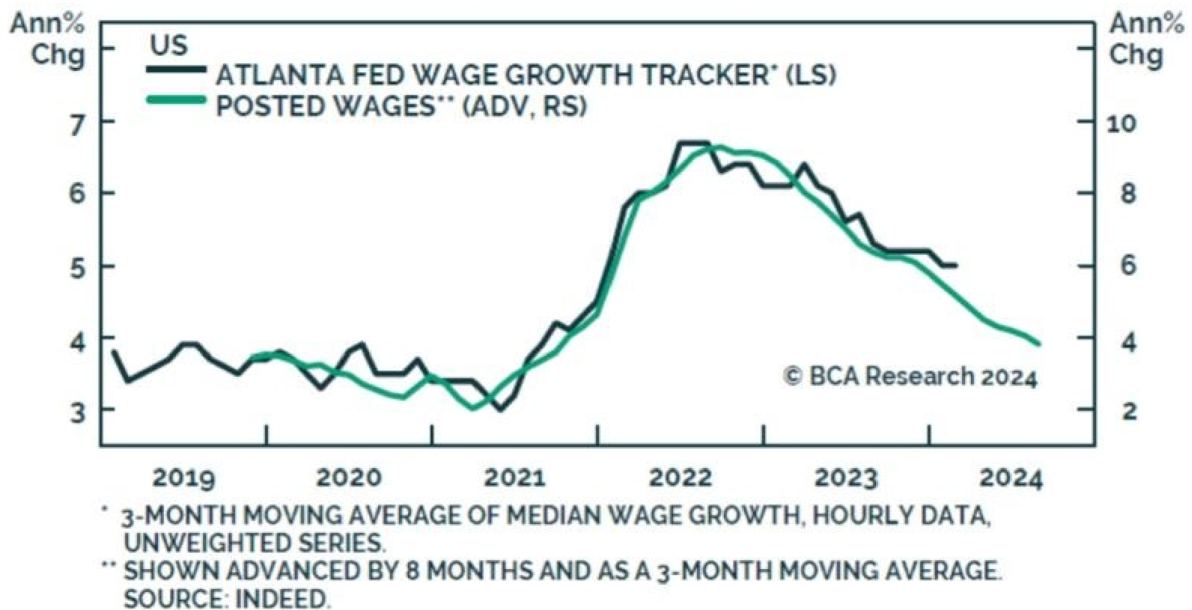


The US consumer savings rate is below pre-pandemic conditions (below left) and delinquencies are rising (below right). "*Credit card delinquencies are at their highest level since 2012 (when unemployment was 8%)* – Peter Berezin, BCA Research

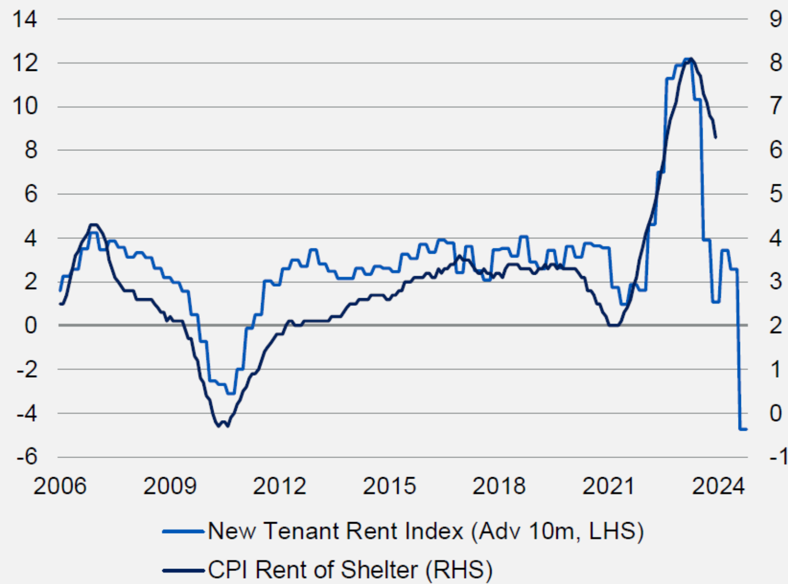




Overall, based on leading indicators, wage growth looks set to fall (graph below). Like other indicators, deteriorating conditions are often from high starting points, pushing a recession to later in the year (if at all).



There remains lingering doubt about the stubbornness of services inflation. Wage growth looks set to fall. Another key component of service inflation is shelter (housing) costs, leading indicators speak to easing shelter pressure (see graph below). Should shelter inflation follow trend, a final victory in the fight against inflation remains probable later this year (assuming financial conditions are not prematurely eased).



