When the recession becomes obvious

17th May 2023 VP-Macrovoices

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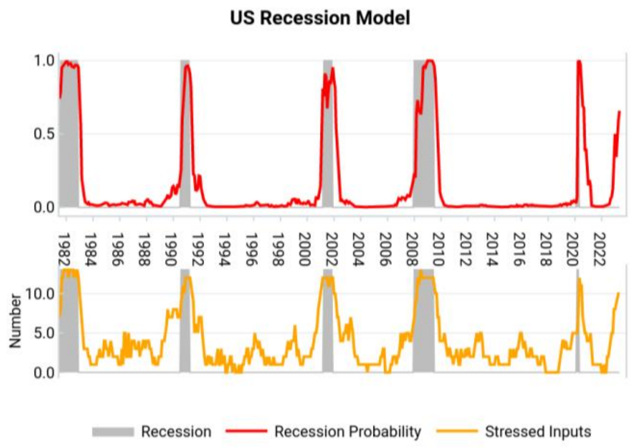
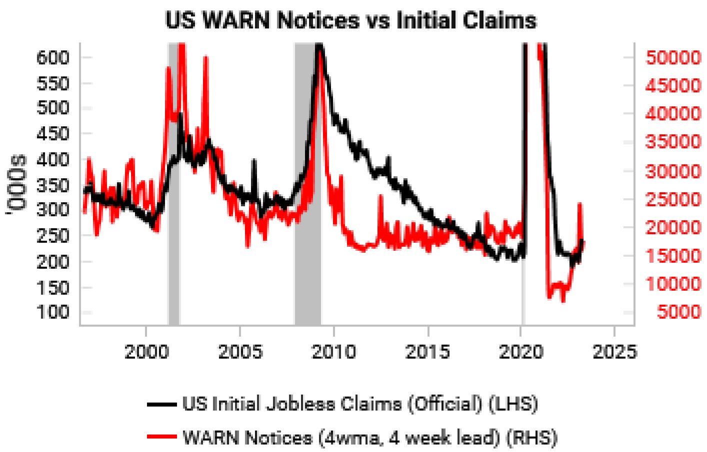
Summary

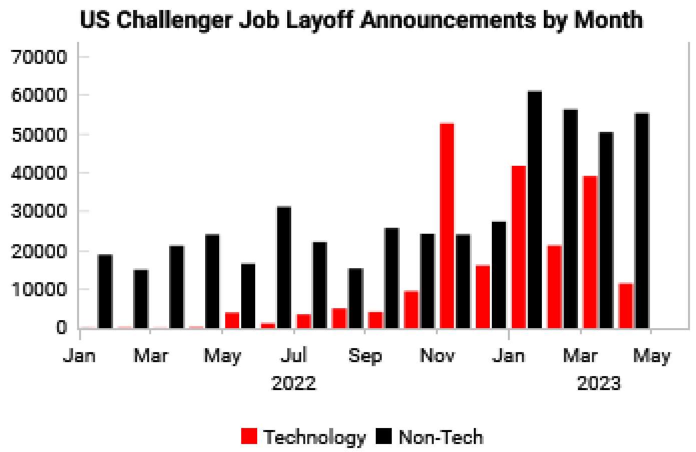
- US recession: initial claims catch up; no outliers left
- Unemployment rate rising = recession scare for markets
- Equities: earnings recessions matter now
- Fed cut not the savior for equities
- Fixed income: tactical mixed; still bullish cyclical backdrop
- China: domestic headwinds faded; not yet tailwinds
- EM: more room to cut
- FX: when to sell USD
- Credit: US HY still complacent
- Commodities: supercycle intermission ongoing
- Gold: LPPL bubble over

US recession: initial claims catch up; no outliers left

- **US initial claims have clearly jumped off the lows (following BLS seasonal revisions). This re-affirms our conviction in our <u>active</u> US Recession Signal (top left chart).**
- Initial claims were the outlier amongst other labor market data (we <u>anticipated</u> this issue with post-Covid seasonal factor adjustments). Now they have caught up to other negative labor market indicators.
- Initial claims is jumping off the lows, which is exactly the behavior seen at the start of recessions (top right chart).
- Challenger Job layoffs announcements are still very high and so are WARN notices (filed by companies with >100 employees in advance of mass layoffs).
- Longer-leading inputs are still recessionary. Building permits are well off their highs, manufacturing new orders are weak, truck sales and production are falling.







Source: S&P Global, Refinitiv, Macrobond and Variant Perception

Unemployment rate rising = recession scare for markets

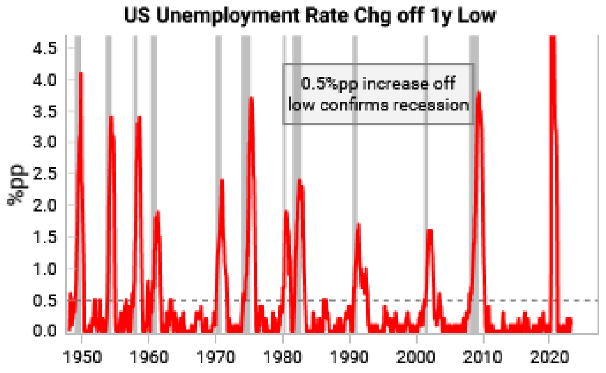
- The key question is when markets get the message that the US recession has started.

