The global economy: recession or rough patch

Economic commentary

23 August 2019

Key points

- The past few weeks have seen an escalation of the trade dispute between America and China, and further evidence of weakness in some of the world's major economies.
- The inversion of yield curves has raised fears that the United States, and some other large economies, may be about to slide into recession. While such inversions have in the past been a good signal of economic contractions, at least in the United States, there are reasons to believe that this signal is no longer quite as reliable.
- There is a risk of brief contractions in export-oriented economies, such as Germany and Japan, but there seems little prospect of a recession in the USA.
- The length and depth of the present cyclical slowdown will depend on how the trade dispute between America and China is resolved, and on the degree to which governments around the world feel able to loosen fiscal policy. This time around, the central banks won't be able to ride to the rescue.

The health of the global economy has taken a decided turn for the worse in the past few weeks. There appears to be no end in sight to the trade dispute between the United States and China, as a result of which businesses around the world are cutting back on capital spending. The upshot is that cross-border trade is now expanding at only a sluggish pace, while the manufacturing sectors in many advanced and emerging economies are contracting. There is even a good deal of gloomy talk about impending recessions, whether in the USA, Germany, the UK (where there are specific concerns relating to a "no deal" Brexit) or the global economy in general. But are things really that bad? Or is the recent outbreak of pessimism just a belated recognition of unfavourable developments that have been simmering for some time?

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A timeline of recent events

For those fortunate enough to have spent the past few weeks on their summer holidays and away from the financial and economic newsflow, here is a brief round-up of what you might have missed …

31 July The US Federal Reserve cut the Fed Funds' target rate, as expected, by 25 basis points, to a range of 2.00-2.25%. HSBC expects another quarter-point cut in September.

1 August President Trump announced that the remaining $300 billion or so of US goods imports from China will be subject to a 10% tariff from 1st September. This announcement came as a big surprise, and followed a month-long truce and the re-starting of negotiations.

5 August The Chinese authorities allowed the yuan to fall below the psychologically-significant level of 7.00 against the dollar, its weakest level since 2008. As investors piled into "safe haven" assets the US Secretary of the Treasury formally designated China as a "currency manipulator". On the same day, the US Institute of Supply Management reported that its non-manufacturing index for July was the weakest reading since August 2016. Together with the readout for the manufacturing sector, it suggests that the USA's annual growth rate will slip to below 2% during the second half of the year.

10 August It was reported that the UK economy contracted by 0.2% in the second quarter. While household spending held up well, increasing by 0.5%, the manufacturing and construction sectors contracted, capital expenditure declined again, inventories were unwound, and exports fell more sharply than imports.

14 August It was confirmed that Germany's GDP contracted by 0.1% in the second quarter, with the annual growth rate slipping to just 0.4%, the lowest since the first quarter of 2013. Not surprisingly, net trade was the main culprit as German exporters continued to struggle in the face of weak global demand for industrial equipment. The Bundesbank has subsequently warned that the economy could be heading for a recession. On the same day, the yield curves in the US and the UK inverted, sending financial markets into a spin.

Needless to say, these developments have caused some turbulence in financial markets. Aside from the inversion of yield curves (of which more below), the price of Brent crude oil fell back below $60 a barrel, while the gold price has broken above the $1,500 an ounce mark for the first time since April 2013. Meanwhile, equity markets have had several rough days, with the S&P500 index plunging by around 3% on both 5th and 14th August.

With all the downbeat news of the past few months it's no surprise that there has been more talk of recessions, either across the global economy generally or in individual countries. The chatter reached a crescendo on 14th August when the yield curves in both the USA and in the UK inverted; that's to say, it was cheaper to borrow money over ten years than to borrow it for two years. As a general rule, money costs more if it's borrowed for a longer period, with lenders having to take account of inflation and the risk of default. So yield curve inversions are fairly rare, and have often been associated with subsequent economic recessions. Indeed, there are many pundits in the United States who ascribe to yield inversions a near-magical power to predict the next recession.

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The inversion frenzy

Let's be clear on one point, though. Yield inversions don't cause anything, and certainly not recessions. They are simply a reflection of how investors perceive the future. If yields on long-term assets which deliver fixed returns, such as bonds, are falling, then it is because investors believe that there will be less inflation over the life of the asset, and by implication slower economic growth.

