



# A Garden Variety Recession Is Coming

It will be very different than 2008 and 2020.

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Evidence continues to accumulate that we are well on the way to a recession. During the final leg of this journey, the labor market will lose speed: slowly at first and then more quickly, until the authorities deliver a circuit breaker in the form of monetary easing. I believe the next recession will be a “garden variety” recession—very different than the global financial crisis and the COVID varieties. Caution is nonetheless warranted, with larger allocations to fixed income likely justified.

There have been some positive developments: The fall in energy price, the fading of the supply chain issues, and the abandonment of the zero-COVID policy in China have lifted global growth momentum from recessionary to something that just looks a bit weak. The key question is whether growth slows to the point at which recessionary dynamics kick in.

In contrast to a more benign slowdown, a recession is a process under which weak growth, through its impact on the labor market, feeds on itself to create a downward spiral. An end to the spiral requires a positive shock, most often administered in the form of a loosening of monetary policy. Labor market dynamics are, therefore, a key variable to monitor. News from the U.S. is not encouraging on this front: Although headline payroll numbers continue to look robust, cracks



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have started to appear under the surface. And given that an easing of labor market pressures is one of the key motivations for the Fed’s hiking cycle, monetary policy will likely remain tight and the cracks will likely continue to grow.

## Draining Liquidity Will Put a Strain on Markets

The bipartisan agreement between Democrats and Republicans on the U.S. debt ceiling was a positive development. However, it also threw up another challenge. Due to debt limit considerations, the U.S. Treasury has run down the cash balances it holds at the Federal Reserve to finance current spending. In essence, this has worked as a form of quantitative easing. The U.S. Treasury must now replenish its cash balance, which will result in a substantial drain of liquidity from the financial system. As we have learned over the past decade, the financial markets tend to perform much better when liquidity is rising versus when it contracts.

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“...the outlook for growth-sensitive assets is challenging.”

The current situation has been further complicated by the recent difficulties experienced by the U.S. regional banks—the primary cause of which was tightening liquidity. Regional banks may face further pressures as more liquidity is drained from the system, but at least they have access to Fed facilities. Nonbank financial intermediaries have no such backstop and, therefore, will be even more vulnerable to a liquidity drain than local banks.

As an offset to some of these risks, at the most recent meeting of the Federal Open Market Committee, Chairman Jerome Powell suggested that the U.S. policy rate has reached a level that is considered adequately tight, so it is likely that we have seen the last interest rate hike from the Fed.

#### **Investor Caution Likely Amid Uncertain Outlook**

Outside the U.S., while manufacturing is in the doldrums, the demand for services is robust. In combination with a tight labor market and rising wages, this keeps pressure on the European Central Bank to tighten monetary policy further. In my view, this tightening process will continue until the eurozone exhibits its own recessionary dynamics.

Until now, the post-zero-COVID policy recovery in China has exceeded expectations. However, as largely expected, the recovery has been concentrated in the demand for services. Consequently, the Chinese growth recovery has had very few spillovers

to the rest of the world. The most recent data suggest that the recovery is moderating and maybe even has lost whatever steam it had on the manufacturing side.

So where does all this leave financial markets? Traditionally, the end of the Fed hiking cycle is a boon for risk assets, such as equities, and leads to an increase in the price of bonds. However, while the bond market response has followed the traditional playbook, the response of risk assets has been surprisingly muted so far. I believe this has reflected concerns over a weakening labor market and the (since resolved) issues over the debt limit. Which investor would like to explain to their boss that they lost big because they owned a lot of risk just before a major political standoff and a deterioration in the economic outlook?

In my view, investors are likely to continue to pursue conservative risk-taking until there is more clarity about whether the U.S., and with that the global economy, will descend into a recession. If I am correct, and we are at the final stages of the current business cycle expansion, the outlook for growth-sensitive assets is challenging. Caution is warranted as limited upside potential meets large downside risks. At present, the more successful portfolio construct likely has a larger weight on fixed income instruments that should benefit if growth slows and a more conservative allocation to assets, such as equities, that should benefit from rising growth prospects.

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