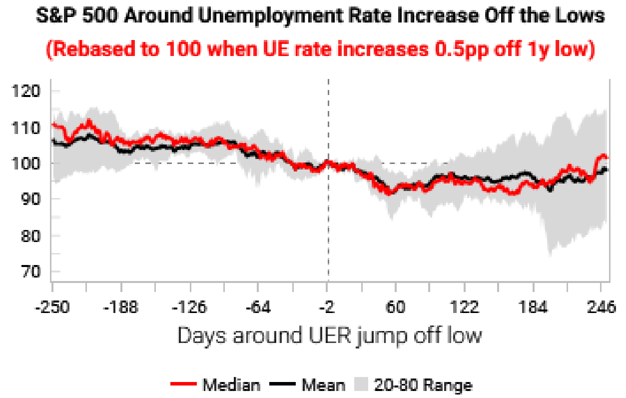
- **The final crash in a recession starts when the unemployment rate picks up 0.5% off the lows.** This is most obvious confirmation that recession has started.

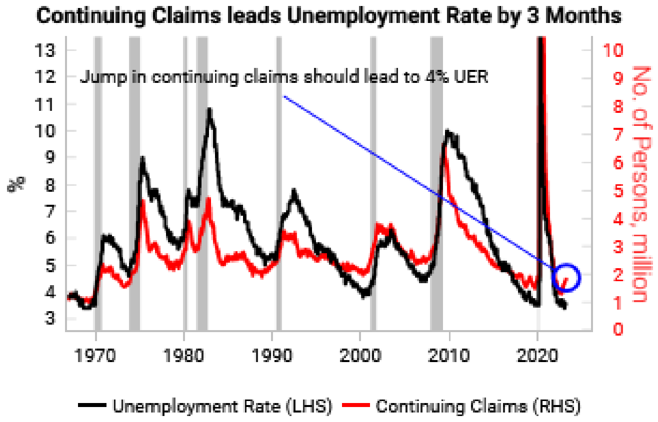
- This means 4% unemployment rate (3.4% today) is a key level to watch.

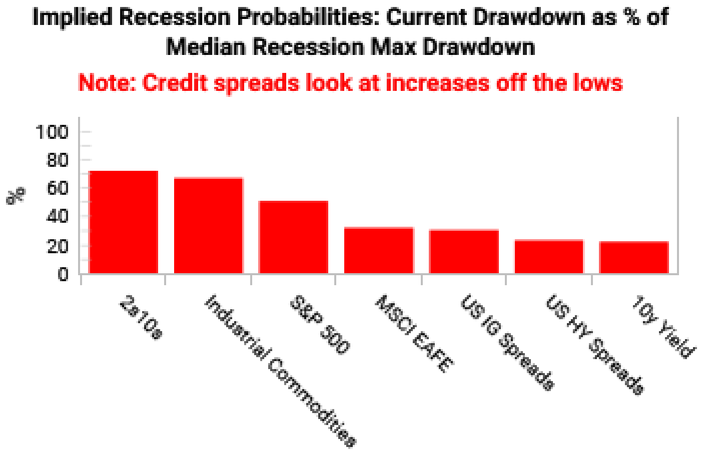
- Based on the mix of leading labor market data, we expect this to happen by end of June (bottom left chart). Continuing claims is one of the best leads for the unemployment rate; the jump in claims is consistent with a 4% unemployment rate for June's print (using YoY regression forecasts).

- Today's pricing across asset classes is NOT consistent with a recession. Only 2s10s behavior has conformed to its usual recession pattern (big inversion, then bull steepening).









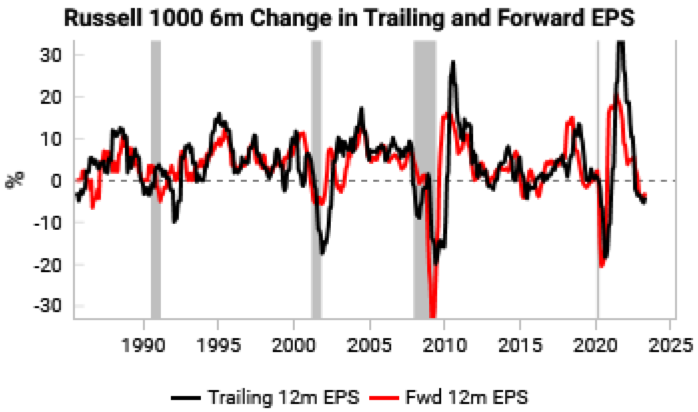
Equities: earnings recessions matter now

- Large-cap earnings have mostly beaten analyst estimates. But do not forget the wider cyclical context: active US recession, negative global liquidity LEIs and missing pieces from our market bottoms checklist = bad risk/reward for US large-caps.

