# FOOLED BY RECESSION DATA

September 2019

## Overview

After a year and a half of economic slowdown, the first real signs of alarming macro conditions are starting to surface. Worried investors now have plenty of evidence to sustain their bearishness. Yield curves are inverted or flat, industrial surveys are at low levels and even the mighty Germany has had a quarter of negative GDP. Is a global recession already here? We do not think so.

We understand that by cherry-picking data, an analyst could make the case for a recession. However, when we look at the large cross-section of data that comprise our proprietary Growth Nowcasters, we find limited evidence that recession risk is currently high.

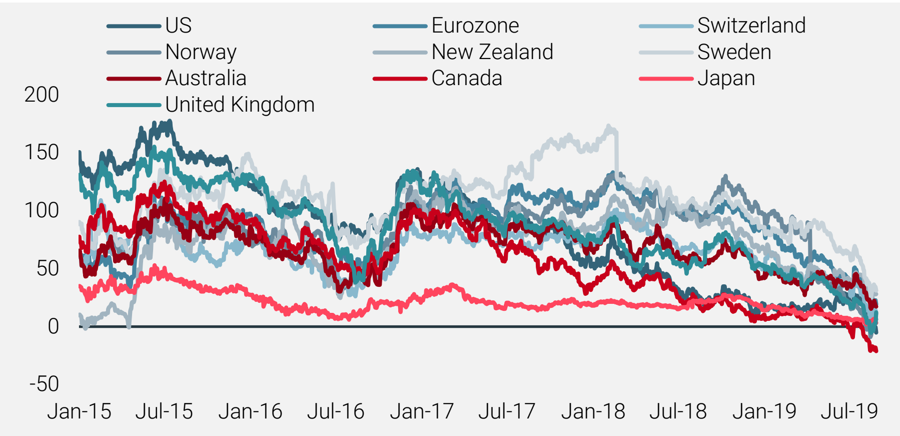
Having said that, China and Europe are at risk and are already flashing red in our metrics. Recession risk is very much uneven around the world and that is probably the reason why investors are puzzled by the recent data. To them we say: look at a large cross-section of macro data and screen for consistent signs of recession across economic sectors and countries.

Will we see a recession in the coming months? Hard to answer, but when looking at (1) the origin of the slowdown and (2) the historical dynamics of growth that preceed situations similar to today's, we find limited risk of a worldwide recession.

### Why Investors are Worried

There are clouds gathering on the investment horizon that are usually a precursor to recession. First, as shown in Figure 1, several yield curves are now either flat or inverted. This means that for many G10 countries, the 10-year yield is either equal to or lower than the short-term yield. This implies that markets are expecting interest rates to be lower tomorrow than today. At this stage of the cycle, there is only one economic scenario that can make this possible – the economy enters into a recession.

Figure 1: Yield Curve Slopes (10-year Minus 2-year) Across G10 Countries




Source: Bloomberg, Unigestion. Data as at September 2019.

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### Key Points

- After 18 months of economic slowdown, the first real signs of alarming macro conditions are starting to surface.
- When looking at the origins of the slowdown and historical dynamics, we find limited risk of a worldwide recession, with a large portion of the economic deceleration reflecting a deterioration in expectations.
- Growth remains at risk as deteriorations such as the current one rarely stop on their own. However, this time, central banks seem to be pre-empting, which is a first.

If this curve situation is on investors' minds, it is because it also comes with a handful of other consistent signals: breakeven rates (market measures of expected inflation) have taken a plunge, the price of commodities are low, volatility curves have recently been inverted and many hedges are currently expensive, including bonds, the Japanese yen and the Swiss franc.

In terms of the macro picture, data here is also less than compelling. In the US, the ISM took a serious plunge and the capacity utilisation rate peaked in October 2018 and has been dropping since. In Germany, the IFO survey already places the country's economy in a recession and this is consistent with surveys from the European Commission. Elsewhere, the growth rate in the production of Chinese electricity dropped to 2015 levels, while South Africa's Q1 GDP was -3.2%. Finally, the CPB World Trade Index shows that global trade volumes declined by 3% over the last year. There is, it seems, no place to hide. All the signs are here and a global recession is looking increasingly likely within the next 12 months. But is this really so?

"Macro data would suggest that a recession is imminent."

## Our Take

We think this question about recession is essential to portfolio positioning, given its bearing on macroeconomic, sentiment and valuation considerations.

