EFFICIENT GROUP

ECONOMIC COMMENTARY

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YOUR WEEKLY ECONOMIC UPDATE

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A RECESSION IN THE US AND ITS BENEFITS FOR SA

Research by the world's largest financial institutions seems to support our view that the monetary policy tightening cycle in the United States (US) is approaching its third stage, an economic downturn. We have been expecting this for quite some time and have made the necessary changes to our investment strategies. Usually, when the US sneezes, the rest of the world catches a cold but, in today's context, an economic downturn in the US will provide the necessary relief to many emerging markets and their currencies. Investors can, therefore, expect a persistently strong equity market in South Africa (SA) and a much stronger rand over the next 12 to 18 months.

The first stage of the monetary policy tightening cycle in the US occurred when markets recognised that the helicopter money provided by the US government produced a spending and inflation overshoot. Markets, consequently, started to price in the upcoming tightening cycle and central banks followed suit with rapid interest rate increases. The second stage occurred as tightening progressed, inflation peaked, and soon started to decline whilst the US economy avoided a more substantial economic contraction. Markets started to price in a soft landing, inflation would be back at 2% within months, and the US Federal Reserve would be able to start cutting interest rates. But, given the current conditions and cause-and-effect relationships, we will, most likely, not see the soft landing that markets have priced in, but an economic downturn; let us not scare everyone and call it what it is, a contraction or a recession.

To get US inflation back down to 2%, wage growth rates need to be cut in half, from their current levels of around 5% to 2.5%. But, for this to happen, household spending must be cut in half, from its persistent levels of around 7% to 3.5%. For this to happen, unemployment needs to be increased by at least 2%. But, to increase unemployment, nominal gross domestic product growth needs to be driven materially below wage growth rates and profit margins need to be compressed enough to produce a 20% decline in earnings. For now, however, the strong labour market is keeping nominal spending too high to slow wages down, which is keeping household incomes too high, which, in turn, is keeping earnings too high. For this reason, a third stage in the tightening cycle, where interest rates remain high or even higher, is more likely. Persistently higher interest rates can then continue to cut into spending and earnings. The funding that companies receive from profits and credit has already started to turn negative, which will eventually cause them to stop hiring. This is an initial indication that we are close to the suggested downturn.

Another favourite indicator used to signal an economic downturn in the US is the diffusion index. This index tracks the divergence of spending on goods versus spending on services. Since 1960, in each of the six prior cases where the diffusion index was negative, there was a contraction in economic growth. Currently, nominal spending on services has grown at a rapid annualised rate of about 6%, whereas real and nominal demand for goods has been on a gradual decline. As a result, the diffusion index has turned negative for the seventh time since 1960. Because spending on services puts upward pressure on employment and wages, inflation will finally be tamed once the contraction does occur and spending is reduced sufficiently.

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