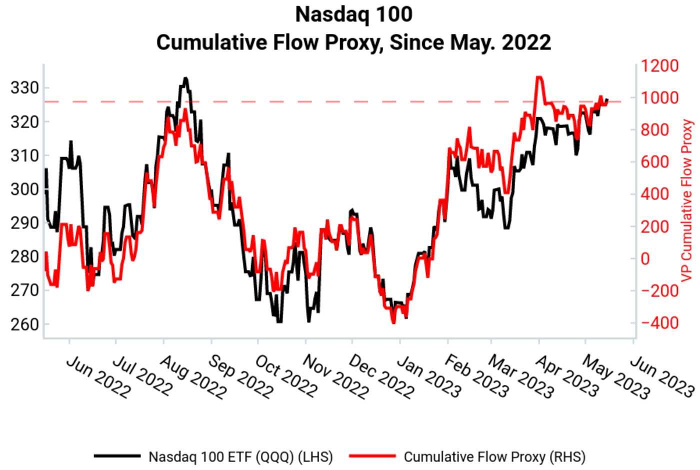
- Earnings recessions that coincide with economy-wide recessions lead to bigger S&P drawdowns (compared to earnings recessions outside of recessions; link to study).

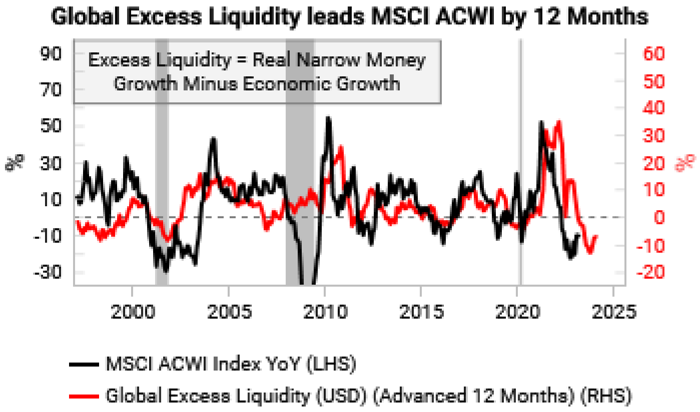
- We remain tactically bearish on tech (link); the tech-led equity rally has sucked in a huge amount of inflows. Global excess liquidity remains very negative, suggesting we are running out of marginal buying pressure risk assets in aggregate.

- Our market bottoms checklist is still incomplete: the most critical signpost of monetary policy easing is absent (i.e. rate cuts). The Fed remains handcuffed by lagging inflation and growth data, suggesting that market expectations of a rate cut in September are too optimistic (see next slide).



Best Times to Invest Market Bottoms	1966	1970	1974	1982	1987	1990	2002	2009	2020	2022
Monetary policy easing	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
> 6 months of net selling	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	No	Yes
> 20% decline in S&P/DJIA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Coppock near 0	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
Plunge in consumer confidence	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Expectations / Current positive	No	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	?
Formal recession	No	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	?
Bond rally reversal	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	?
18 month RSI <30	Yes	Yes	Yes	Yes	No	No	Yes	Yes	No	No





Fed cut not the savior for equities

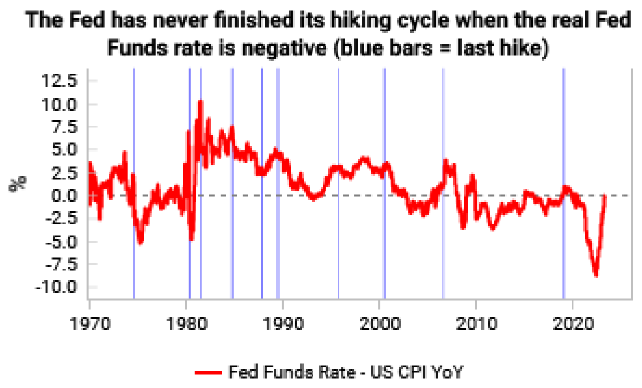
- The real policy rate (Fed funds minus CPI YoY) has now turned positive. The Fed has always waited for the real policy rate to turn positive before its last hike. Our inflation LEI suggested CPI would fall to ~5% in May (see here).

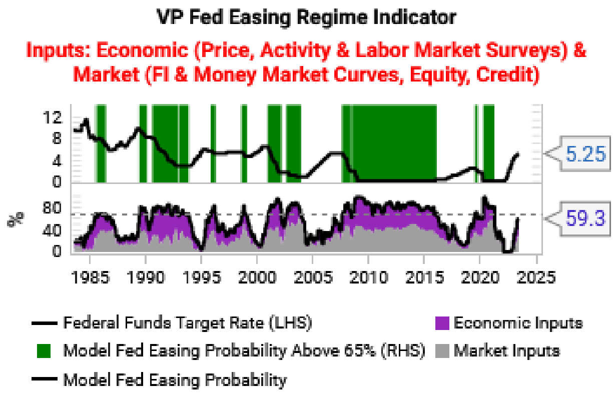
- Our Fed easing regime model probability is ticking up quite slowly as lagging growth data is still not terrible (top right chart; 59% today, last month was 52%).

