Investment Insights

Whatever happened to the recession – and does it matter for bonds?

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Marketing communication

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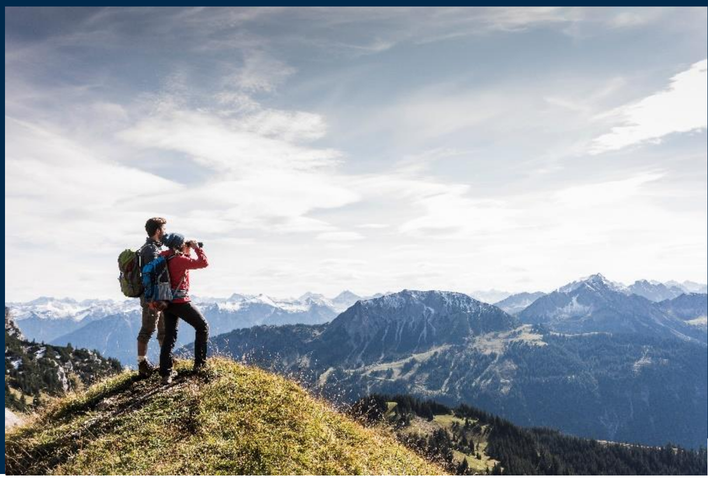

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Key takeaways

- **So far, developed markets have avoided recession, but the risk of one occurring has not gone away.** The current US macro-economic environment is highly unusual. One standout anomaly is the labour market, which, despite over a year of aggressive policy tightening and a mini banking crisis, is still strong, supporting consumption and, ultimately, the US economy.
- The most likely scenarios are now either a soft landing in which recession is avoided but inflation remains above the 2% target, or the economy does enter a recession and disinflation accelerates providing the US Federal Reserve with space to pivot. **Despite the uncertainty, bonds are poised to provide solid returns in most scenarios;** the main risk is a re-acceleration of inflation that requires central banks to hike more. However, we assign a low probability to this outcome.
- **Higher for longer is the most likely outcome for interest rate policy** if the developed market economy proves to be more resilient and inflation remains above central banks' targets. Although uncertainty would remain high, this is an overall positive (and possibly more normal) environment for bonds. Holders continue to earn the current high level of carry, which provides a good cushion against future volatility.
- **On the other hand, bonds, in particular high quality bonds, should be well placed to successfully navigate a scenario in which the economy enters a recession and central banks cut rates.** This is because of both the high level

of carry the asset class currently offers and the potential gains from duration as rates fall.

"Prediction is very difficult; especially if it is about the future." Niels Bohr

Twelve months ago, financial markets confidentially predicted that the US and global economies would enter a recession in 2023. The Bloomberg Economic US recession probability model in October 2022 gave 100% probability of a recession in the US in the next 12 months. And yet, despite interest rates being hiked to their highest level since the mid-2000s and a mini crisis in the US banking sector, the US and other developed market economies remain in relatively robust health. A large part of the market now thinks central banks will be able to achieve a perfect soft landing and avoid recession altogether. Predicting the future is indeed very difficult.

In this paper we unpick a few topics:

- What has been happening in the macro-economy and why we think a recession has so far been avoided.
- The arguments for the economy staying out of or going into recession over the next 12 months.
- We discuss what this uncertain environment means for monetary policy.
- Against this backdrop, we provide our thoughts on the investment implications for fixed income markets. Readers purely interested in this aspect of the report should jump ahead to the section titled: What does this mean for fixed income markets? on page 7.

How has recession been avoided?

The current macro-economic environment is highly unusual. Rarely, if ever, have we seen the combination of a global pandemic, breakthrough technologies, increased geopolitical risk and structural labour market changes. This unique set of circumstances might help explain why the typical economic cycle has not played out. Perhaps this time really is different (or, maybe, it is just a matter of time and monetary policy is working with longer lags).

1. Maybe the US avoided a synchronised recession but had small rolling ones instead

It is possible we avoided a conventional broad-based synchronised recession, and instead, are in the midst of a series of rolling, sector level recessions. This can be observed if we look across sectors.

For example, travel experienced a significant downturn at the onset of pandemic lockdowns in 2020 but has since recovered as economies reopened and activity in the sector has returned to pre-pandemic levels.

