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ON THE BRINK OF RECESSION?

Martina Hoffard, Head of Marketing, Spectrum Markets.

The world had just seen the biggest fiscal and central bank recovery package in history after the Covid-19 pandemic – and was about to digest it – when the energy shortages as a result of Russia's invasion of Ukraine sent prices to dizzying heights. Eurozone inflation peaked at above 10% in November 2022 and it seemed that the world economy would slide straight into recession. While prices have started to decline moderately, they're still nowhere near any economically reasonable level. So, the question remains whether a recession is inevitable. If it is, how severe will it be and is there anything retail investors can do to protect themselves? We asked Martina Hoffard from Spectrum Markets, for her opinion.

Martina, the European Central Bank (ECB) raised rates four times in 2022 and is obviously committed to follow its set course in 2023…

Yes, the ECB raised rates by 0.5 percentage points in July which was the first 50 basis points hike in eleven years. Shortly after, in September and November, interest rate hikes of 0.75 percentage points followed. In December, they were raised by a further 50 basis points. The September and November steps were totally unprecedented. We saw the ECB cutting rates by 1.0 percentage points at the beginning of the global financial crisis in 2008, but until 2022 it had never raised rates by more than 0.5 percentage points. There has been a lot of criticism regarding the late start of the central bank's interventions. However, one must bear in mind the exceptional economic circumstances that left central banks across the globe caught in a dilemma – having to apply quantitative tightening and quantitative easing at the same time. It's not just about the impacts on the currency or market volatility, it's about preventing unwanted consequences on refinancing markets and the economy as a whole. While there may be broad consensus about the determinants of monetary policy action, this is not always true for its timing or the intensity.

What would be the reason for becoming divided over rate hikes if prices remain where they are?

One of the critical and maybe less appreciated goals of a central bank in times of rising prices is to not just to introduce quantitative tightening as a measure to relieve pressure on prices, but also to manage people's inflation expectations. In other words, they want to avoid a de-anchoring of inflation expectations. 'Anchored' in the context of inflation expectations is a term used by central banks to describe a state where people expect long-term inflation to remain relatively unchanged even if prices temporarily rise beyond their short-term inflation expectations. Accordingly, expectations are de-anchored when people's long-term inflation expectations go up considerably as a result of prices rising beyond their short-term expectations only temporarily. There was a longer period over which central banks didn't react to high inflation. They then started rate hikes in summer and now for them it is important that they keep the credibility of their open market operations to show an impact. If they fail by under-tightening, the cost of fighting inflation will become even higher – an effect better known as wage-price-spiral.

And what about the risk of over-tightening?

This would be equally detrimental to the credibility of the ECB as it would incur significant economic burden. Hence, it has to find the right balance avoiding both a too weak a stance on inflation and a too aggressive an increase in the cost of money. This is even more sensitive due to the fact that European economies are each exposed to factors putting pressure on prices in a different manner. Italy, for example, whose economy developed better than those of the other major European countries at the beginning of the year, is greatly dependent on Russian gas. The same is true for Germany which has been a huge consumer of Russian gas and oil. Energy supply shortages will weigh on industrial output. France and Spain, for example, are better off in terms of energy independence. France has a strong nuclear power sector which it kept despite the security discussions around this energy source. Spain has been importing shipped liquid gas making it less vulnerable to the current supply shortages. Its consumer price inflation was at 5.7% year-on-year in December – I think this is illustrative of the dominant impact of the costs of energy. Then there are different structural issues across countries within and outside the European Union, such as in the United Kingdom which faces challenges resulting from Brexit. And the same heterogeneity in terms of exposure to the effects of rate hikes is applicable worldwide with a demarcation line between developed and emerging markets. So, from a monetary policy point of view, I would deem the current situation even more challenging than at the peak of the Covid-19 pandemic.

For the ECB?

