



Recession risks or not?

Market Comment, February 2023

Inflation, stagnation or recession. Which term best describes the situation and represents the primary risk? As things currently stand, the stagflation scenario is probably the one with the greatest likelihood of coming to pass. Such a scenario would see little or minimal growth in the economy together with inflation that remains at above-average levels by historical standards, even if the latter may decrease somewhat over the coming months. However, there are also risks of recession. This remains the case in the Eurozone due to its energy dependency – despite the fact that it has succeeded in increasing its gas inventories to higher levels than before. And the US may also not be spared, especially if the US Federal Reserve (Fed) and the European Central Bank (ECB) do not cut interest rates and reverse the trend of making money more expensive.

In the Eurozone, the likelihood of a recession could increase again this year if energy shortages become more pronounced once more, triggered by high demand owing to cold temperatures or by a further ratcheting down of energy supplies from Russia or the OPEC countries. This is despite the fact that gas inventories currently still appear to be well-stocked. Thanks to its better balanced energy supply and production that is geared more towards pharmaceuticals, the probability of a recession is lower in Switzerland than in the Eurozone. In Germany and Italy, on the other hand, the likelihood of a recession is considerably higher than in the bloc's other member states due to the higher share of gas in their overall energy supply. But what about the US, the world's biggest economy and the decisive influence on the financial markets?

Upon looking at developments closely, it was already possible to observe a “technical” recession in the US during the first half of 2022, although this dissipated over the course of the past summer. In the US, a technical recession is defined as two consecutive quarters of negative growth in gross domestic product (GDP), which measures

economic activity. In quantitative terms, the first and second quarters in the US delivered growth of -1.6% and -0.9%, respectively. While this can be deemed to represent a technical recession, these negative figures came about due to special constellations. During the first quarter, commodity prices and other commodity-related changes relative to the prior period meant that the trade balance contributed negatively to GDP growth. In the second quarter of 2022, there was an unusual increase in inventories, which is also viewed as an extraordinary reason for the negative change in GDP. This is why we cannot talk of a real recession in either quarter and instead have to refer to a “technical” recession. So what are the risks now of a real recession and how is this defined?

“Against a backdrop of rising economic risks, less cyclical investments are less risky and represent the more cautious strategy.”

Gérard Piasko, Chief Investment Officer

In the US, this is decided on by the “National Bureau of Economic Research”, or NBER for short, which is a think-tank organised as a non-profit private research organisation that involves professors from major universities. The NBER defines a recession as follows: “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in GDP, real income, employment, industrial production and wholesale and retail sales”. The slowdown observed in the first half of 2022 was therefore not classified as a recession by the NBER despite the “technical” recession that took place.

However, the risks of a real recession in this sense are increasing in the US for a number of reasons, even if it is by no means certain that the NBER will ultimately also proclaim that a recession has occurred. The main reason for this is the continuation of the enormously aggressive interest rate hike policy by the Fed, which would like to

push down inflation to its target figure of 2%, an objective that Fed Chair Powell has himself said cannot be achieved without pain. While a supply shortage cannot be tackled with interest rate hikes, meaning that it is by no means certain that the Fed's policy will in the end bring inflation back down to 2%, it is possible to use them to put the brakes on economic demand. A recession may thus be triggered in the US by a decline in private consumption, a reduced level of business investment, slowing real estate activity and, above all, a deterioration of the labour market (i.e. employment) and not only by an external energy shock as experienced by the Eurozone in 2023 or in the US itself during the 1970s. History has shown that the current marked inversion of the US yield curve should be viewed as a warning, as every recession in the past has been preceded by such a development.

Against a backdrop of rising economic risks, less cyclical

investments likely represent the more cautious strategy that entails lower risks compared to cyclical assets that are more dependent on the economy. It therefore remains sensible to favour defensive, less cyclical equity markets, such as the Swiss equity market, over their more cyclical counterparts, while in the bond space preference should be given to bonds with better credit quality over those with poorer credit ratings.

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