In mid-2020, chemical manufacturing, which had initially held up well, fell back as demand collapsed. A key example was synthetic rubber used extensively in the automotive industry. As with travel, demand returned when economies reopened.

In 2022, residential housing collapsed, and it is now recovering while, with some lags, the commercial real estate market is now under a lot of pressure. Recessions maybe happened in different sectors at different times, and so we did not feel the proper pain of a broad synchronised one.

2. Potential structural changes in the labour market may be the answer

Central to achieving this benign economic outcome has been the labour market, which has remained resilient and is helping to support consumer spending growth. As a reminder, consumer spending is a key factor in US economic growth that accounts for around 70% of GDP. As long as people have a job and spend, the US economy will do fine. At the same time, the Inflation Reduction Act (IRA) is starting to come into effect. This will boost CAPEX spending and should translate into higher productivity, as well as being positive for nominal economic growth.

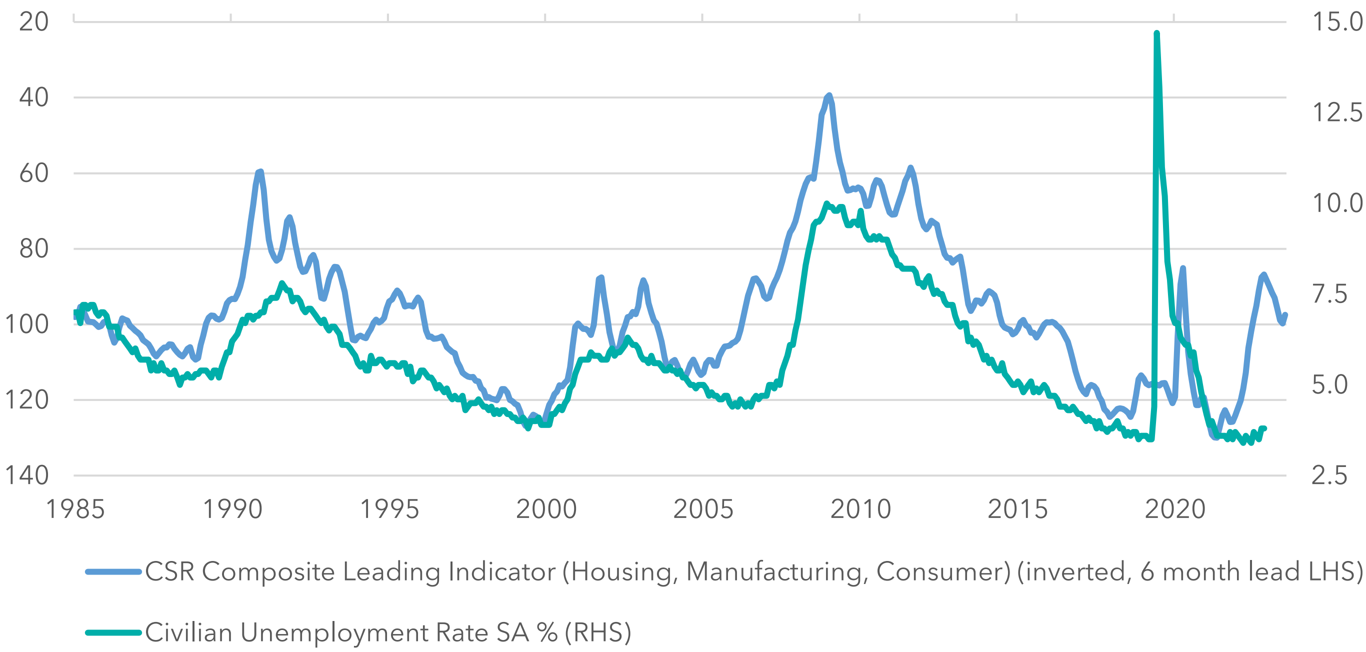
But why, despite the most aggressive tightening from the US Federal Reserve (Fed) in 40 years, has the labour market been so resilient, enabling the unemployment rate to reach near record lows for the post-war era?

In theory, this should not happen. Ordinarily, when economic activity slows, companies reduce their workforce to align with the lower demand. This is reflected in a rising unemployment rate.

