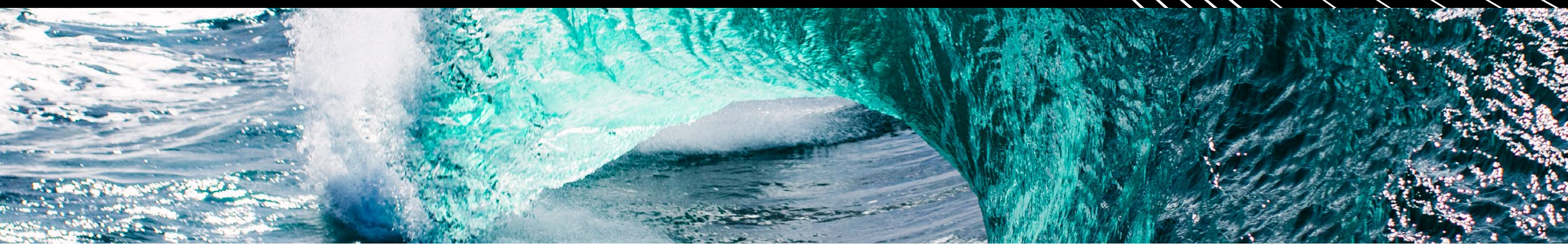
MACQUARIE ASSET MANAGEMENT

Recession: Everything and all at once?

Macquarie Fixed Income Strategic Forum 2023 | Issue 02



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Executive summary

As we near the midpoint of the year, we build on our outlook from Issue 01 of the Macquarie Fixed Income (MFI) Strategic Forum 2023 series and very much see a familiar pattern that appears to be unfolding. We previously called out the most aggressive central bank tightening cycle in recent history, the influence of liquidity contraction, and the recessionary conditions beginning to form in the US and global economy. As those themes continued to play out over the recent months, the pressure built and more and larger things in the financial markets continued to break, first in US regional banks and then in Switzerland with Credit Suisse. As more time passes, we ask ourselves if the slew of indicators now suggests that a recession is unavoidable. Looking at the usual patterns and hallmarks (with the addition of much tighter credit standards and further inverted yield curves), it increasingly seems so. There are several valid counterpoints to this (the central bank pivot, offsetting fiscal policy, the opaque role and proliferation of private credit, and the promise of the artificial intelligence (AI) revolution) although we remain wary of the optimism. We know that monetary policy and tighter credit conditions work with long and variable lags, and we know that the impacts from liquidity contraction are yet to be fully realised. As the effects of these increasing pressures eventually materialise, we ponder whether a recession and its impact on leveraged economies and well-informed financial markets will, as it often does, hit faster and harder than many expect. It is quite normal for equities and risk assets to react late and then not hit bottom until midway through a recession.

State of play

The MFI Team, comprising more than 130 investment professionals, came together again for Issue 02 of the MFI Strategic Forum 2023 series to set our medium-term views. Many of the themes that we have highlighted in previous forums remain relevant. The journey to date is outlined in "The bigger they are, the harder the fall," "Central banks are hiking, quantitative tightening (...very, very frightening?)," and, most recently in Issue 01 of this series, "Delayed reaction, liquidity contraction."

In Issue 02, we collect, summarise, and then extend the culminating evidence and information regarding the increasingly familiar pattern that appears to be unfolding.

We have been, and still are, experiencing the most aggressive monetary policy tightening cycle since US Federal Reserve Chair Paul Volcker's hiking cycle during the 1980s. In the past, whenever these cycles have occurred at this pace, a recession has followed.

As we have previously highlighted, similarly aggressive tightening cycles, such as Volcker's 1980s policy action, happened during economic conditions drastically different from today's indebted modern economy. These past cycles featured little indebtedness; the current cycle is occurring in one of the most indebted global environments of all time. High debt and higher yields do not mix well.

Simultaneously, we are experiencing a significant shift toward liquidity (money) contraction and quantitative tightening (QT), following more than 10 years of constant positive liquidity support via quantitative easing (QE). Consequently, this is proving to be more challenging as things are breaking in financial markets, requiring emergency liquidity injections (UK liability-driven investments (LDI), Japan yield curve control (YCC), and US bank failures, to name a few). Nonetheless, the prior conditions of liquidity expansion no longer exist, and the desire to quantitatively tighten remains. We note that money supply contraction is occurring at pace, and this warrants close watching.