Whilst interest rates remain restrictive, economies will continue to cool. Often recessions emerge quickly out of nowhere. The market may be correct in pricing an improbably soft landing, but pricing out a recession entirely seems unrealistically optimistic.

Aside from interest rates, there are elections and geopolitical tensions to consider. There's never been a time like it… or has there.

1948 or 2024?

"History doesn't repeat itself, but it often rhymes" – Attributed to Mark Twain.

In the U.S. there is a shortage of new housing, high inflation (although falling), low unemployment and the economy appears to be booming. Yet Americans aren't feeling economically better off. There is a democrat in the Whitehouse with an approval rating at 36% and emerging conflict between Israel and the Arab world… The year is 1948.

For reference President Biden's approval rating is c.39%.

During post war United States, food rationing was lifted and demand to restock wardrobes/pantries, in addition to an influx of returning veterans struggling to find accommodation, saw pent-up demand create an inflation shock. 1948 was an election year, with inflation at 10% in January. Truman's polling numbers plummeted, and re-election seemed unlikely.

Then, in late 1948 an economic miracle arose, inflation halved over 10months, without falling into recession. American voters felt the warm glow of economic prosperity. Truman confounded polling and won. Truman campaigned on a populist campaign lampooning a "do-nothing Republican congress"… A campaign message hiding in plain sight for President Biden.

In 2024, US disinflation is ahead of what it was at the same time in 1948. In 1948 Truman gets elected and shortly thereafter the US falls into recession in response to higher interest rates slowing the economy. The bad news for Biden is that 2024 appears to be a few quarters ahead of 1948. If a recession emerges ahead of the

election in November (not a consensus view but not improbable in our view), what does that mean for US politics and the presidential election? Not easy to answer.

Labour markets in depth – Kinked Phillips curve

Looking for your next stimulating dinner party conversation topic… this next section is not for you.

Historically unemployment in the US has either risen by less than 0.5% or greater than 2%. There has never been an instance of unemployment rising only 1%, a requirement to stick a soft landing. In Australia, unemployment recently rose from a cycle low of 3.4% to 4.1%, it then surprised by going back to 3.7%. Staying in Australia, 92.8% of all net job additions over the last six months have being part-time (average hours worked is falling rapidly). Full-time employment gains have essentially flat-lined.

Will unemployment plateau at 4.0-4.5%? Consensus is saying it might because "this time is different". However, is it different, and if so, why? This has not been adequately explained by those with that view.

The Kinked Philips Curve framework provides an intuitive way of thinking about the relationship between unemployment and inflation, whilst also providing a rationale as to why unemployment has historically accelerated rapidly higher. A video explanation is available here.

The Phillips curve is the relationship between unemployment and inflation. The initial model was somewhat linear between the two variables (unemployment down, inflation up etc). This linear relationship wasn't supported by real world data. However, by incorporating a linear spline, this introduced kink much better reflects real world experience.

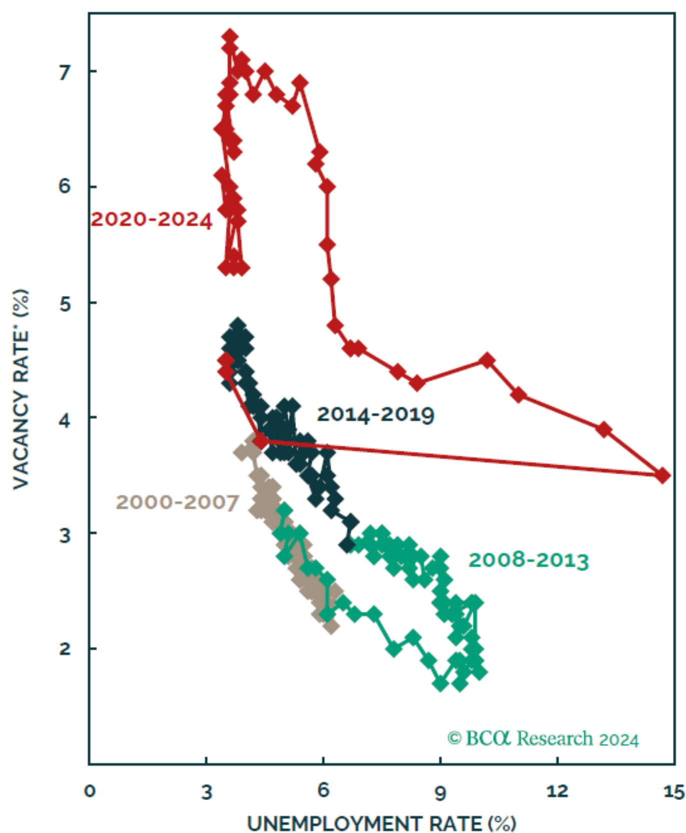
As economies reach full employment, inflation pressure kinks higher as labour markets become highly sensitive to additional pressure. At full employment, bargaining power shifts dramatically from employer to employee, with employers paying a premium to poach or keep employees from other companies, creating cost-push inflation. This also stimulates demand pull inflation as higher wages enhance purchasing power.