In this cycle, despite deterioration in the underlying components of the economy, the unemployment rate remains very low (see below chart). Firms are still having trouble finding qualified candidates and are holding onto existing employees or looking for new ones. Now, with economic indicators (the blue line in the chart) showing signs of improvement, it would be highly unusual (although still possible) for the unemployment rate to start rising.

Economic indicators have deteriorated but labour markets remain resilient

US unemployment rate and CSR economic indicator



Data as at 30 September 2023. Source: NAHB/WF, BLS/Haver/Capital Strategy Research (CSR)

One possible explanation for this phenomenon is that the pandemic has caused the economy and the labour market to decouple. This could be because a structural deficiency has been created in the labour supply as workers are now spread out geographically and working from home has become a permanent feature of the labour market. As a result, multiple economic sectors can decline, but because labour markets are structurally mismatched, companies hold on to workers rather than fire them. There is some evidence for this: three years after the pandemic, labour demand still exceeds supply, and although there is some realignment, it is slow.

Importantly, recent experience may also provide an explanation: having reduced headcount aggressively during the pandemic, and then struggled to recruit as economies reopened, companies are reluctant to go through a similar process again. Instead, they are labour hoarding, holding on to employees.

A soft landing is possible, but warning signs of a hard landing persist

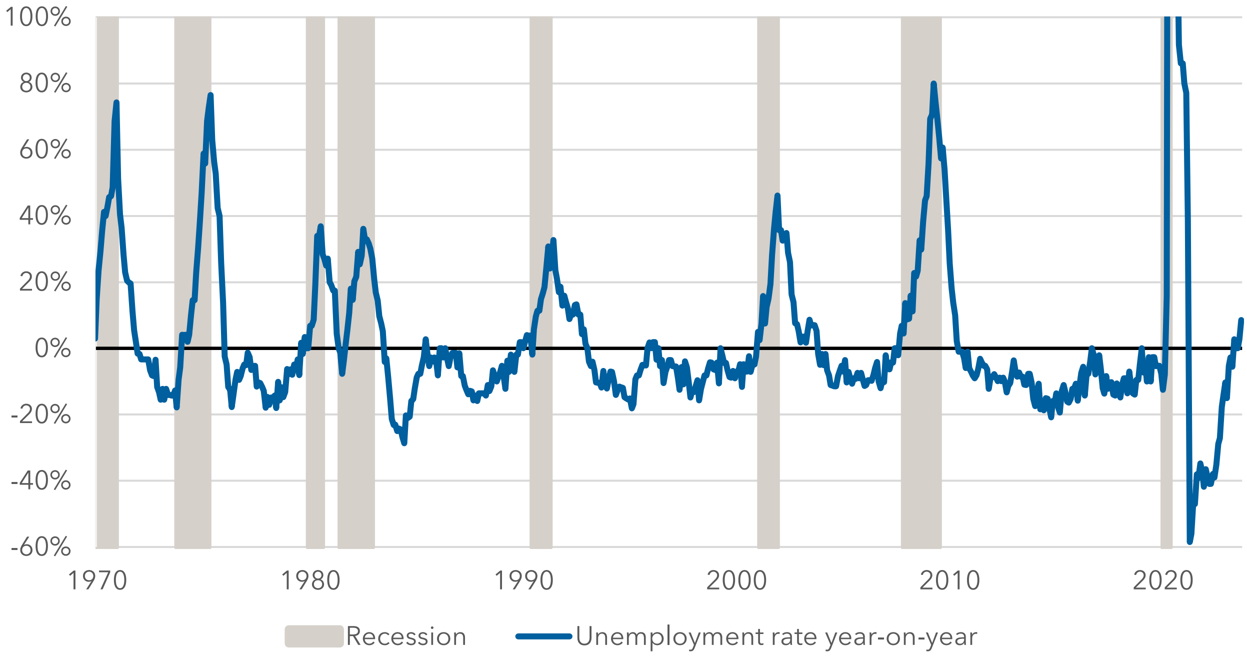
Another view is that this time is not different and there is simply a longer lag until monetary policy takes effect, or that the pass-through from economic activity to the labour market is weaker than in the past. And so, it is only a matter of time before the existing hikes lead to recession.