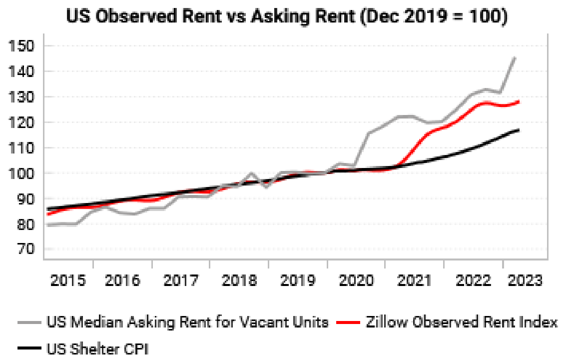
- Risk assets are taking cues from rate-cut pricing (markets pricing in at least 2 cuts to YE23). **We think there is scope for disappointment as: 1) a US recession becomes obvious, and 2) Fed will be slow to cut due to data and historical precedent.**

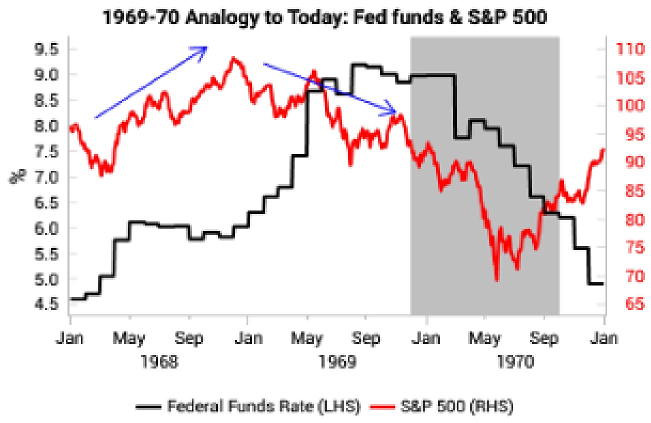
- Shelter CPI is still very elevated and is keeping measures like sticky CPI at high levels. Lagging jobs data paints a picture of labor market strength (but should catch up to bad leading data in the coming months).

- The 1969-70 inflationary recession highlighted that **equities can still plunge after the first Fed cut**: inflation hampered the Fed's ability to cut earlier, so the first rate cut confirmed recession stress. And Powell's Fed has acknowledged the mistake of cutting too early in 1980 before the inflation problem was resolved.





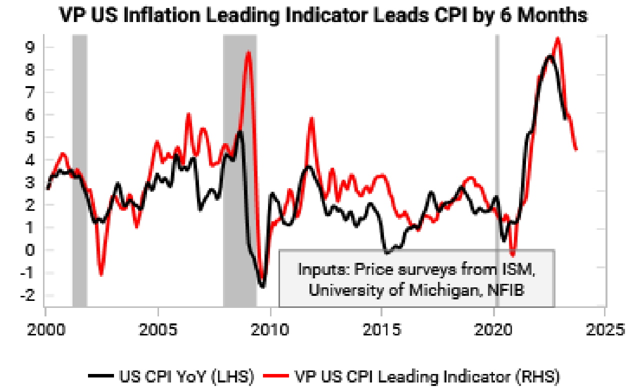


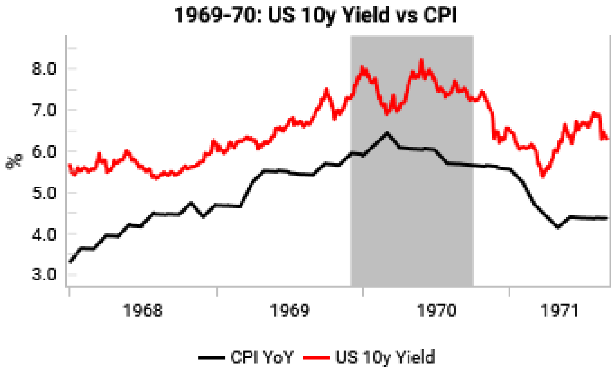


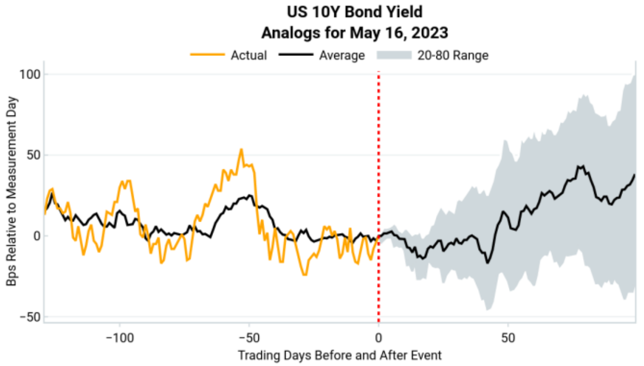
Source: S&P Global, Refinitiv, Macrobond and Variant Perception