This combination of policy actions has resulted in stark changes to prevailing conditions, featuring a much higher cost of capital, much higher levels of volatility, and a significant shift from an ongoing ultra-easy liquidity injection to liquidity contraction that is expected to increase in intensity as the year progresses. It is often said that central banks hike until something breaks, and in 2022, the early signposts of things breaking began to appear and gather pace.

Since January of this year, there have been additional developments – as the monetary tide has further receded and "the game of musical chairs" (as we like to refer to it) has gained pace – and bigger things are breaking. While it is not always easy to pinpoint the next breakage fault line, "things breaking" is highly typical of what occurs at this point in the tightening cycle. In March, Silicon Valley Bank and two other US banks abruptly failed, triggering a crisis of confidence in (the unrelated) Credit Suisse, which was forced into the arms of national compatriot UBS. Then a few weeks later, US bank First Republic also failed. In effect, we witnessed rapid bank runs on very large institutions that were ultimately triggered by the central bank-induced "rate shock" and not, as traditionally might occur, from the "bad loans" that a recession often creates. So, we are having bank failures already, and we are not even in recession (yet). The "game of musical chairs" continues as conditions tighten further. As such, we remain on alert for what may break next.

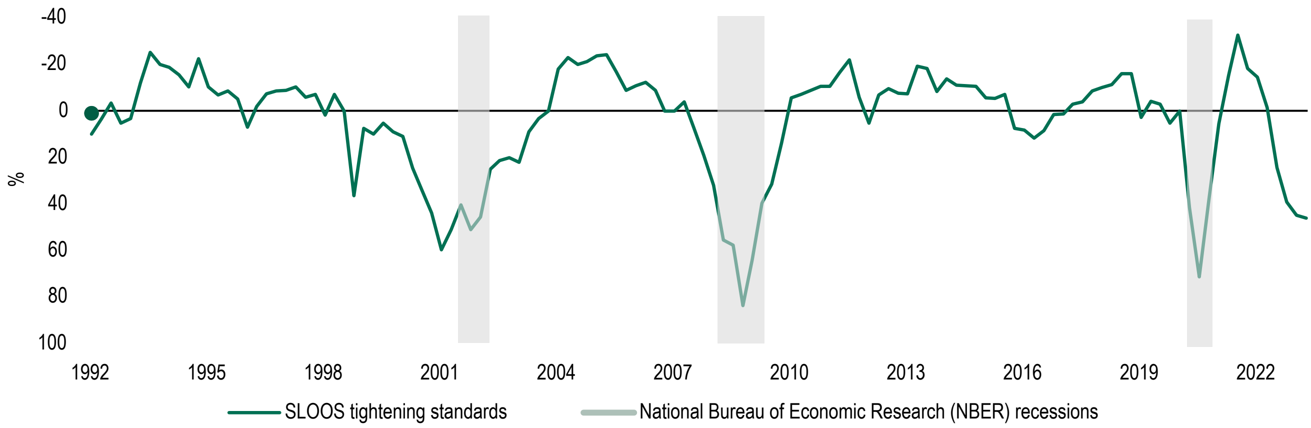
Central banks continue to remain focussed on inflation and continue to err on the side of caution and keep conditions tighter longer rather than ease up early only to see inflation flare up again. This is very different from the prior 10 years when central banks were constantly required to be ultra-easy, supporting growth for longer, concerned that if they withdrew too soon, economies would roll over. This suggests a central bank pivot is still some way off, and indeed if markets continue to perform well and economies hold in, it is more likely that central banks would be emboldened by the success of tightening so far. Without seeing a broader impact, it is a reasonable forecast to expect things to break.

We also know that the monetary policy reaction function occurs with long and variable lags of approximately 12 to 15 months at least, and therefore it would seem rational to anticipate that one of the most aggressive and rapidly implemented tightening cycles (a succession of 75-basis-point hikes per meeting without pause) will reveal significant impacts on the economy in the coming months.

"Things [now] breaking" in the banking system has triggered essentially a form of credit crunch – when banks and other financial institutions, including the shadow banking system, tighten lending standards and risk positioning considerably. They aim to shore up their defences and do what they can, so they're not the next weakest link to fall. The risk that credit conditions continue to tighten should not be discounted. Similar to monetary policy's long and variable lags, the US Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) now shows the level of tightening that has always led to recessions, with the onset lagging by approximately six months (Figure 1). This aligns with likely impacts on the economy revealing themselves toward the end of the third quarter of 2023.