Despite the resilience of the labour market and the economy over the past year, we believe we are not out of the woods yet. There is a still a clear path with a meaningful probability that leads to recession. This is underlined by a number of economic indicators that clearly point to one happening.

- The labour market, while still resilient, has continued to weaken, with rising unemployment claims, falling labour demand and the increase in unemployment YoY. As mentioned, because its economy is driven by consumption, the labour market is a key indicator to forecast recession in the US.

A sign of recession?

US unemployment rate year on year and recession periods



Data as at 30 September 2023. Source. Bloomberg

- We continue to see bifurcation in consumer spending by income, with lower income consumers facing the most headwinds. While overall consumer spending is holding up fine, the consumer is facing numerous cross currents – support from still strong employment and recent real wage growth is offset by the depletion of excess savings, resumption of student loan payments and an acceleration of credit card delinquencies.

- Financial conditions are tighter, and money is slowly getting drained from the economy. In December 2022, M2[1] money supply (started to contract for the first time since the Fed began publishing data in 1959. Historically, a reduction in the money supply is associated with recession.
- Potential pressures on US regional banks: It seems March 2023 happened a long time ago. The memories of US regional bank volatility and defaults seem far off. However, the capital ratios for some regional banks adjusted for securities losses at current 10-yr Treasury yields look concerning – i.e. the negative impact on balance sheets of mark to market losses as a result of lower US Treasury prices.

  The continuing increase in yields for government bonds and mortgage backed securities is putting direct pressure on Real Estate Investment Trusts (REITS) and indirect pressures on banks as unrealised losses on the banking book are growing. Banks still own a large portion of the Mortgage Backed Securities (MBS) market. With MBS underperformance into the selloff, these unrealised losses have been building at banks. MBS spreads have continued to widen and have been very correlated with financials conditions indicators. If MBS valuations continue to cheapen, this could be a harbinger of worsening financial conditions.

How are central banks going to react? Inflation developments remain key to finding the answer

Inflation dynamics are likely to be the key factor in determining how central banks are going to react in the near future. While a recession would clearly bring inflation down faster and force central banks to pivot, the plausible scenario of no recession and slowing inflation would likely allow the Fed to cut nominal rates to avoid a passive tightening – i.e. real rates going higher passively alongside a decrease in inflation.

Inflation: cyclical vs secular factors

We continue to see cyclical disinflationary forces, which would likely help lower US core inflation from around 4% now to 3% in 2024 and potentially to 2% in 2025. However, secular forces such as the slowdown in globalisation and increased geopolitical risk may keep inflation above central banks' target rate for longer, limiting the ability of central banks to cut rates.

1. Core goods and services inflation are decelerating

Over the past year, inflation has been easing and it is possible to build a case for it falling back toward 3% next year. Further improvements in supply chain bottlenecks, along with a stabilisation of energy prices, could help inflation fall to around 3%. Headline inflation has been falling for some time and core inflation measures are also now starting to ease. Importantly, along with core shelter and commodity measures, which have been falling since 2022, core services (a broad

[1] US M2 money includes currency and coins held by the non-bank public, checkable deposits and travellers checks plus savings deposits, small time deposits under $100,000 and shares in retail money market mutual funds.

category including components such as medical care services, tuition fees and insurance) is now also lower.

2. Rents tend to be stickier but high frequency indicators show rent below 2%

The question is therefore: can this rate of disinflation continue? One of the most important considerations when forecasting CPI is the outlook for rents, as they represent a large component of this measure. This component tends to be a stickier part of the inflation, as usually rents tend to be negotiated less frequently – e.g. annually. However, high frequency data have started to show rent growth below 2% and is even showing negative rental growth in some cities. Rents are further contained by an increase in the vacancy rate. These have been low for some time but have now started to rise. As at the end of August, half of US states had vacancy rates at pre-COVID levels. The fallback suggests the supply/demand imbalance within US housing is easing, which should help rental growth to decelerate.

3. Wages and unit labour costs at the core of inflation dynamics

We're seeing wage growth slowing from 6% in 2022 toward 4% in 2023 without an increase in the unemployment rate. This, along with slowing inflation, is turning real wages positive in 2023. This trend may continue in 2024 if inflation keeps falling.

