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Way Out Recession?

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The prices of risk asset classes are subject to downward pressure. Both theoretical channels of action are at work: First, the discount rate rises because both credit risk-free yields and the risk premium rise. Second, the prospect of falling earnings growth also increases. The underlying driving factor is inflation.

Risk inflation spiral

Inflation rates are surprisingly high. As long as inflation was low, companies and consumers were not very concerned about inflation. However, because inflation is trending upward, trend inflation could eventually reach a level at which inflation expectations start to rise in a sustained manner. An inflation spiral would be the result. In this scenario, inflation remains high because this is what consumers and companies expect.

Severe recession scenario

Central banks can do little to influence current inflation. However, they can try to dampen demand. Positive real interest rates are necessary for this. The key question is which inflation rate to calculate with. High, because an inflation spiral is likely, or low, because it can be prevented. To break an inflation spiral, key interest rate hikes to above the high inflation level would be necessary. A severe recession would be the consequence.

Scenario growth below potential or mild recession

To prevent this, central banks in developed economies are raising key interest rates as quickly as possible. The problem with this is that there is considerable uncertainty about the size of the output gap, inflation dynamics and the relationship between policy rates and economic growth. A soft landing for the economy – slowing growth to below potential growth – can only be achieved with a certain amount of luck. The risk of a recession being triggered by the key rate hikes is thus increased. However, this recession would be milder than in the case of an inflationary spiral.

Falling growth

Already, more and more economic indicators are pointing downward. Consumer sentiment has been hit hardest. In April, it fell to its lowest level in the OECD area since 2008. Last week, economic activity in the US for the month of May contracted in several key segments (housing starts, retail sales, manufacturing). The Conference Board's Leading Economic Indicator fell for the third consecutive month in May, but does not yet suggest a recession. The Philadelphia Fed's Business Outlook Survey for June stood out, falling into contractionary territory for the first time since spring 2020. On the positive side, in China, economic indicators (retail sales, industrial production) rose in the month of May due to the opening measures, after falling significantly in previous months due to the lockdown measures. Overall, GDP in China is expected to contract significantly in Q2. Next Thursday, the flash estimates of purchasing managers' indices for some developed economies for the month of June will provide an important update. On Friday, the Ifo index for the month of June will be published in Germany.

Key interest rate hikes as quickly as possible

Last Wednesday, the US Federal Reserve raised key interest rates sharply by three quarters of a percentage point. This measure had only been hinted at a few days earlier in the Wall Street Journal. The new target range for the key interest rate is now 1.5% – 1.75%. At the beginning of March, it was still 0% – 0.25%. Chairman Powell is signaling that hikes of half a percentage point at each Fed meeting could be the new baseline. Surprisingly high inflation rates and rising inflation expectations could mean a three-quarter percentage point hike. That's all but priced in for the next meeting on July 27. Convincing evidence of easing inflation pressures could lead to a reduction in pace to one-quarter percentage point per meeting. By the end of the year, market prices reflect a policy rate of just under 3.6%. This is realistic and probably already implies a restrictive interest rate environment. Two clues: First, the Fed estimate the neutral (nominal) rate at 2.5% (median of Fed Meeting Participants' estimates). Second, more and more parts of the yield curve are becoming inverted. Currently, the yield on five-year government bonds (3.34%) is higher than the yield on ten-year government bonds (3.23%).

Gas supply reduction

Reductions in gas supplies from Russia have been among the biggest risks since the outbreak of war in Ukraine. Last week they became reality. On the part of Russia, the official reason given is sanctions. The West, in turn, argues that it is a strategic measure to put pressure on Europe. In any case, the economic downside risks have increased once again.

Spread Management by ECB

The European Central Bank held an extraordinary meeting on fragmentation in the Eurozone last Wednesday. The Governing Council decided to take a flexible approach to the reinvestment of maturing redemptions in the PEPP portfolio. In addition, the preparation of a new anti-fragmentation instrument is to be accelerated. According to the ECB, the aim is to ensure the functioning of the monetary policy transmission mechanism, which is a prerequisite for fulfilling the price stability mandate.

23 years after the introduction of the euro, the biggest design flaw of the euro has not been remedied. Economic and fiscal policy is not common. This leaves a residual risk of the currency zone breaking apart. The European Central Bank has also been performing the function of a lender of last resort for ten years, although this is not actually allowed. As long as inflation was below the central bank's target, this was not a major problem because the central bank could act expansively. However, because inflation rates have risen sharply, the conflict of objectives between price stability and preserving the euro zone has become more intense. There are several problem areas in the management of country credit risk spreads. Among other things, no one knows where a fundamentally justified yield premium lies. But the announcement alone has been enough to bring about a narrowing of spreads.

Conclusion

For the financial markets to calm down (rising share prices), it is (probably) necessary for inflation rates to fall at monthly intervals. This is because it would reduce the pressure to raise key interest rates very quickly. The prospect of sustained economic growth is based primarily on the potential for current GDP to catch up with the pre-pandemic trend. The high consumer savings surplus supports this. However, the high price level, which will continue to rise at an above-average rate also due to the pass-through effects, will further reduce consumers' purchasing power. A growth phase below potential is the most likely scenario. Downside risks remain, also due to restrictions on gas supplies from Russia.

For a glossary of technical terms, please visit this link: [Fund Glossary \(erste-am.at\)](https://www.erste-am.at/fund-glossary)

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