Pandemic induced stimulus created an explosion in employee demand and job vacancies (Beveridge curve, graph right). Recent history in Red shows incredible levels of vacancies. This vacancy bulge shielded economies from recession in 2023 and will continue to insulate economies a little longer yet.

Tight monetary conditions are slowly eating into the vacancy bulge (which is still above pre-COVID levels). Workers suffering job losses in a slowing economy have easily found work elsewhere to date.

As vacancies continue to fall (as shown by the falling right tracking data), unemployment will eventually balloon out.

It remains possible for Central Banks to get the timing right and cut interest rates early enough to prevent a



recession emerging. However, historically **it seems more likely that the Central Banks will not lower rates early enough, and rising unemployment will accelerate a further deterioration in aggregate demand faster than any lagged benefits from the lowering interest rates can offset.**

Central Banks are in a tough position. Loosen financial conditions prematurely (as markets priced in through the last quarter of 2023) and risk an immediate inflation bounce above the disinflation trend. Or, wait until vacancies are absorbed, and you risk a breakout in unemployment that snowballs. It is very difficult to get the timing right.

Most of the above discussion is focused on the US. As they say *'if the US sneezes the rest of the world catches a cold'.* New Zealand, United Kingdom, Germany, Japan have all had technical recessions. Canadian unemployment recently surprised higher to 6.1%. Australia is in a per-capita recession and the IMF recently painted Australia as the most sensitive economy in the world to interest rates. China's economic problems are well known.

If the US does sneeze, it might be infecting an immuno-compromised global economy.

Investment Update

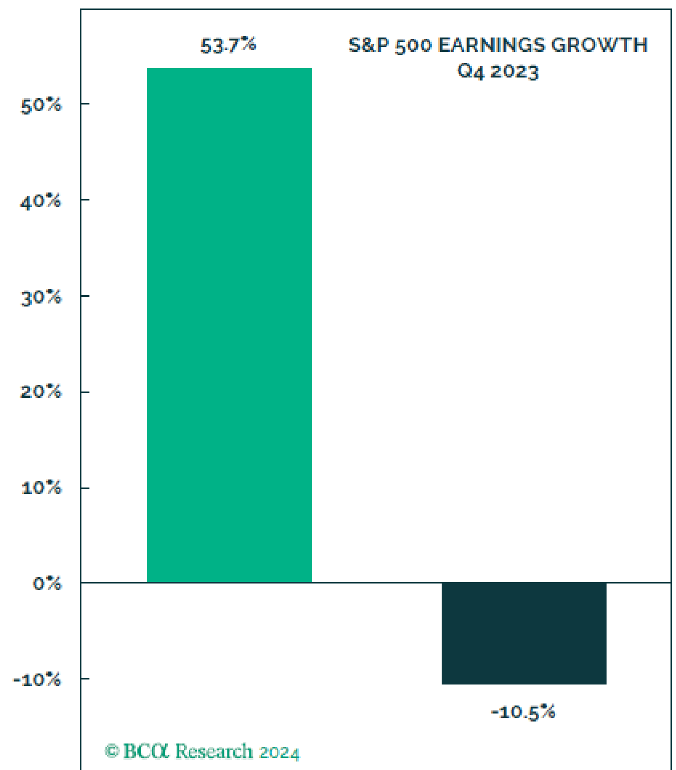
Quick take

The risk reward for being overweight in growth investments is now unattractive. Investor sentiment is at odds with current subdued growth, earning deteriorations and elevated funding costs. It has been said in the past '*Be fearful when others are greedy*'.

We are now more tactically defensive (c.10% below strategic growth asset allocation targets) in our investment recommendations. We will likely remain here until either recession arrives, or there is a clearer signal a new business cycle has emerged, or interest rates are around their neutral settings. This is unlikely to become clear until early 2025.