Figure 1:

Senior Loan Officer Opinion Survey on Bank Lending Practices and recessions



Source: Macrobond, May 2023. Data are for commercial and industrial loans, large and medium firms.

We additionally highlight that many of the hallmarks, indicators, and even narratives leading up to economic growth slowdowns and recessions are already here, such as significant yield curve inversion, with both the 10 year-2 year (2s10s) Treasury yield curve (Figure 2) and, quite extremely now, the near-term forward spread (Figure 3). As the saying goes, "It's never different this time."

Figure 2:

US 2s10s Treasury yield curve and recessions

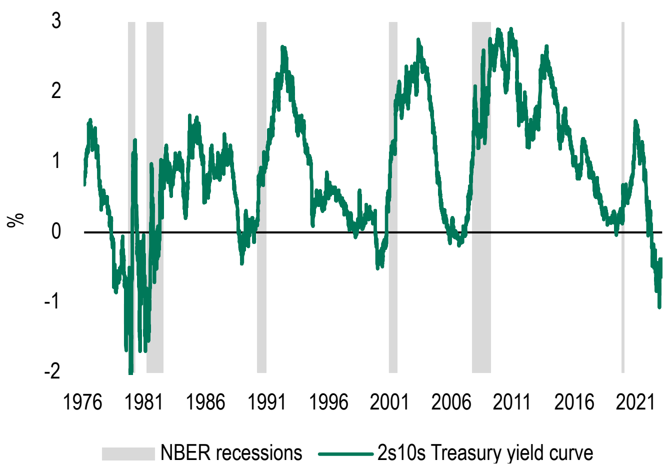
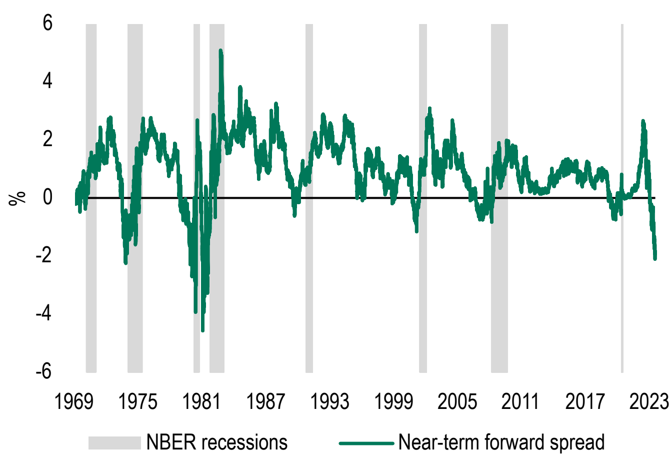


Figure 3:

Near-term forward spread and recessions (18 month forward 3 month yield-spot 3 month yield)



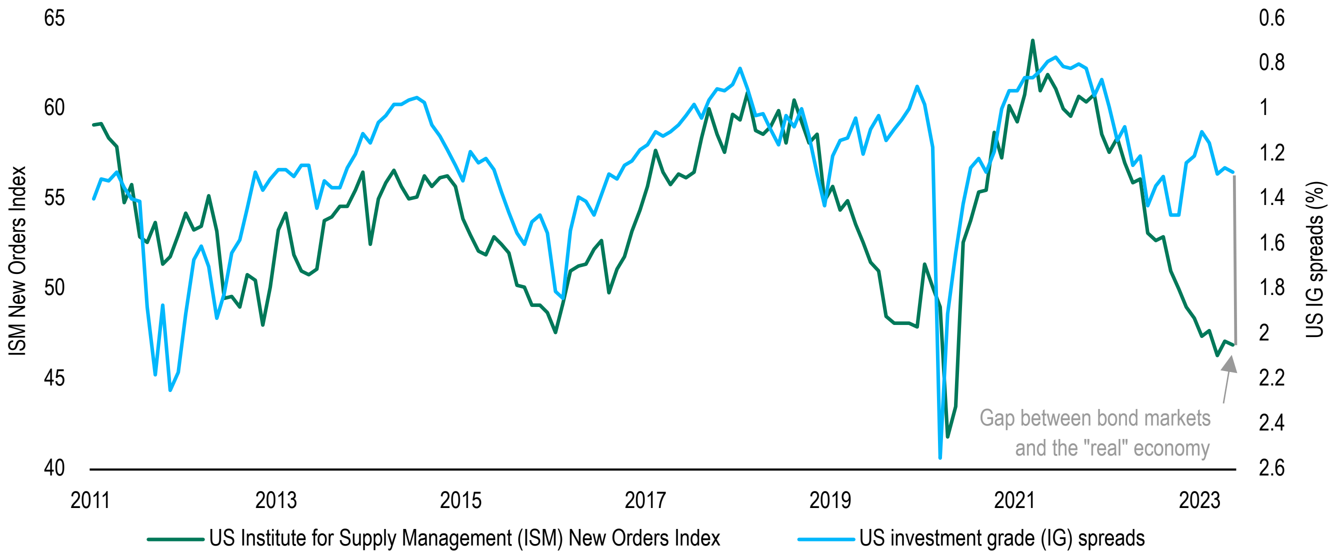
Source: Macrobond, May 2023.