The other important aspect is unit labour costs (employee compensation as a percent of nominal GDP), which are an anchor for inflation, as well as being linked to productivity. Twelve months ago, productivity growth was negative and unit labour costs were rising – a dynamic that pointed towards squeezed profit margins and a recession. This year, however, productivity has improved and is now positive, and unit labour costs are falling, which points to a continued slowdown in inflation.

But is the pace of disinflation sustainable?

Although inflation is falling and, encouragingly, core services are also declining, there is a risk that the pace of disinflation that we have seen in 2023 could slow. CPI for medical services illustrates this point. Year-on-year changes in this important part of the CPI index have been falling throughout 2023 and are now negative. This is its lowest level of growth since at least the mid-1960s, and it is therefore questionable how sustainable this level of disinflation is.

Returning inflation to 2%

Despite encouraging signs in core inflation, it remains sticky and above central banks' target rate. This could be due to secular factors such as increased geopolitical risk, a slowdown in globalisation and a workforce potentially recruited at home at a higher cost than in past decades where workers were delocalised to places where the labour market was cheaper. This is likely to make reducing inflation to 2% on a sustainable basis a much bigger challenge. However, there may be some other factors that may help to ease inflation:

1. An exogenous deflationary shock such as a hard landing in China.
2. A near-term boom productivity growth.
3. A sharp easing in wage growth.

To an extent, the first two factors are happening, but they are unlikely to be a reliable source of disinflation for central banks. Policymakers are therefore instead focusing efforts on wage growth as the main tool they can use to return inflation to 2%.

The crucial variable in setting wage growth levels is central bank credibility, which is typically measured through inflation expectations. The less credibility a central bank has, the more likely it is that workers ask for above-inflation pay rises. Intuitively, this makes sense; the more frequently a central bank misses its inflation target, the more likely it is that workers will want to base their expectations on current inflation rather than the 2% target.

Nominal wage growth is still growing strongly across developed markets and remains well above pre-COVID trends. As mentioned above, the only exception is the US, where wage growth has fallen back from its peak. So far, this has happened without a material rise in unemployment, which possibly suggests the US could achieve a soft landing.

Nonetheless, the strong growth in wages and the importance of central bank credibility in setting expectations is likely to mean rates are going stay higher for longer.

The most important thing from a monetary policy perspective is that the slowdown in inflation means central banks are likely at, or very close to, the peak in rates. The question today is not how much the Fed will continue to hike rates but for how long it will keep rates at these levels.

In previous cycles, the peak in policy rates has been a good moment for investing in fixed income markets. High-quality corporate bonds, for example, have historically outperformed cash by 17% on a cumulative basis in the three years after rates peaked, with almost half the outperformance happening in the 10 months after the last hike.[2]

What this means for fixed income markets

This backdrop remains a supportive environment for fixed income, with soft landing and recession scenarios both likely to be broadly positive for the asset class.

Soft landing. If central banks can achieve a soft landing, it would suggest policy has been set at exactly the right level. Therefore, rates are likely to remain high and bond investors will continue to benefit from a high level of carry. This should help to offset periods of volatility and be supportive of total returns. If inflation eases towards central banks' target and maintenance cuts in the policy rate are needed to avoid passive tightening, bondholders would also benefit from price appreciation.

Recession. Tighter financial conditions, the impact of rates staying higher for longer, mixed signals on consumption and ongoing uncertainty around US regional banks and commercial real estate mean the risk of recession remains meaningful. However, in a recession scenario, bondholders continue to benefit from the initial high level of carry and the potential decision by central banks to cut interest rates as a means of stimulating economic growth. Such a decision would provide a tailwind for bonds, particularly the high-quality component of the market.

[2] Based on the analysis of the Bloomberg US Corporate index and JP Morgan USD 3 month cash index over the last 4 hiking cycles.

