The Fairy Tale of a Soft Landing

The consensus view shift toward a mild downturn looks misplaced.

Arif Husain
Head of International Fixed Income and
Chief Investment Officer, Fixed Income

Early in 2023, the consensus view was that a global recession was coming later in 2023. But as the year has matured, the consensus outlook has completely shifted. A soft landing—or even no landing—is now the consensus. What is remarkable is how strong the consensus has become. The consensus is, indeed, so consensus!

I think differently. A soft landing is merely a convenient and comfortable fairy tale, backfitted to match the market prevailing narrative and based on backward-looking unique circumstances. A hard landing is coming—it’s just a matter of when.

Likely One-Offs Provide False Hope

Europe’s warm winter allowed the region to avoid a deep recession, which was viewed as almost inevitable amid the high energy prices and supply problems following Russia’s invasion of Ukraine. This led to a burst of optimism about the region coming out of the winter. The European energy dynamic has surely improved, but probably not enough. Will we get another warm winter? I’m not sure investors should be allocating capital based on that hope.

On the fiscal side, U.S. growth received a boost from the Inflation Reduction Act in early 2023. It authorized almost US$900 billion of total spending, mostly dedicated to manufacturing and climate change projects. The CHIPS and Science Act provided another fiscal tailwind to growth. While the fiscal impulse, or net stimulus from government spending, may still be positive, its power is waning. The upcoming U.S. election and the already large government deficit make a strong case that additional fiscal support will be limited.

Also, during the U.S. regional bank crisis in March, the Federal Reserve (Fed) stepped in to create a new term funding facility to ease the liquidity crunch at banks. Markets anticipated that the Fed would soon slow or stop its rate hikes, leading to a material loosening of financial conditions. The two-year U.S. Treasury note yield plunged to 3.77% on March 24 from 5.07% on March 8 as markets rapidly repriced their expectations for Fed tightening. Mortgage rates fell, providing another fleeting boost to the economy as yields and mortgage rates have now moved back up in response to the soft landing narrative.

1 The Inflation Reduction Act and the CHIPS and Science Act were both enacted in 2022.
2 Financial conditions are measured by Treasury yields, credit spreads, stock prices, and the price of the U.S. dollar.
3 Data source: Bloomberg Finance LP.
Peak Everything: What Goes Up Must Come Down

But the temporary benefits of looser financial conditions and U.S. fiscal spending will soon wear off. In fact, I worry that we’ve reached “peak everything” in that all factors that have contributed to the global economy’s resilience have now turned.

- Peak fiscal
- Peak inflation
- Peak liquidity
- Peak China growth
- Peak housing
- Peak credit
- Peak employment

Aggressive Tightening, Leverage Set Stage for Hard Landing

It already appears that global manufacturing is flashing signals of being in a recession. The Covid-induced boom in the services sector is showing signs that it is also past the peak. Labor markets are not as strong as they were.

Most importantly, when global economic activity indicators were around current levels in past economic cycles, central banks were already well into rate-cutting mode. But this time around, we have central banks still tightening while also winding down their balance sheets through quantitative tightening. Global central bankers appear to have calibrated monetary policy to a world where the extreme tailwinds coming out of the pandemic—the spending boom driven by Covid-induced saving as well as the services-led recovery—continue well into the future.

The Fed has hiked the federal funds rate by more than 500 basis points (bp) since kicking off the tightening cycle in March 2022, and it currently looks like it could increase rates once more in 2023. The European Central Bank has tightened by over 400 bp and the Bank of England by more than 500 bp. Even the Bank of Japan, which has faced much lower inflation than in other developed markets, has widened its target range for government bond yields to let them increase.

As central bankers remind us, monetary policy works with long and variable lags. The cumulative global tightening is massive.

This will eventually become the dominant narrative instead of the current market consensus’s focus on the warm glow of the recent one-offs.

Making matters worse, all the conditions for a hard landing are present. Leverage in pockets of the financial system seems to be rising, and we know from past experience that elevated leverage can quickly cause cracks to become craters. And we’ve already seen some cracks—regional bank liquidity problems in the U.S. as well as severe stresses in China’s property sector and UK pension funds. I fear that the next one may be a crater.

Leverage is now likely in different places than during the global financial crisis. We have seen large-scale disintermediation of the banking system into less well-regulated and more opaque areas. This just means that the vulnerabilities may play out in different areas than in the past.

Market Pricing in Soft Landing Is Unrealistic

The other area where leverage has increased is on government balance sheets. During Covid, there was a large scale transfer of leverage from the private sector to the public sector. This has a few consequences. First, fiscal balances are now largely tapped out. When the recession comes, it will be hard for governments to spend their way out.

Second, global governments need to sell a ton of new bonds. Recently, a lot of issuance has been in the Treasury bill market, but as we move into 2024, much of these bills will need to be termed out and replaced with longer-maturity debt.

Who will buy all this duration, especially at a time when central banks are stepping back from bond purchases? The implication is higher long-term bond yields. So while eventually central banks will respond belatedly to recession with rate cuts, there is the potential that the calming power of those official rate cuts may be offset by a lack of response in longer yields. A late, blunted, and incomplete response could lead to a deeper and longer malaise.

A soft landing is consensus. In the near term, China’s stimulus and potentially a build in inventories may prolong the good mood. But a hard landing is much more likely in the longer term. The only questions are when those long and variable monetary policy lags will show their inevitable dominance and how to navigate that journey.

---

4 A basis point is 0.01 percentage point.
5 Duration measures a bond’s sensitivity to changes in interest rates.

T. Rowe Price cautions that economic estimates and forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual outcomes could differ materially from those anticipated in estimates and forward-looking statements, and future results could differ materially from historical performance. The information presented herein is shown for illustrative, informational purposes only. Any historical data used as a basis for the analysis are based on information gathered by T. Rowe Price and from third-party sources and have not been verified. Forecasts are based on subjective estimates about market environments that may never occur. Any forward-looking statements speak only as of the date they are made, and T. Rowe Price assumes no duty to and does not undertake to update forward-looking statements. The views expressed may differ from those of other T. Rowe Price group companies and/or associates.
T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

Important Information

Where securities are mentioned, the specific securities identified and described are for informational purposes only and do not represent recommendations.

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. Past performance is not a reliable indicator of future performance. Investment involves risks. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources’ accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

Hong Kong—Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission (“SFC”). This material has not been reviewed by the SFC.

Singapore—Issued by T. Rowe Price Singapore Private Ltd. (UEN 201021137E), 501 Orchard Road, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.

© 2023 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.