Our approach to measuring recession risk is based on two conclusions from our macro research:

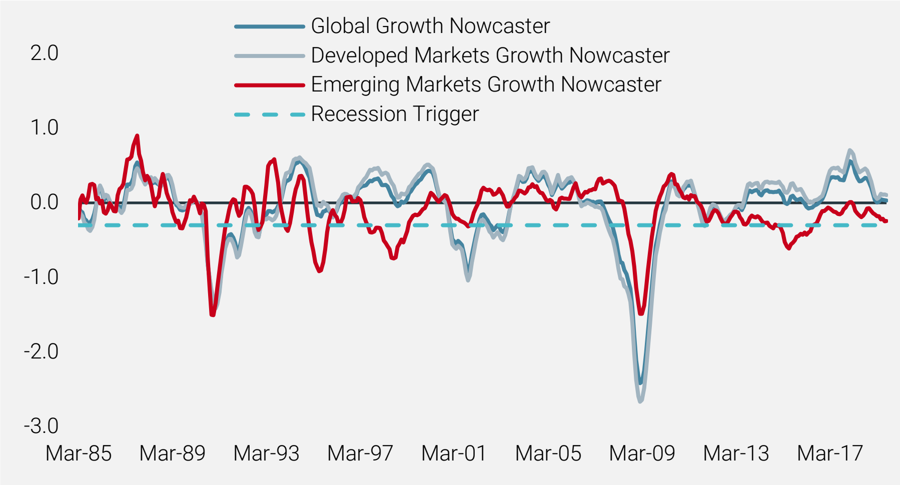
- Recessions are hard to predict. They always come for different reasons, from the bursting of an equity bubble in 2001, the collapse of the US housing market in 2008 or excessive debt in the Eurozone in 2011.
- Asset returns are connected to the current macro situation. A prediction exercise is usually not rewarded by markets, even when getting it right. From this perspective, a nowcasting exercise makes a lot more sense.

Our Nowcasters aim at assessing the current macro situation across a set of 39 countries, including 11 significant emerging economies. In total, our indicators cover about 90% of the world's GDP. They screen for signs of recession risk across the different key dimensions of each economy. Instead of looking at a cherry-picked set of time series, they favour the inspection of a large cross-section of data. What do these indicators have to say?

Figure 2 shows our global Growth Nowcaster, alongside its breakdown between developed and emerging countries. The blue dotted line on the chart highlights the threshold that needs to be crossed for the economy to be at risk of recession. This threshold is set at -0.3 and has been calibrated from the past 30 years of history. When the Growth Nowcaster of a country historically declines and drops below this number, it has been through either a sharp slowdown or a recession. For the moment, we have seen a decline, but not the drop. Today, the risk of being in a recession is limited, especially for developed economies.

"When we look at the large cross-section of data our Growth Nowcasters are comprised of, we find limited evidence that recession risk is currently high."

Figure 2: Global Growth Nowcaster, 1985–2019

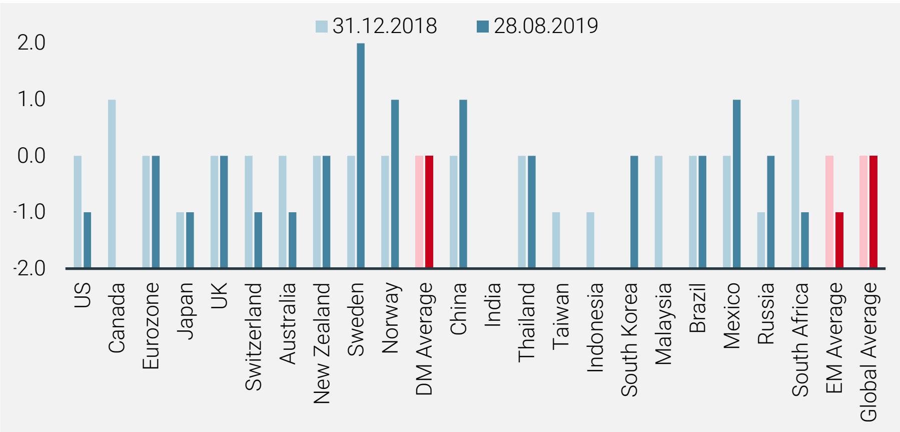



Source: Bloomberg, Unigestion. Data as at September 2019.

Given the geographical granularity of our indicators, we can also rank countries for their level of recession risk, from -2 (very low risk) to +2 (very high risk) based on the Growth Nowcaster and the level of its Diffusion Index (the percentage of improving data in the Nowcasters). Figure 3 shows such country-level information. As indicated by the previous graphical analysis, global recession risk is overall neutral. However, looking at a more granular level, this neutral level hides disparities: Sweden, Norway, China and Mexico are currently ranking the worst, with Sweden the most likely to currently be in a recession. Selected Asian economies, the US and Japan are getting the best grades. If no recession today, what of the medium term?

"Recession risk is very much uneven around the world, with China and Europe most at risk."

