Soft Landing

In the 10 months for the calendar year to October 2023, both the US DowJones Index and the Australian ASX/S&P 200 Index showed modest losses. On the other hand, the technology heavy NASDAQ Index in the USA had a stellar gain, primarily due to the 7 megatech stocks including (over) excitement from the positive Artificial Intelligence (AI) sentiment. Since those lows at the end of October 2023, all indices have staged a stellar performance of over 10% such that the "Santa rally" delivered a good present for investors to close out what would've otherwise been for most a lacklustre six months.

For most of 2023, the main macroeconomic issues that have dominated markets were high inflation leading to higher interest rates, whereby rates in Australia rose from a cash rate of 0.25% in May 2022 to 4.35% at Christmas 2023. Inflation numbers were reported in the 6-8% range, numbers which truly shook confidence. Central banks spent most of the year talking tough on inflation. As late as 10 November 2023, the chair of the US Federal Reserve, Jerome Powell said that they "were not confident we've achieved the stance to hit 2% inflation. The Fed will continue to move carefully. The Fed won't hesitate to tighten further if appropriate. They expect growth to moderate in coming quarters."

Against the central bank rhetoric, the CPI numbers in the US were cooler than expected on 15 Nov 23. Commentators were in two camps. On 5 Dec 23, Bloomberg showed several commentators saying that US stock markets was not pricing any scenario in 2024 other than a soft landing and interest rate falls. On 13 Dec 23, Janet Yellen, US Treasury Secretary, said "the US was on a path to taming inflation without a deep economic slowdown i.e. a soft landing in the US."

On 14 Dec 23 the FOMC (the Fed) announced it would leave interest rates unchanged in the 5.25-5.5% target range. The decision was unanimous. GDP for 2023 2.5%. but the dot point range which is the consensus from all of the members of the FOMC showed 3 rate cuts equalling 75 basis points (.75%) in 2024. They said this reflected inflation coming down quicker than expected to 2.6%/3.1% for the year ended November for personal consumption expenditure (PCE) and Core PCE respectively. The forecast for 2024 is 2.4%.

It is this pivot from the formerly hawkish stance of several years to a view that not only were rate increases finished, but that there will now be rate declines in 2024. It is that pivot which has fuelled the rally globally including in Australia from 6800 to 7600 on the index.

Recession? It's a question of definition

Recessions are not easy to analyse at the time as they depend on data after the event including industrial production, consumer spending and employment. In the US, the job of calling a recession has been outsourced to an independent body called the National Bureau of Economic Research (NBER). Because the data lags, it took a year to identify that the US was in recession during the global financial crisis, which started in December 2007. For this reason it has become common to use the simpler definition of recession from US economist Julius Shiskin i.e. that a recession be defined by two successive quarters of declining GDP. But the simplicity of Shiskin's definition means it is at best a rule of thumb and one that is subject to false-positives and negatives. The chart from Capital Economics shows that recessions come in four flavours.

	Supply Shock Recession	Balance Sheet Recession	Cyclical Recession	Growth Recession
Example	COVID, 1970s oil shock	Global Financial Crisis, Great Depression	2001 US recession, early 1990s UK recession	DM weakness in mid-1990s
Cause	Supply-side shocks; war; pandemics; energy shocks, drought	Asset price collapses requiring extended periods of balance sheet repair that weigh on private sector demand. Housing bubbles particularly painful.	Demand weakens in response to policy tightening, creating feedback loops into employment, and back into consumer and business spending.	Multiple, including monetary or fiscal policy tightening, deterioration in terms of trade, and weakness in export partners.
Policy Response	Monetary and fiscal policy insufficient beyond cushioning subsequent weakening in demand.	Substantial: large interest rate cuts, possibly QE, large fiscal stimulus.	Moderate: rate cuts but no QE, some fiscal stimulus.	Modest: small rate cuts, fiscal support through automatic stabilisers but little discretionary stimulus.
Effect	Large loss of output. Quick recovery once supply problems resolve.	Large and persistent loss of output. GDP often fails to return to pre-crisis trend.	Moderate loss of output, GDP returns to trend, no permanent loss of output.	GDP doesn't fall but remains below trend for several quarters, causing unemployment to rise.