Bonds

- Recent inflation data has firmed to push out a first interest rate cut to the second half of 2024, and possibly only a small cut. This has seen yields rise through the quarter making global bonds relatively more attractive.
- We increased weighting to global fixed income through the quarter, back to benchmark. We remain tactically overweight in Australian fixed income, seeing Australia as more susceptible to succumbing to interest rate pressure, as well as there being less complexity with Australia's sovereign debt position.
- Either bonds deliver an acceptable yield in a soft landing or capital appreciation in a hard landing/recession. Capital upside in a hard landing would be material given how few rate cuts are now priced in.
- There remains scope for a further outbreak in inflation which would see bonds underperform in the short term (albeit still most likely low single digit positive returns). Nevertheless, bond investment performance in the medium-term is likely to revert to an even higher yield and this scenario potentially increases the probability of a harder landing in the more distant future, leading to even higher capital upside.

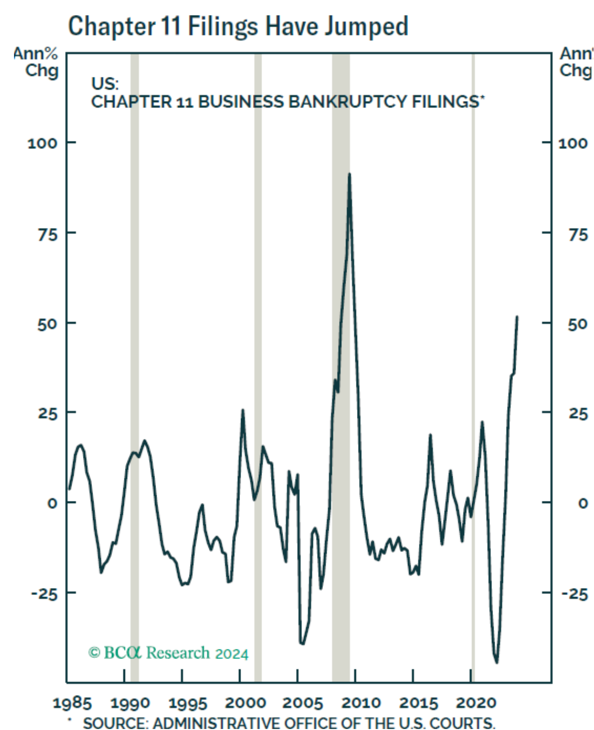


Equities

- One of the confusing statistics is the apparent success of equity markets during a period of increasing interest rates. A large part of this success is concentrated to six stocks. As the graph to the right shows, once we omit the magnificent six stocks and their earnings growth, the average annualised earnings growth in Q4 of the S&P 494 was-10.5%.
- We retain concentrated positions to some of these magnificent six equities in our client portfolios. Some of these companies have compelling earnings growth prospects unimpacted by short-term macroeconomic changes, generating revenue from a global customer base through a product/service almost monopolistic in nature.
- Companies reduce their workforces when earnings deteriorate. As discussed above in our kinked-Phillips curve discussion, current vacancies are absorbing the shedding of staff at present. However, should

unemployment figures jump, most company earnings will deteriorate further. This will result in equities performing poorly.

- In Australia, credit reporting data is showing quickly increasing levels of distress. January data showed a very low level of B2B invoice value and well below the pre-covid level. Payment defaults in February are at record highs. Credit bureau data is interesting in that it gives an unvarnished and early insight into quantitative business conditions. The NAB business confidence index fell, while NAB business conditions rose (these are qualitative surveys capturing human biases). Forward orders fell.
- Chapter 11 filings in the US are rising (see graph right). It has been a benign period for insolvencies and bankruptcy from the time of the GFC to 2023. This is changing rapidly and showing up in Australia as well.
- We have incorporated long/short mandates in client portfolios to seek returns from a potential downturn in equity markets. Short positions can profit when equity value falls, long position being normal equity ownership.



Housing

- House prices have gone up c.38% since COVID, and increased household debt in Australia from AUD $2trillion to AUD $3trillion.
- Household repayments have gone from $9 billion per month to $21 billion per month. It would be a miracle if this does not slow the economy, and with it, banking.
- The dividend yield on CBA shares is 3.9% (its lowest in history) and is now lower than the deposit rate on cash in the bank. If Australian property isn't rationally priced, we shouldn't be surprised that a bank's equity isn't also?
- With housing prices continuing higher against a 40% reduction in borrowing capacity, this is an asset class that is difficult to rationalise. In the US, Sweden, UK and NZ there are signs of house prices stagnating or falling modestly. But Australian property remains a perennial outlier and supply through new housing starts is at its lowest level in ten years. Construction finance continues to fall, a leading indicator that housing starts will remain subdued and homes remain undersupplied.
- It would take a material uptick in unemployment to dent the steady rise of house prices.

By Matt Vickers

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