Global Recession Fear Looms Large: What Does It Mean For Equities?

Rajiv Singh / Wednesday, December 26, 2018

Predicting a change in the economic cycle is always fraught with risks. Even the renowned economists have gone wrong with their predictions many a times. An exercise of this sort is tougher than predicting earthquake in a particular seismic zone. However, based on economic data, we have made an attempt here to assess how valid is the fear of global recession. As of now, global economy seems to be in a spot of bother. Near inversion of the US yield curve as well as a sharp 16 per cent decline from all time high for the S&P 500 has heightened these fears.

These fears are not restricted to the US alone, data indicates that Chinese growth may be slowing down significantly and Japan & Europe (especially Germany) are also showing signs of fatigue. According to the NBER, the longest business cycle expansion in the US lasted for 120 months starting from March 1991 to March 2001. The current cycle, the second longest expansion in history began in June 2009 and questions about how long the business cycle expansion will last are natural.

To boost slowing growth, China has announced a fiscal stimulus program on 21st December; this comes on top of a reduction in the Reserve Requirement Ratio to 13.5% for smaller banks and 15.5% for large commercial lenders. Since April this year, the China Caixin Manufacturing PMI has reduced from levels higher than 51 to a reading of 50.2 for November, indicating a slowdown in overall manufacturing activity. The business confidence numbers have also seen a continuous decline from 51.9 in May to 50 for in November 2018. A Bloomberg survey indicates that economists foresee a 15% probability of a recession in China in the next 12 months. China contributes the most to global growth, and with a debt to GDP ratio of 265%, the problems in China are structural in nature.

Adding to these data points from China, data coming in from the US is also troublesome. While the 38% drop in oil prices reflects a glut in supply, a slowdown in demand cannot be overlooked. The International Energy Agency forecasts oil demand growth of 1.4 million barrels per day, after an estimated increase of 1.3 mbpd. The manufacturing PMI in the US has declined from 56.5 in April to 53.9 in November, we are likely to witness deceleration in growth rates.

Tax cuts approved by the US last year have acted as a fiscal stimulus for not only the US but the entire world. Last quarter, the US economy grew by 3.5% QoQ seasonally adjusted annualized rate. The US economy is expected to slow down to 2.6% growth in 2019 and 1.9% in 2020. The slowdown largely reflects the fading of the fiscal stimulus provided by the tax cuts. It is important to note that many economists believe that US economic trend growth rate has declined and is closer to 2.0%. Thus, 2019 would still witness above trend growth.

Some policies from the US government have been unhelpful- trade wars between the US and China can be harmful for growth, the Chinese economy may slowdown significantly if trade slows down, which will have implications, especially for Asia as China may resort to a competitive devaluation. In an extreme scenario, China can retaliate by selling its holdings of US treasuries. In addition, domestic developments in the US are concerning. Shutdown of the US government over a showdown between President Trump and the legislature has soured sentiment. Democratic control of the Congress is also leading to fears that the President will find it difficult to get proposals through.

Since 2009, the US Fed had been pumping liquidity into the financial system. But now, as the Fed opines that the US economy has strengthened, it has been reducing the size of its balance sheet by USD 50 billion per month. US Fed Chairman has stated that the current reduction program of the Fed balance sheet will continue and proceed as planned. This is in addition to tightening via increasing policy rates. A recession has been preceded by an inversion of the yield curve, but right now, 10 year yield is higher than the 2 year yield by 13.5 bps. The last two recessions were triggered by rate tightening, but we believe US rates currently are at lower end of the “neutral” rate. Recessions have occurred one to two years after the yield curve inverted.

While the US Federal reserve has indicated that it is likely to increase rates twice in 2019 and once in 2020, money markets indicate that 1) there is a split between no or one rate rise in 2019 2) there will be a rate cut in 2020. Thus money markets are pricing in a recession in 2020.

With the liquidity moving out of the system and with other fundamentals deteriorating, fears are rising. CBOE VIX or the “fear gauge” has increased to 28. In India too, in the recent past, we have seen that the VIX index has doubled over last few months and has risen almost 300% (in US) since the beginning of 2018.

Concerns from the Eurozone include weak exports from Germany (down 0.9%) in the recent quarter, while the imports have risen by 1.3%, the Germany economy grew by 1.1% YoY for the third quarter in 2018. The Flash Composite PMI index (Services + Manufacturing) fell to 52.2 from 53.4 in the month of October, recording a 4 year low. For December 2018, Manufacturing PMI fell to 51.5, according to preliminary estimates, a 33 month low.

Another risk to the world arises from the possibility of a disorderly Brexit, the probability of which has increased recently. While the long term economic impact is limited to a large extent to the UK and EU, and an orderly Brexit would be a minor blip for the rest of the world, Britain exiting from the EU without a transition deal would have a global impact, especially in the area of financial services.

The Japanese economy hasn’t been in the best of shapes lately, with the Bank of Japan’s Governor Mr.Kuroda highlighting the risks to the outlook of Japan’s economy and his readiness to infuse more liquidity if needed. At 19, the Tankan survey indicates continued weakness, Japanese economy declined by 0.6% last quarter. He has also implicitly said that banks have room to cut interest rates, increase buying of assets and also can accelerate the pace of printing money.

However, while growth is slowing down; we are far from the cusp of a recession. In the Bar Analysis grid of US, currently 11 out of 19 economic indicators are pointing to positive economic growth though eight indicators are negative. In the US, consumer confidence is near an 18 year high, whereas unemployment rate at 3.7% is at a 40 year low. This indicates that consumption will be resilient as wages are likely to rise on account of a tight labor market. China has plenty of policy tools at its disposal to counteract a slowdown; its FX reserves are USD 3.1 trillion, which gives it flexibility.

According to the IMF, India is among the few large economies where growth is resilient. IMF forecasts growth for FY2019-20 to be 7.4%, which is a strong number. What we find more encouraging is that the driver of growth is changing, increasingly led by capex. Gross Fixed Capital Formation (GFCF) increased by 12.5% YoY during Q2FY19; the third consecutive quarter of double digit growth.

What does this mean for equities- if the global economy is tipping into a recession, a bear market is a natural outcome. However, our analysis indicates that while we are experiencing a deceleration in growth prospects, a recession is not on the horizon yet. Withdrawal of liquidity and a slowdown in growth prospects mean valuations need to adjust lower. Also the dispersion in stock returns has been low on account of accommodative policies; stock picking will become more important for portfolios in the coming months.

Lastly, we need to keep a keen eye on economic data, especially from China in the coming months. In our view, while there may be a deceleration in growth in 2019, we do not rule out the possibility of recession in the second half of 2020.

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