An array of leading economic indicators and surveys, through to patterns of central bank rhetoric, also afford considerable support for this cycle, having the usual fingerprints of, and timing similar to, the eventual onset of a recession. Further, sectors like commercial real estate that have already had COVID-19-related challenges are under more acute pressure given the restriction of credit, which is a poor sign for the outlook of this significant, always leveraged sector and its many lenders. Housing has also slowed considerably as mortgage costs have climbed, and so now it really is just the last two lagging indicators, inflation and employment, that appear to be holding in – and there are early signs that both are slipping.

Finally, we are not the only ones to have collected the evidence laid out above. Indeed, one survey showed that as many as 70% of market economists are now forecasting a recession – this in and of itself is an unusual situation as generally most market economists tend to err on the more optimistic side until such time that the recession is clear and obvious. The key question for market participants then becomes, if this is now one of the “most forecasted recessions,” why are financial markets seemingly either not paying attention or more confident in a softer or mild recession (Figure 4)? Or is this also quite normal, and will the recession suddenly appear faster, hitting harder than currently expected?

Figure 4:

Economic and financial market divergence example



Source: Macrobond, May 2023.

Consensus sees recession, markets not so much

In examining past cycles, it is not uncommon for earnings forecasts and financial markets to react only when it is clear that the recession has begun. We appreciate that the post-pandemic economy may be different from the past and possibly resilient to aggressive monetary policy tightening, and so below we outline some of the reasons as to why we think the "delayed reaction" continues to exist.

Firstly, **inflation is falling** and with base effects rolling off, it should continue to do so. This may enable central banks to loosen their stance before the economic slowdown takes hold, and in doing so, this could enable financial markets to look beyond the slowdown and embrace a no landing/recovery narrative. Second, markets are experiencing a boost by the **positive outlook for AI** that may offset the traditional impacts of a recession. The AI revolution is currently lifting the large technology sector, thereby improving the appearance of the entire market given its influence in market indices. Third, the **private debt/credit** trend that proliferated during the zero interest rate policy (ZIRP) plus QE cycle may perform a softening role in this credit cycle with less leverage, a longer-term focus, and few liquidity gates. Or perhaps the problems are in the shadow banking system, and they will be revealed in time. Fourth, the **US debt ceiling** is both distorting sentiment and influencing liquidity (and this is likely to change shortly). Fifth, there has been and could continue to be greater support from the **fiscal policy** side (CHIPS Act of 2022 and military spending, for example). Sixth, **passive** is now massive, and passive doesn't trade the macro cycle. Flows from here don't have an impact until the underlying investors, mainly retail, react to the market noise as it occurs. Finally, with **consensus** already very much forecasting some form of recession, positioning surveys suggest many market participants may already be positioned with a skew toward a recession.

Of most interest in the above counterpoints, we undertook more in-depth analysis and reviews into recent themes that may also be playing a role in softening the macro cycle – the recent and burgeoning prevalence of private credit/debt and also the thing that everyone is now talking about: AI. The latter gets its own special section below. We undertook a deep dive into this new transformative technology that appears set to have profound ramifications on the investment environment.

Spotlight: Generative artificial intelligence

At our Strategic Forum we undertook a deep dive on generative artificial intelligence (GenAI) to understand the profound ramifications that this new transformative technology will have on the investment environment.

GenAI is a type of AI that can generate new content like a human. It is based on models that entail enormous amounts of data, optimised through training, and utilises probabilities to generate a unique output to a given prompt. GenAI models can be trained on various forms of data (for example, text, images, or software code), depending on the desired specialisation. This technology is not new, however. It was advancements in computer technology, model training methods, and big data availability that allowed it to recently step into the limelight.