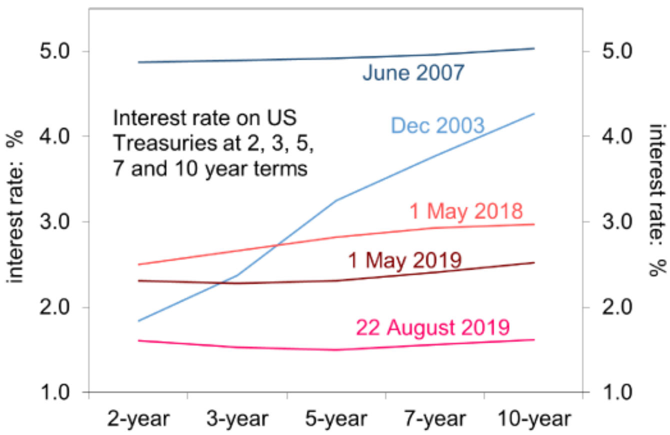
It's true that inversions have provided fairly reliable advance warning of recessions in the United States over the past 60 years, having sounded the alarm correctly ahead of all eight contractions and having sounded only one false warning. But, as was noted in an article in *The Economist* (27 July 2019), the same is not true in other countries, where the link between inversions and subsequent recessions is much weaker, and the number of false alarms is greater.

This time it's different

But there are also reasons to believe that this time around the inversion of yield curves is unlikely to presage a slide into recession, particularly in the United States. For one thing, investors may simply have belatedly woken up to economic realities that took rather a long time to dawn on them, in particular the contagion to the rest of the global economy, and to America itself, from the ongoing trade disputes launched against China and others by President Trump. With most of China's $500 billion or so of goods exports to the United States set to face tariffs from the start of September, and with China taking retaliatory measures, the global trading environment has altered fundamentally. The old assumptions about a globalizing world, and about the power of cross-border trade and investment flows to power that process, look to be on shaky ground in the present environment.

Having woken up to this reality, it's quite possible that financial markets have done what they so often do, which is to overdo their reaction ("over-shooting"). It shouldn't therefore come as any great surprise if there is something of a pull-back in the bond markets in the coming months as sentiment stabilizes.

Evolution of the US yield curve



Source: US Federal Reserve

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The death of inflation?

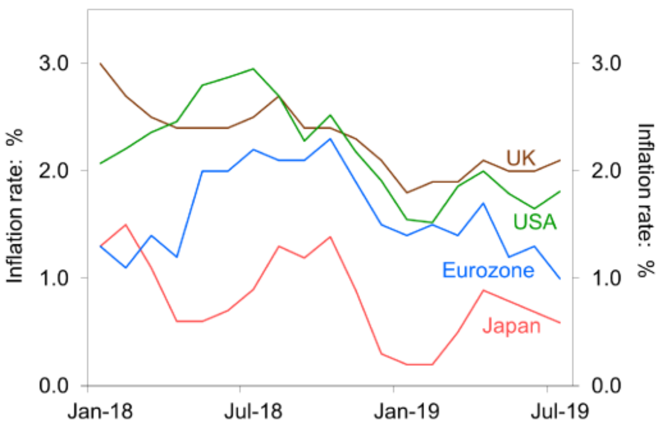
Perhaps more important is the fundamental change that has taken place in financial markets since the crisis of a decade ago. Back in pre-crisis days the yield curve would typically steepen (with long-term rates rising more than short-term rates) during an economic upswing, as investors anticipated that a continuation of growth would eventually stir inflationary pressures. Once the upswing had run its course the curve would then flatten as the central bank raised short-term interest rates to bring inflation back under control. These situations are illustrated for the USA in the chart above, which shows a steeper yield curve from 2003 when short-term interest rates were low and growth prospects robust, and one from 2007 when the economic skies were darkening and the Fed was tightening policy.

But these days there is no inflation to speak of in most advanced economies, and hence no justification for central banks to hike interest rates. Only in the United States was the last economic upswing long enough and strong enough to warrant more than token rate rises. This means that most of the action has taken place at the longer end of the yield curve. It's therefore all the more remarkable that curves have inverted when short-term rates haven't risen.

In the UK, for instance, the yield on benchmark 10-year government gilts has fallen by around 80 basis points in the past three months, with the yield currently at just 0.45%. This is partly related to concerns about a "no deal" Brexit, which many economists, including those at HSBC, believe would trigger a recession, but is also a response to the general deterioration in the global environment. It's certainly not all about Brexit though, as the decline in the yield on 10-year US Treasuries has been just as sharp, as is clear from the chart above, which also shows yield curves for May 2018, May 2019, and for last Thursday. Indeed, for a brief period last autumn these bonds were yielding more than 3%, but today yield under 1.6%.

The essential message from these recent down-shifts is that markets no longer believe that monetary conditions will 'normalize' in the foreseeable future. They are pricing bonds on the basis that the world of very low interest rates and subdued inflation will be with us for quite a few years yet. And, if central banks were unable to tighten monetary policy in a meaningful way during the last economic cycle, what chance is there that they will have better luck in the next one?