Fixed income: tactical mixed, still bullish cyclical backdrop

- **<u>We remain bullish on duration</u>** on a **cyclical** (6-12 month) outlook and this remains our core positioning to play for recession risk re-pricing.
- In the 1969-70 inflationary recession the 10y yield plunged at the start of the recession and drifted higher again as inflation failed to roll over (bottom left chart).
- <u>The key difference today</u> is that we see clearer cyclical disinflationary pressures (our US inflation LEI is still falling; top left chart). This allows a yield plunge to happen as a recession becomes obvious.
- Our tactical tools have helped us manage positions around the wider positive cyclical trend. The tactical (1-3 month) picture is **mixed** for US 10y.
- Today our analog model is pointing to slightly higher yields, albeit with a wide range of outcomes. Our analog model has helped us flag key short-term trading opportunities in the 10y (Mar 7th bullish; Mar 17th flipped bearish post-SVB).







Analogs: Apr-1983, Aug-1998, Apr-2007, Sep-2017

Source: S&P Global, Refinitiv, Macrobond and Variant Perception

China: domestic headwinds faded, not yet tailwinds

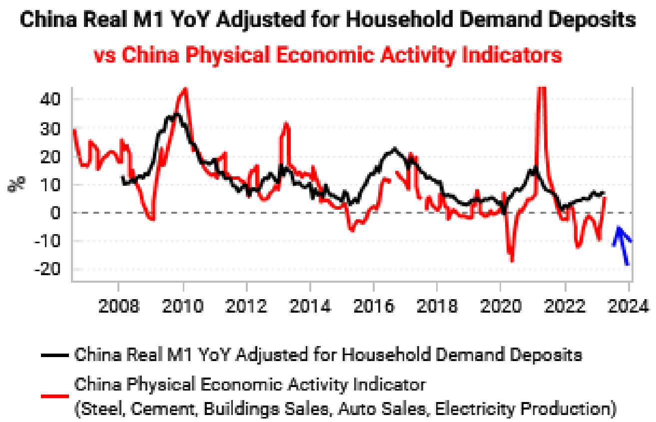
- Our China recession model collapsed to zero last month, confirming the exit from recession. This means that China is back in a “normal” regime vs the previous recessionary regime of disorderly negative feedback loops.

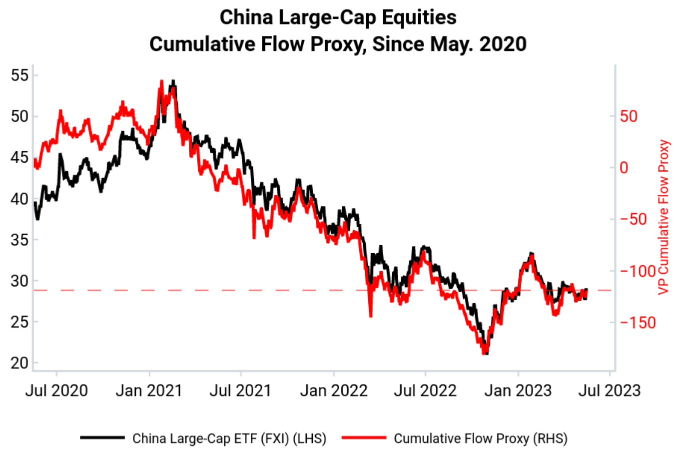
- Last month we said: ***“Chinese assets can outperform RoW but in absolute terms upside may be limited by global headwinds”.***

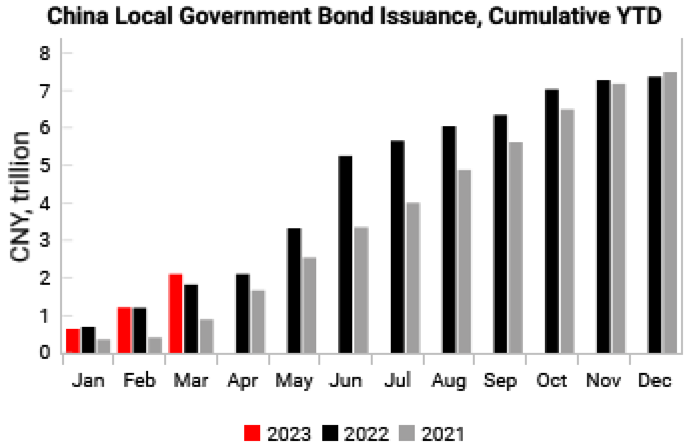
- The cyclical (6m+) setup in China is getting better. External headwinds (from global trade and liquidity) remain, which is keeping our China LEI at the lows (top left chart).

- **Domestic headwinds have faded but are yet to turn into significant tailwinds.** Real M1 growth is starting to tick up as physical activity expands again (top right chart). Local gov issuance is outpacing 2022’s run rate, but we note that local gov land sales are lagging.

- <u>**We stick with our long China vs US equities trade**</u>. There is a huge amount of room for inflows as the domestic cyclical picture is set to improve (bottom left chart).