Source: Capital Economics

Firstly, those in the wake of major shocks, such as that caused by the pandemic. US GDP contracted for only one quarter at the onset of the pandemic, but the sheer size of the decline in output and the accompanying surge in unemployment meant that the economy was clearly in a recession. These shocks from the supply side of economies such as the pandemic and the oil shocks of the 1970s may lead to extreme short-term falls in output, but activity tends to recover sharply once supply problems ease.

It is submitted that there was a failure by many to correctly analyse the pandemic as a supply shock recession that would include a large loss of output, but would recover quickly once the supply problems were resolved. By incorrectly classifying the covid recession, this led policy makers to over stimulate, resulting in excessive inflation and then led policy makers to raise interest rates at an unprecedented rate. This led many including your diarist to be concerned that we would have a cyclical recession. On the balance probabilities, the view now is that there will not be a cyclical recession.

To return to the Capital Economics chart, the three other types of recessions are caused principally by developments by the demand side of economies. The most extreme involves asset price collapses and financial crises, these are often precipitated by excess credit growth and the development of asset bubbles, the most damaging of which has historically been in housing. Once these bubbles burst, balance sheet recessions ensure and the loss of output is substantial. This was the case in the 2007-08 recession.

The second type of demand-driven recession is a cyclical or plain vanilla recession. These typically follow periods of policy tightening that are aimed at staunching excess demand or inflation problems.

The final type of recession is known as a “growth recession”. Economies continue growing, but so slowly that unemployment rises.

The absence of large financial imbalances or strains in house-hold balance sheets, suggests that a major recession of the type experienced in 2007 is highly unlikely. Cyclical recessions are a bigger risk in countries where central banks have raised interest rates to well above their neutral levels e.g. the Eurozone and the UK.

The policy response to the pandemic should’ve been reduced when it became clear that the vaccines would work and so economies were dealing with a supply shock recession, not a cyclical recession. What is a little more confusing is that the rapid increase in interest rates appear to have brought down the excessive inflation in the USA and so the economy has produced a quick recovery in line with the left hand box in the diagram. Many economic commentators were concerned that the interest rates would lead to a cyclical recession and

that inflation would not come down. In the US at least, the good news is that inflation is expected to continue to fall sharply with only a modest weakening in demand pressures. A mild form of growth recession could therefore be enough to return inflation to target in most countries.

In Australia, there are a number of learned economists now taking the view that Australian inflation will be close to 3% by the end of calendar 2024. This would be sufficient to support interest rates at lower rates in Australia as well. A growth recession in Australia is also now the likely central case rather than a cyclical recession because unemployment remains low, household balance sheets are strong and most people have a job, at least those who want one. This is indeed a pleasing outcome for the stock markets and has led to recent rallies. It is a good indication of the rule that one needs to be invested to take advantage of those five to ten best days in any one year.

In the previous blog, your diarist commented that not all economies move in tandem, nor do stock markets. The US economy is the strongest, Australia is in the middle, while the UK and Europe are lagging. A query in Australia is whether the institutional factors including central wage fixing mean that inflation will be slower to reduce i.e. will be sticky. The passing on of inflation into the wage fixing process is much more institutionalised in Australia than in the US.

Conclusion

In conclusion, the shift from a central case of possible cyclical recession caused by high interest rates to growth slowing but not negative i.e. a growth recession is good news for the Australian people, the economy and the stock markets.

Winners and losers will result, particularly as there is likely to be margin pressure in 2024. With costs continuing to increase through lagged inflation including wages, but difficulty in passing on these costs in full as consumers and businesses are being careful with their dollars, the resulting margin contraction will see pressure on profits through 2024 in many sectors. This will in turn lead to some reappraisal of earnings per share growth estimates and some reductions in valuation ratios. As our Senior Portfolio manager said in his New Year's comments, it will be a good year but a hard year.

Happy Investing in 2024,

Chris Burrell