There are still many unknowns about GenAI's potential impacts, but we believe it is on track to be among the greatest technological trends in recent decades – akin to the adoption of personal computers and the internet. From a fundamentals perspective, we point to:

- Increased productivity boosting gross domestic product (GDP) but also possibly becoming a deflationary force.
- Uncertain impact on labour markets as efficiencies could see redundancies (namely in knowledge-based industries) but could also see material job creation (like in previous technological revolutions).
- Corporate margins could increase, but there will be dispersion due to diverging GenAI "winners" and "losers."

From an investor perspective, this may result in:

- A boost to equity markets, though widespread euphoria among the uninformed could lead to another technology bubble.
- Tightening of credit spreads for companies that handle this transition well (more likely to be from well-resourced investment grade names).
- An increase in short-term volatility as the true impacts of the technology are realised and as perceptions on "winners" and "losers" are tested. In the long term, we could experience lower volatility as companies and investors obtain better data for decision making.
- Downward pressure on interest rates if efficiencies translate into deflationary forces.

Taking all of this together, we anticipate that credit, industry, and asset class selection (driven by fundamental analysis) will become even more vital for investors as GenAI realities unfold over the next few years.

Patience – the long and variable lags

In light of these potential reasons for a more resilient economy – and financial markets – we are reminded that history demonstrates both monetary policy and the tightening of credit availability work with long and variable lags. This indicates the slowdown may not begin in earnest until the third or fourth quarter of 2023. Perhaps the aggressiveness of this cycle led to assumptions that the lags would be shorter; nonetheless, we recommend prudence and defensive portfolio positioning. Further, given that the "game of musical chairs" continues with further central bank and credit tightening, it is a reasonable forecast to expect more things to break.

Additionally, we maintain that liquidity is still the most important thing. Financial markets, as we have outlined in prior notes, were significant beneficiaries of persistent almost-zero interest rates and incredible amounts of liquidity (QE) that suppressed volatility. And you know, I know, we all know that QE supported asset prices. We have made the case before that this component – liquidity expansion or contraction – is the most important factor in the performance of financial markets. And liquidity is forecast to drain. Adding this to our outlook for a recession only amplifies our concerns on the vulnerability of current market pricing. Further, it is quite normal for equities and risk assets to react late and then not hit bottom until midway through a recession, and the upcoming recession has not commenced. It is also quite normal for strong and pervasive countertrend squeezes as patience runs thin (seeing markets rally), only for the recession to then commence.

Fixed income investment implications

Knowing we are in a pre-recessionary environment, our approach to markets dictates caution. Hence, utilising duration, hedging, and sector allocation to express that caution is key. As tightening monetary policy, tightening liquidity, and tightening credit standards ripple their way through the economy, we remain positive on bond markets and more cautious on credit/risk markets. Though as the “delayed reaction” of markets eventually arrives (and likely affects all asset classes at once), flexibility and a dynamic approach will be key to take advantage of the volatility.

Rates: Our view is that we are close to peak rates and continue to be constructive on duration, with yields at attractive levels. We have started shifting exposure from a flattening bias to the belly of the curve, as we anticipate central banks shifting into a dovish stance. Geographically, we have removed our overweight exposure from Australia, which has performed well, to be more balanced with a US bias given we expect the US economy to require more and faster rate cuts going forward.

“Recessions see bond yields decline, credit spreads widen, and risk assets falter, and this recession also has a backdrop of liquidity contraction. The reaction may be delayed, but we are paying attention.”

- From Issue 01 of our Strategic Forum 2023 series

Credit: Recessionary forces along with credit tightening are not priced into current valuations, with widening to date mainly limited to weaker financials. We have witnessed a reduction in new credit issuance, which we attribute to a combination of corporate treasurers looking to delay until after the US Federal Reserve pivots combined with tighter lending standards, and we believe that relative scarcity of issuance has been supportive of credit’s resilience to date. We are positioned defensively across our credit exposures, and as a result, we will be looking to progressively increase exposures as spreads move higher across both investment grade and high yield sectors.

Emerging market debt: Emerging market (EM) governments have been ahead of developed markets in terms of tightening monetary policy, providing a buffer when an economic downturn presents itself. Given the economic and market headwinds are not centered on the EM universe, we expect the EM market to behave in line with equivalent quality developed market sectors. We will look to increase exposure to EMs when valuations compensate us for the additional country risks.