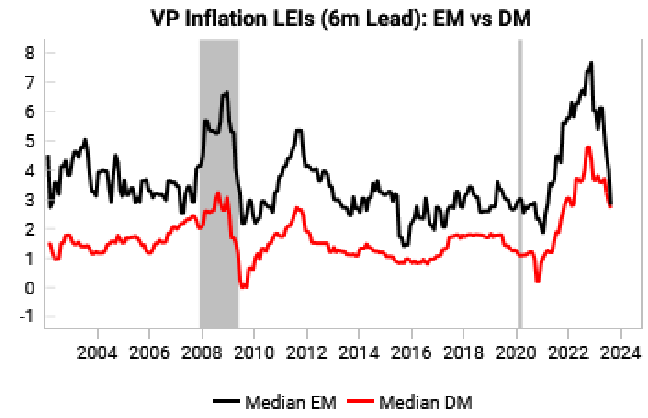


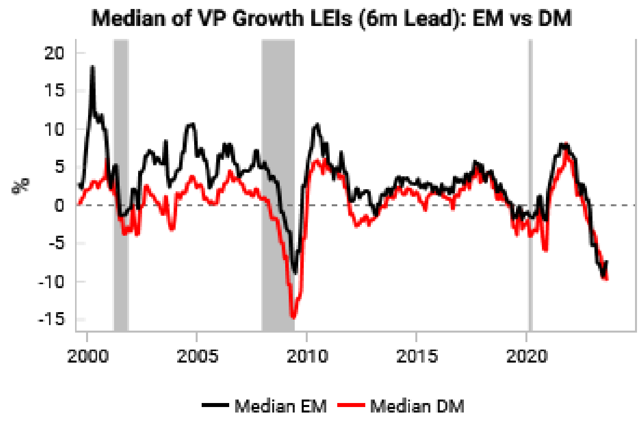


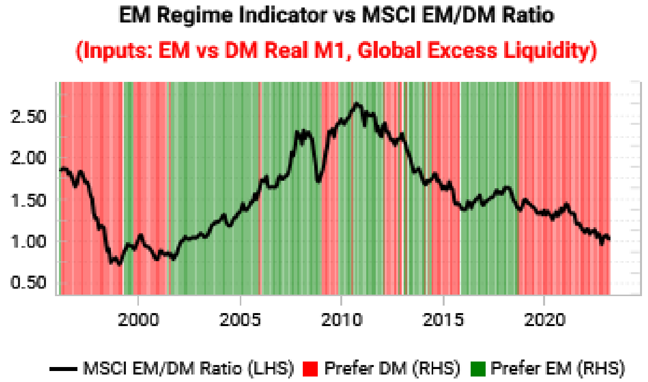
Source: S&P Global, Refinitiv, Macrobond and Variant Perception

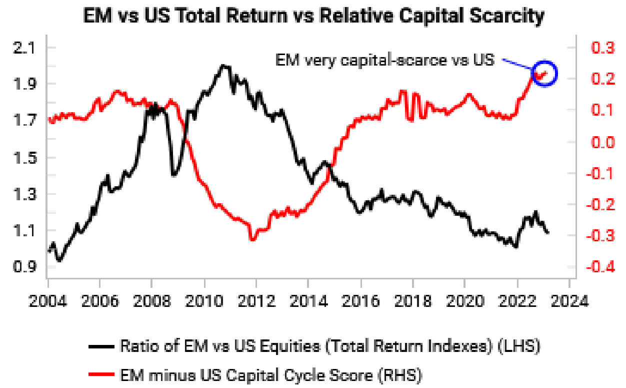
EM: more room to cut

- EM inflation LEIs are falling very quickly now. The median EM inflation LEI is now LOWER than the median DM (which we've never seen before).
- This will allow some EM central banks to pivot faster to react to downside growth risks. Historically EMs do NOT need to wait for the Fed to pivot first.
- We still like select EM debt: Brazil and India (link; and South Korea in low-yielders). Their sovereign bonds are starting to rally with more upside to come as markets start pricing in cuts.
- **The cyclical (6-12 month) backdrop for EM equities in aggregate remains weak**: global excess liquidity has not turned up meaningfully yet and our China LEI does not yet confirm big hard data improvement (despite the economy exiting recession).
- Once the cyclical backdrop improves, we would look to buy into EM equities as a long-term theme. The capital cycle has turned very positive for EM. The relative capital cycle score of EM vs US is the highest its ever been (bottom right chart).









