Recessionary concerns continue to build

Monthly Commentary

For wholesale or professional investors only

Investors continue to assess the devastating impact of war on the global economy. Inflation is at levels last seen in October 1988 (source: OECD) driven by rising energy prices and supply chain issues, prompting a cost-of-living crisis for households and limiting production for many businesses. Focus is now increasingly being shifted to the 'stag' component of stagflation. The IMF sharply repriced their growth forecasts in the latest WEO this month and project a fall in global growth from 6.1% in 2021 to 3.6% in 2022 and 2023. The 2022 forecast was a 0.8% downgrade from their January update and 1.3% lower than initially projected in October. This comes alongside increases in inflation forecasts for almost every economy. The risks are firmly to the downside and the probability of a global recession this year, although unlikely, has dramatically increased in the span of a couple months.

Among the major economies, Germany is likely to be most affected by the war in Ukraine. The IMF cut their German growth forecasts by 1.7 percentage points to 2.1% growth this year. An indication of the potential damage to the economy can be seen in the staggering increases in German producer prices. For the month of March, annual growth in the producer price index (PPI) was at a 73 year high of 30.9%, up from 25.9% in February. The fact that consumer prices have increased by 'only' 7.4% over the last year indicates that profit margins are under serious pressure. Consumers will eventually have to take on more of the burden, with CPI likely to hit double-digits this year. Underneath the headline PPI figures, the German Federal Statistics Office said the price of gas paid by domestic manufacturers increased 144% in March. Fertilizers increased 87.2%, wood containers 68.8% and metals 39.7%.

Is an embargo on Russian gas on the table?

Russia has so far enforced the decree issued by Putin in March that required 'unfriendly countries' to pay for gas in rubles. This month, Russia reportedly cut off its gas supply to Poland and Bulgaria for refusing to comply with their demands. According to Josep Borrell a top EU diplomat, the EU has spent 35bn euros on Russian gas since the start of the war, compared to the 1bn euros spent on aid to Ukraine. This has triggered serious debate on the need to embargo Russian gas and the subsequent hit to GDP that would follow. In it's latest monthly bulletin, the Bundesbank warned that a sudden stop on all Russian gas imports would lead to a sharp recession and a collapse of around 5% of GDP for the German economy. Understandably, industry figures and policymakers have been hesitant to move forward with the embargo. Europe's 3 largest gas companies, Uniper (Germany) Eni (Italy) and OMV (Austria) have all indicated they are taking steps to comply with the order to ensure the supply of gas continues. An embargo would certainly crash the Euro Area economy, which according to the latest GDP numbers already appears to be on the brink of recession. GDP in Q1 was 0% in France, with consumer spending falling 1.3% in March. Spain's economy grew by 0.3% in Q1, Germany 0.2% and Italy -0.2%.

The other drag on growth comes from tightening policy from central banks around the world. In April, central banks in Sweden, New Zealand, Canada and Israel were among those who hiked their base rates. The Fed is expected to hike 50 bps and the BOE 25 bps to 1% at the beginning of next month. The persistence of inflation and continued policy tightening has taken some air out of global bond markets, bringing financial markets a step closer to a sense of 'normality'. The Bloomberg Global Aggregate Index, which broadly tracks global IG sovereign and corporate debt has fallen 11.2% since the start of the year. Although only a small dent in the 40-year bond bull market, the moves have been significant equating to the largest quarterly drop on record. Furthermore, the value of negative yielding debt according to the same index, has fallen from a record $18tn in December 2020 to under $3tn.

The aggressive tightening priced in from the Fed has also triggered large swings in currency markets. The dollar index (DXY), which tracks the value of the dollar against a basket of major currencies has hit its highest level since 2002, gaining 5% in April alone. Those economies which have failed to keep pace with the tightening of the Fed, and have seen growing rate differentials against the US, such as the Euro Area, Japan and China, have all seen their currencies plummet against the dollar. In April, the yen fell 7% against the dollar to a 20-year low, the Euro fell 5.3% and the Yuan 4%, the sharpest monthly fall since 1994.

China persists with a zero-covid policy

Finally, China's severe lockdowns pose a growth shock of equal if not greater magnitude than the war in Ukraine. The surge in cases began in March and has been concentrated in Shanghai, which is reporting roughly 20,000 new cases a day. Shanghai's roughly 26 million residents have been under complete lockdown for a month. Shanghai produces roughly 4% of China's GDP, and close to 8% of total exports. Throughout China, under the strict zero-covid policy roughly 340 million people have been affected by varying degrees of lockdown over the last month and the hit to the economy will likely show up in next months data. What is clear is that supply chains will continue to be heavily impacted given the partial lockdowns in cities that are key to global shipping. Perhaps the only silver lining is the reduction in Chinese imports which will put downward pressure on commodities prices.

Is growth dead?*

Downside risks to global growth are rising, as China's lockdowns expand, Europe moves towards sanctioning Russian energy, and the Fed signals more aggressive tightening. At the same time, high inflation will likely pressure the ECB to signal its willingness to act, while Japan remains the clear outlier with regards to central bank policy.

Market gyrations rolled through the quarter, encouraged by hawkish comments from Jerome Powell. The Federal Reserve Chair backed a 50bp hike at the upcoming May meeting whilst flagging a further 50bp hike in June is on the table. Hikes of this magnitude will quickly test just how resilient the global economy and markets are to higher rates.

Global growth expectations have plummeted given the prospects of a further tightening of financial conditions. A recent BofA survey reported that investors regard a global recession as the most important macro risk for markets, followed by hawkish central banks and inflation. Rates have pushed higher at a rapid rate with the 10-year US Treasury rising around 55 bps, touching highs last seen in late 2018. Such a move was not limited to the US with the 10-year UK Treasury rising to 2.01% at its peak, a yield last on offer in mid-2015.

Higher rates have weighed on equity markets with the MSCI World down around 8.5% led by the long-duration assets reaffirming their sensitivity to interest rates. Growth sold off heavily over the month with value and dividend paying stocks outperforming the MSCI World index. Buying the dip, which had persistently underpinned growth stocks, has dissipated meaning any misses reported through earnings season are being heavily punished.

Pyrford International

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*we are kidding of course.

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