Figure 3: Recession Risk Grade Across Countries



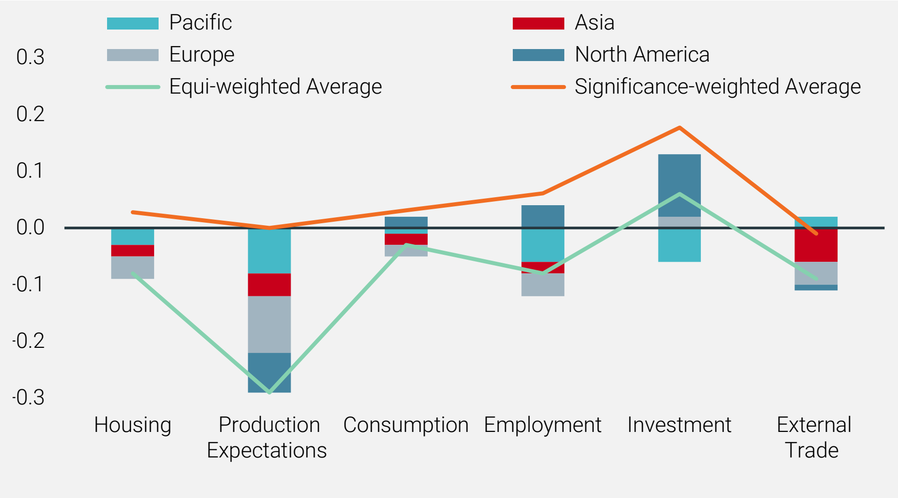

Source: Bloomberg, Unigestion. Data as at September 2019.
Reading note: a grade of 2 implies a very high recession risk. A grade of -2 implies a very low recession risk.

There are two ways to try to gain knowledge on this matter. First, by looking at the origin of the current lower numbers and, secondly, by looking at what has happened historically once we have reached points similar to today's.

First, the origin of the slowdown. A key feature of recessions is that they consistently affect a broad range of sectors of an economy: Figure 4 shows the value of our Nowcasters per economic zone as well as their detailed breakdown by component. A large portion of the economic deceleration reflects a deterioration in expectations, probably tied to the trade war situation. Without this component, the Growth Nowcasters would stand much higher.

"The deceleration reflects a deterioration in expectations, probably tied to the trade war."

Figure 4: Nowcasters' Decomposition Across the Key Sectors of Each Zone

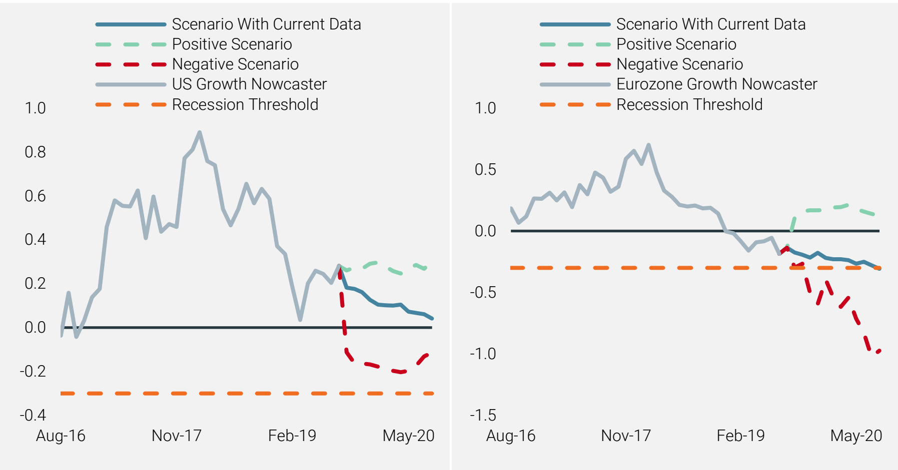



Source: Bloomberg, Unigestion. Data as at September 2019.
Reading note: "Significance-weighted average" shows the average across nowcasters' components using the economic and market significance of each country to weigh each of them.

Second, we can also run regressions to assess the usual trajectory taken by an economy once we have historically reached the macro conditions that are with us today. Figure 5 shows such numbers, alongside projections obtained by assuming (1) a further significant deceleration and (2) a significant improvement in the macro momentum. When applying this scenario analysis to the US and to the Eurozone, two very different conclusions arise. First, in the US, even with a significant deterioration of the macro situation, by historical comparisons there are very limited chances of a recession occurring over the next year. However, in the case of the Eurozone the situation is very different. If the current trend continues, the Eurozone is set to enter into a recession within 12 months.

"Even with a significant deterioration in the macro situation, by historical comparisons there are very limited chances of a US recession."

Figure 5: Historical Scenario Analysis for the US (left) and the Eurozone (right) Economies




Source: Bloomberg, Unigestion. Data as at September 2019.

## Conclusion

These are the three key takeaways from our set of Nowcasters:

- For now, recession risk is neutral and uneven across economic zones, making the current situation incomparable to 2008 or 1990.
- There are no signs in the US of an imminent entry into recession, though the situation for the Eurozone is very different.
- Despite a limited overall risk of recession, growth remains at risk as the current deterioration has been ongoing for a year and a half, and such slowdowns rarely stop on their own. Yet, this time, central banks seem to be acting pre-emptively, which is a first.



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