Source: S&P Global, Refinitiv, Macrobond and Variant Perception

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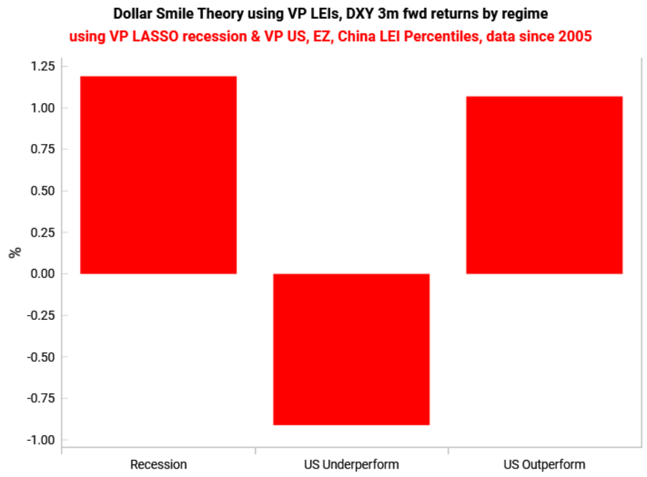
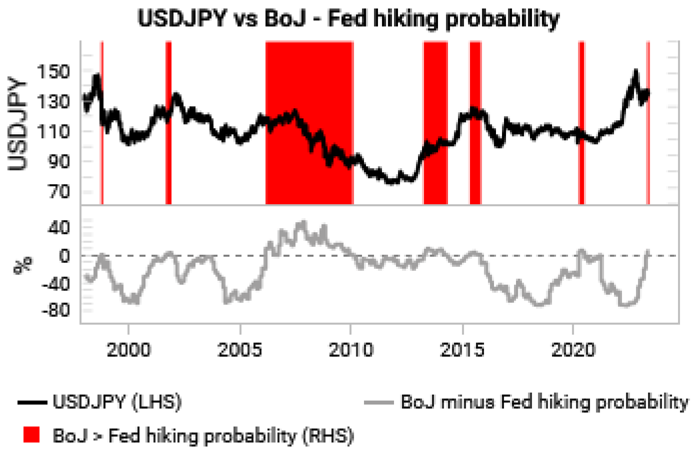
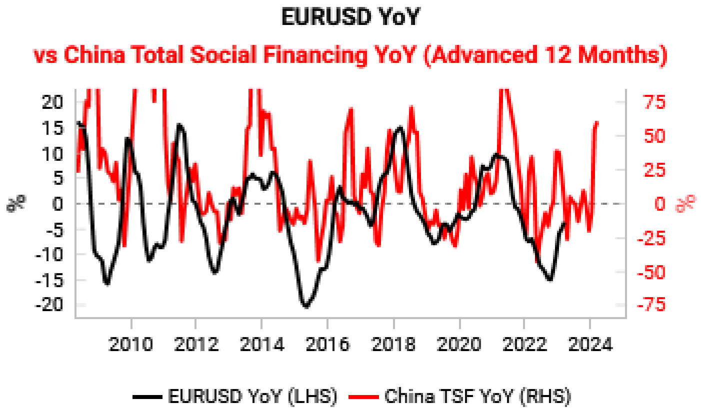
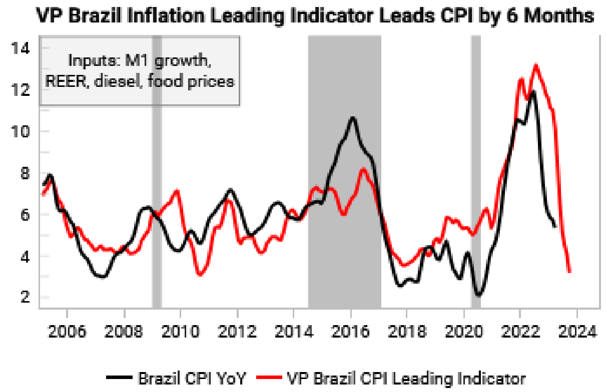
FX: when to sell USD

- We appreciate that bearish USD narratives are getting louder.
- **Tactical and cyclical signals are too mixed for us to sell USD.** A US recession is usually bullish for USD, but there was an outsized rally heading into it.
- We do note that cyclical conditions are aligning for long EUR and long JPY trades. We want to see more evidence of China cyclical tailwinds to go long EUR.
- Our BoJ vs Fed hiking probability model has triggered, confirming a positive cyclical backdrop to go long JPY. We wait for tactical tools to confirm the exhaustion of the bullish USDJPY trend.
- **EMFX as a whole is unlikely to find a major trend with competing dynamics of China reopening vs bad global liquidity / US recession risks.**
- Within EM, we continue to like long BRLMXN as a positive carry tactical trade. BRL remains an outlier in EMFX, offering the highest carry but its currency drawdown is still large. With inflation tamed in Brazil, the BCB is in a much better position to stimulate growth relative to other countries.