Structured: Commercial mortgage-backed securities (MBS) remain challenged given dramatic shifts in underlying asset valuations (particularly office), with banks concurrently reducing exposure to this segment. In contrast, residential MBS continue to benefit from solid financial conditions and improved loan-to-value ratios. We have increased our exposure to MBS, especially US agency-backed MBS, which are offering attractive spreads backed by robust structures and strong credit fundamentals.

Currency: We see the US dollar (USD) as close to its near-term peak but expect it will exhibit a topping pattern for the next few quarters. The European Central Bank (ECB) remains the most hawkish central bank in the Group of Ten (G10), which is a support for the euro; however, the euro more broadly is a beneficiary of global growth. Given our near-term caution of USD strength, we maintain a neutral given our cautious outlook. The Australian dollar (AUD) remains highly correlated to growth and risk sentiment, each of which has weighed on the AUD. China’s recent service sector strength broadening into its goods sector would be a potential positive catalyst for the AUD. The Japanese yen (JPY) remains a funding currency into carry trades. We expect an unwinding of the Bank of Japan’s yield curve control policy would see a sharp snap higher in JPY although timing what is essentially a political decision is difficult.

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Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

Natural or environmental disasters, such as earthquakes, fires, floods, hurricanes, tsunamis, and other severe weather-related phenomena generally, and widespread disease, including pandemics and epidemics, have been and can be highly disruptive to economies and markets, adversely impacting individual companies, sectors, industries, markets, currencies, interest and inflation rates, credit ratings, investor sentiment, and other factors affecting the value of the Strategy's investments. Given the increasing interdependence among global economies and markets, conditions in one country, market, or region are increasingly likely to adversely affect markets, issuers, and/or foreign exchange rates in other countries. These disruptions could prevent the Strategy from executing advantageous investment decisions in a timely manner and could negatively impact the Strategy's ability to achieve its investment objective. Any such event(s) could have a significant adverse impact on the value and risk profile of the Strategy.

International investments entail risks including fluctuation in currency values, differences in accounting principles, or economic or political instability. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility, lower trading volume, and higher risk of market closures. In many emerging markets, there is substantially less publicly available information and the available information may be incomplete or misleading. Legal claims are generally more difficult to pursue.

Currency risk is the risk that fluctuations in exchange rates between the US dollar and foreign currencies and between various foreign currencies may cause the value of an investment to decline. The market for some (or all) currencies may from time to time have low trading volume and become illiquid, which may prevent an investment from effecting positions or from promptly liquidating unfavourable positions in such markets, thus subjecting the investment to substantial losses.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

Liquidity risk is the possibility that securities cannot be readily sold within seven days at approximately the price at which a fund has valued them.

Quantitative easing (QE) is a form of monetary policy in which a central bank, like the US Federal Reserve, purchases securities from the open market to reduce interest rates and increase the money supply.

Quantitative tightening (QT) refers to when central banks raise the federal funds rate. In a tightening monetary policy environment, a reduction in the money supply is a factor that can significantly help to slow or keep the domestic currency from inflation.

Recession is a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in gross domestic product (GDP) in two successive quarters.

A Treasury yield refers to the effective yearly interest rate the US government pays on money it borrows to raise capital through selling Treasury bonds, also referred to as Treasury notes or Treasury bills depending on maturity length.

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year US Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. It is also used to predict changes in economic output and growth.

The shape of the yield curve is closely scrutinized because it helps to give an idea of future interest rate change and economic activity. There are three main types of yield curve shapes: normal, inverted and flat (or humped). A normal yield curve is one in which longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time. An inverted yield curve is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of upcoming recession. A flat (or humped) yield curve is one in which the shorter- and longer-term yields are very close to each other, which is also a predictor of an economic transition. The slope of the yield curve is also seen as important: the greater the slope, the greater the gap between short- and long-term rates.

Yield curve inversion is when coupon payments on shorter term Treasury bonds exceed the interest paid on longer-term bonds .

The **ISM New Orders Index** shows the number of new orders from customers of manufacturing firms reported by survey respondents compared to the previous month.

Index performance returns do not reflect any management fees, transaction costs or expenses.

Indices are unmanaged and one cannot invest directly in an index.

Economic trend information is sourced from Bloomberg unless otherwise noted.

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