The world of low inflation



Source: Thomson Datastream

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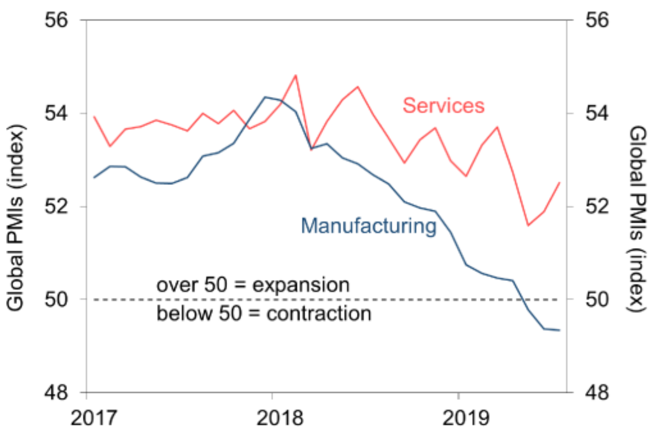
Heading for a spell of slower growth

The recent inversions of the yield curve needn't therefore be taken as a harbinger of recession in the United States or the global economy; but they do mean that financial markets are pricing for the pace of economic growth to be slower in the next few years. And it didn't need a yield curve inversion to tell us that: it's been clear that the global economy was heading for a rocky patch ever since President Trump put the USA on a more aggressive trade policy footing in the first half of 2018. Any hope that this might be a short-term exercise in megaphone diplomacy was surely dashed in May when negotiations on a much-vaunted trade deal with China fell apart.

Among the world's major economies, a recession looks especially unlikely in the United States. Household confidence and spending are strong, as is the American labour market. The same will be true of the UK if it can avoid a "no-deal" departure from the EU, while France and Spain are also bearing up fairly well. But some export-orientated economies may not be so fortunate. The downturn in capital expenditure has precipitated a manufacturing malaise, which has especially affected the automotive, industrial equipment, and electronics sectors. The global Purchasing Managers' Index (PMI) which amalgamates the results from all the various national surveys, has been tracking at under 50, that's to say in contractionary territory, for the past three months. To be sure, some of the present weakness has little to do with international trade conflicts, but relates to changes in consumer behavior. In many countries, for example, people are now shunning diesel-fuelled vehicles following the emissions scandal, while the market for smartphones has matured, with consumers now less keen on frequent upgrades. Whatever the cause, these trends clearly put Germany and Japan in the firing line, with South Korea and Taiwan also feeling pain.

How severe the downturn turns out to be, and how long it lasts, will clearly depend to a large extent on how the trade conflict between America and China evolves from here. But even if the two sides come to some sort of rapprochement, there is no guarantee that all of the measures that have been taken in the past year or so will be reversed. Moreover, the United States is also seeking to settle trade gripes with other countries, with the prospect that it will soon take action against imports from the EU.

A global manufacturing slowdown



Source: IHS Markit

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Tepid policy responses

The other determining factor is how, and to what extent, policy actions in both the monetary and fiscal arenas will be deployed to counter the headwinds. In addition to the cut in US interest rates announced by the Federal Reserve at the end of July, other central banks have also been busy trimming rates, as evidenced by recent announcements from South Korea, India, Australia, New Zealand, and Brazil. The European Central Bank (ECB) is also primed for action, with the Governing Council expected to slash its deposit rate further into negative territory, from -0.40% to -0.60%, when it next meets on 12th September. At that meeting, the ECB is also expected to launch another round of quantitative easing, although on a smaller scale than its previous programme.

But while this central bank action all looks very pro-active, it is questionable what practical difference it will make. With the exception of the US Federal Reserve, none of the advanced world's central banks has much scope to make meaningful cuts in borrowing costs, and certainly nothing like the firepower they could have brought to bear in previous cyclical downturns. So, while the monetary authorities around the world will no doubt continue to look busy, in reality the baton will pass back to governments and fiscal policy.

After a decade of painful reductions in budget deficits most advanced, and many emerging, economies have at least some fiscal headroom, especially with yields on many country's sovereign bonds being at all-time lows. The UK government will certainly splash some cash if it ends up leaving the EU on 31st October without a withdrawal agreement. But elsewhere there has been little decisive action, with the EU in particular showing no sign of relaxing its fiscal strictures, with another ding-dong looming over Italy's budget. The one country that would seem to have plenty of room for manoeuvre is Germany, and indeed there has been talk of a €50 billion boost funded by borrowing dressed up as a climate protection programme. But political and legal constraints mean that any stimulus from this quarter is likely to be on a modest scale.

So, while there is no doubting that the global economy has taken a turn for the worse in the past few months, it's questionable whether the policy responses will be able to make much of a difference. Central banks are mostly out of ammunition, and while some governments are coming round to the idea of fiscal stimulus, such measures are likely to be on a modest scale. The global economy isn't about to plunge into a recession of the sort that occurred in 2008, but it is facing an extended rough patch. Meanwhile, any hopes of a return to monetary normality have been kicked firmly into the long grass.

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