For the ECB in particular. Unlike other central banks, it faces the additional challenge that the national governments of Eurozone member states are still strongly divided about how their fiscal policies could be aligned. Remember the Stability Growth Pact (SGP) which has been a bone of contention since the very beginning? The SGP was suspended in the aftermath of the pandemic and the suspension has been extended until the end of 2023 as a result of the Russian invasion of Ukraine. According to the SGP, a country's budget deficit should be capped at 3% of its economic output while government debt shall remain below 60% of the country's gross domestic product (GDP). However, the rules weren't followed consistently even before the global financial crisis fourteen years ago and it got worse thereafter. The debt to GDP ratio of Greece, despite the progress the country made, is still at around 190%. Italy, with outstanding credit of some €1.8bn, is indebted by over 150% of its GDP. Estonia's debt to GDP ratio is below 20%[1]. The ECB's monetary policy steps have to account for the multiple different effects that one open market operation will have due to an economically and, more importantly, politically fragmented environment. While being somewhat distant to what Great Britain has experienced in terms of doubts regarding its debt servicing capacity, the Eurozone's structural manoeuvrability hampers its capacity to fine tune and align relevant fiscal and monetary policy measures.

Now back to our core question – is a recession inevitable?

That cannot be answered with a simple yes. First, we need to decide what you would define as recession. Everybody will understand it is when the economy goes down, jobs get lost, corporate earnings decline, all of which becomes visible in shrinking economic output data. But when would you call such development a recession? There is the common definition of two consecutive quarters of economic decline[2]. The United States' NBER[3] defines recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

This is not just showing that there isn't any official definition narrow enough to delineate the entry and exit points of a recession, which you would justifiably dismiss as quibbling. The problem is how official institutions, such as governments and central banks, can identify when an economic downturn starts to perpetuate. When it has become a cycle which is, simply put, marked by declines in consumption and investment triggering declines in production, triggering job cuts, triggering declines in consumption and investment and so on.

The second important aspect, as discussed, is that different economies are each exposed to price pressure effects in a different manner so that the causes of their inflation, the relevant fiscal and monetary policy countermeasures and the degree of them sliding into recession will vary, too. So, by some metrics, some regions are in recession already while others will follow and yet others might not at all. According to the latest IMF report[4], the labour markets in economic areas such as Europe, including the United Kingdom, and the United States have remained extremely resilient. In the United States, the inflation rate has been falling since July and it has started to come down in the Eurozone as well in line with falling energy prices. In my view, a global downturn of significant size and tenor is all but on the cards.

What can and should retail investors do to protect themselves?

As discussed, I currently see no reason to panic. That is, investors that have turned to tangible assets in response to inflation or that have long-term exposure to passively managed assets such as equity ETFs or ETF savings plans have not much reason to change their approach fundamentally. But that doesn't mean that times of falling share prices or a decline in consumption are times to stay away from trading.

Where you had been invested before the recession, it may make sense exploit the low market valuations to add to your portfolio positions. If you pay into a fund savings plan, you also have options depending on your personal situation and the duration of a recession. Since you now receive more shares of the fund for the same amount of money, you may lower the savings rate by the mathematical difference and use the additional liquidity for alternatives. Should there be high concentrations within your portfolio note that, during a recession, diversification is more important anyway.

It may sound obvious, but active investors should stay away from cyclical sectors and move more into defensive ones in times of recession. That could be consumer staples such as food, beverages, healthcare, pharmaceuticals or financial services. It can be sensible to look for stocks of companies which are price makers, but often their products are exactly those things that people forego in times of constrained budgets, so this should be done carefully.

What else can active retail investors do?

In general, they should increasingly try to slightly deviate from regional or industry allocation approaches and look in to single stocks as, in times of rising insecurity, the selection aspect becomes more important.

First and foremost, however, they may bear in mind that prices on stock markets are being built in a forward-looking manner. That is, they should remain capable of acting and remain flexible. The expectation of recession has been in the market for some time now and we have discussed the varying economic definitions of a recession and the impact this may have.

Don't forget, we're living in an era of increased retail investor participation and very short response times on every kind of news that may move markets in either direction. In other words, I expect volatility to remain a constant companion, pronounced in the commodity sector and particularly strong in the oil and precious metal segment.

Investors with sufficient risk appetite and risk-bearing capacity may also explore short-term positionings via leveraged products in order to adequately benefit from price fluctuations.

Martina Hoffard is Head of Marketing at Spectrum Markets. Prior to this she held similar positions at Deutsche Börse, Visa and Research in Motion (Blackberry). She's a regular social media commentator on consumer-centric topics.

Thank-you very much!

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2 As defined in a 1974 article by U.S. economist
3 National Bureau of Economic Research
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