Sensitivity analysis

As this paper has outlined, there remains uncertainty about the persistence of inflation and the risk of recession. As a framework to help investors navigate this uncertainty, we have undertaken a sensitivity analysis of the global investment grade corporate bond market. In our view, this area of the market provides the best combination of income and duration. Four scenarios have been built that we think best capture the most realistic paths of the underlying variables:

1. **Goldilocks**. This is the scenario central banks are trying to engineer where growth remains resilient while inflation eases and reaches the 2% target enabling central banks to cut interest rates.
2. **Recession**. We look at a range of recession scenarios from a mild to full blown crisis.
3. **Continuation of current environment**. In this scenario, growth remains resilient, but inflation remains stickier and central banks continue to hold rates higher for longer to reduce inflation and continued pressure on yields.
4. **Reacceleration of inflation**. We consider the impact of an increase in inflation that leads to central banks continuing to hike rates, bring yields higher and a significant widening of credit spreads.

How Global IG could fare under various scenarios

Hypothetical global IG credit returns (%) across rate and spread scenarios including 1-year carry

Change in US IG spreads (bps)

Goldilocks
Resilient growth, inflation at targets; rates move lower

Recession
Mild to full-blown crisis

Change in Rates (bps)*

Change in Rates (bps)*	-50	-25	0	25	50	75	100	125	150
-100	14.3	12.9	11.4	10.0	8.5	7.1	5.7	4.3	2.9
-75	12.9	11.5	10.0	8.6	7.2	5.8	4.4	3.0	1.6
-50	11.6	10.1	8.7	7.3	5.9	4.5	3.1	1.7	0.3
-25	10.3	8.8	7.4	6.0	4.6	3.2	1.8	0.4	-0.9
0	9.0	7.5	6.1	4.7	3.3	2.0	0.6	-0.8	-2.1
25	7.7	6.3	4.9	3.5	2.1	0.7	-0.6	-2.0	-3.3
50	6.5	5.1	3.7	2.3	0.9	-0.4	-1.8	-3.1	-4.5
75	5.3	3.9	2.5	1.1	-0.2	-1.6	-2.9	-4.3	-5.6
100	4.1	2.7	1.4	0.0	-1.4	-2.7	-4.1	-5.4	-6.7

Continuation of current environment
Resilient growth, hawkish central banks while inflation gradually moves lower

Re-acceleration of inflation
Central banks continue to hike policy rates

Hypothetical returns shown for illustrative purposes only and are not a guarantee of future returns. Data shown is based on Bloomberg Global Aggregate – Corporates (USD hedged) Index

Proxied by US 10-year treasuries

Period of analysis: Past 5 years from 6th October 2023. Source: BlackRock Aladdin

The figures include 1-year carry, which measures the projected return of a security over one year (due to both market value changes and reinvested cash flows) assuming the yield curve and portfolio composition remain unchanged. Projections are derived from Capital Group's proprietary risk model, based on changes to select factors (rates and spreads) and assumptions about the behaviour of other factors based on weekly returns (of these factors) over a 5-year period. A covariance matrix between these factors was used to simulate changes and corresponding outcomes. The scenarios do not represent all possible outcomes and the analysis does not take into account all aspects of risk. Bps: basis points.

There are some important takeaways from this simulation.

Investment grade (IG) credit is well placed to provide positive returns over one year given the most likely macroeconomic scenarios. In a mild recession scenario, returns are positive. Even under a severe recession, results could still be positive if rates were to fall. This reflects two important characteristics of the asset class. First, the positive duration impact of falling interest rates and second, the higher level of starting yield that IG credit now offers which helps cushion against periods of price volatility.

A continuation of the current environment in which central banks keep rates higher for longer also generally leads to positive returns. This is again a result of the high level of carry, which is able to absorb both the spread and rate volatility.

Under a Goldilocks scenario, the asset class benefits from both the high carry and the duration tailwind from falling rates.

High starting level of yields help reduce losses even under the most bearish of outcomes. The only scenario where results are expected to be negative is in an environment where both rates and credit spreads increase significantly, which could happen if inflation accelerates. This outcome is captured in the bottom right quadrant of our analysis. Even in the most extreme of scenarios tested, where rates rise 100bps and spreads widen by 150bps, the negative outcomes are anticipated to be less severe than those incurred during 2022. This is because of the healthy buffer offered by higher starting yields today.

The importance of investing in fixed income

This sensitivity analysis points to one clear implication: the importance of investing in fixed income despite ongoing uncertainty. Given the set of likely outcomes outlined in this paper, we believe fixed income markets have become a much more attractive proposition for investors. Credit markets in particular now offer sufficient carry to offset periods of potential volatility.

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