EFFICIENT GROUP

ECONOMIC COMMENTARY

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YOUR WEEKLY ECONOMIC UPDATE

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RECESSION... SO WHAT?

In the past week uncertainty caused volatility in global stock markets to drag on. Uncertainty about war, commodity prices, inflation, interest rate increases, lockdowns in China, global economic growth, and the likes, are all keeping investors, and the markets that they represent, both nervous and restless.

Most notably, the minutes from the previous monetary policy meeting in the United States (US) signalled a very hawkish Federal Reserve (Fed), which caused markets to falter. In a hope to curb soaring inflation, the minutes showed that the Fed's plan is to reduce their $9 trillion balance sheet by more than $1 trillion a year, while hiking interest rates.

Despite geopolitical tensions, many Fed officials seem to be prepared to start hiking interest rates by as much as 50 basis points (0.5%) at future meetings. Their aim is to quickly reach the neutral/natural rate, the sweet spot interest rate that is not too low to deter investors, but not too high to curb consumption. Although no one knows exactly how 'normal' looks nowadays, it is believed that the neutral rate in the US should be somewhere around 2.4%, far off from the current 0.25%. The problem with hiking interest rates too quickly is that it could upset consumption, the largest contributor to economic growth in the US, and thereby push the world's largest economy into a recession. And, if hiking interest rates was not enough of a concern, the news about reducing the balance sheet made a bad case worse because no one really knows what will happen in a world of quantitative tightening (QT). QT has only occurred once in the last decade and it did not last long because US equity markets threw a huge tantrum, which caused the Fed to start quantitative easing (QE) again.

All of the bonds that inflated the Fed's balance sheet to $9 trillion were purchased during the last 12 or so years of the Fed's QE programme. The idea was to buy government bonds from institutions and to force liquidity into the economy. Liquidity that could be used to get consumption going by aiding the credit cycle with both low interest rates and easy money (liquidity). But all it ended up doing was to inflate asset prices, especially those of technology stocks, and through an oversupply of bonds, force down bond yields. If we now start QT again and reduce the Fed's balance sheet, should the opposite not happen? Should asset prices not deflate and bond yields rise? The markets do not want to believe that this is possible, although it very well may be. The reason markets want higher yields is because the short-term interest rates are rising quickly as the Fed hikes interest rates. As the short-term rates increase, they may cause the yield curve to invert, which is usually a good indicator that a recession is looming; the very recession that can deflate asset prices.

If all of this was not upsetting enough for the markets, the impact of the ongoing war in the Ukraine, escalating international sanctions on Moscow, and China's confusing zero-COVID strategy, make for an upsetting concoction. But our advice, as always, is not to worry too much. Rather step back and use the correct lens to interpret events in context. Research on these topics are very clear; what matters most is time in the markets. Over the last few decades, there have been many more reasons to not be invested, especially in equity markets, but those who have stuck around have been handsomely rewarded. So, rather manage your risk, and your expectations, by speaking to your financial advisor.