Source: S&P Global, Refinitiv, Macrobond and Variant Perception

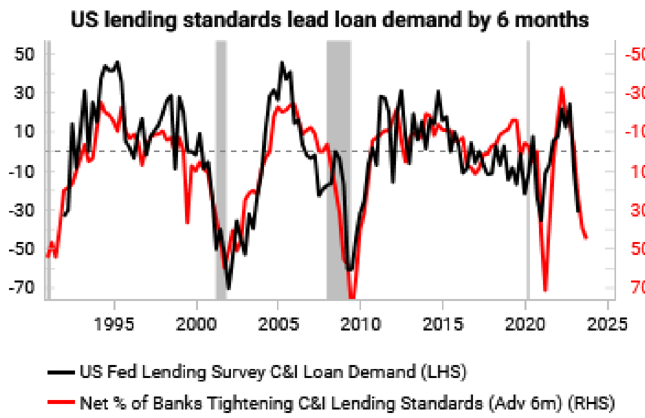
Credit: US HY still complacent

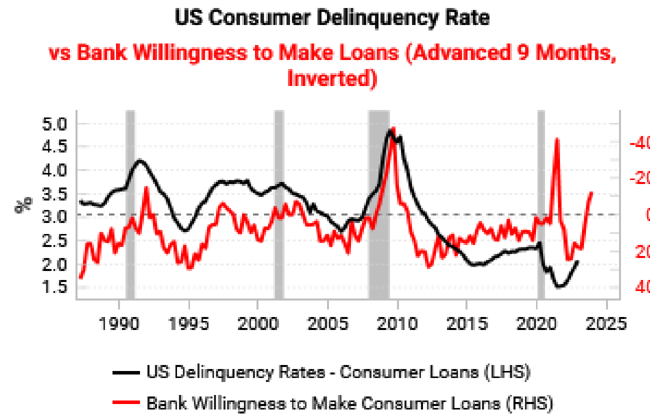
- Credit spreads remain fairly well-behaved despite obvious deterioration in the credit cycle. Lending standards were already tight pre-SVB (top left chart; next survey release on May 8th).

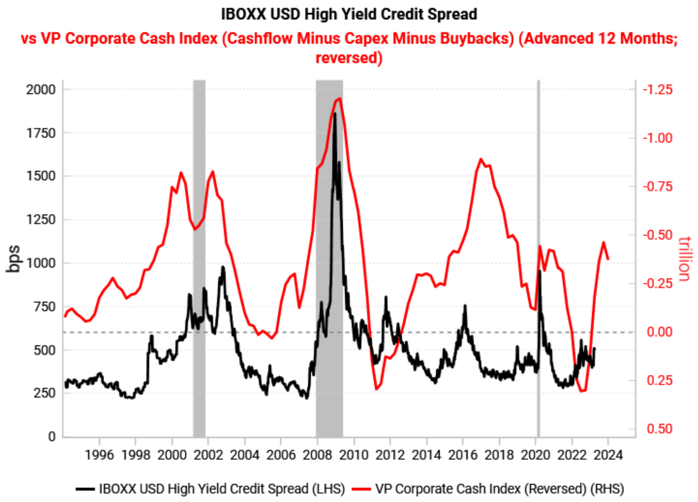
- We expect high yield credit spreads to jump as a recession becomes obvious (i.e. unemployment rate rising to 4%).

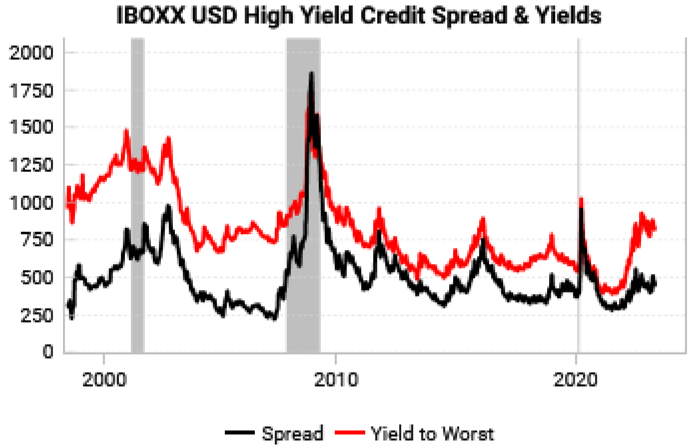
- In a recessionary regime, market data and economic data get caught in reflexive feedback loops. Recent bank failures are likely to lead to further credit tightening, which should lead to further hard data stress and bankruptcies.

- We are already seeing household delinquencies rise, following the lead from tighter credit (top right chart).









Source: S&P Global, Refinitiv, Macrobond and Variant Perception

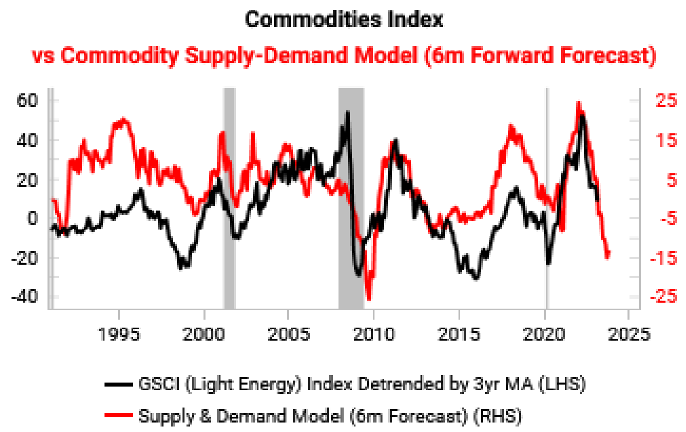
Commodities: supercycle intermission ongoing

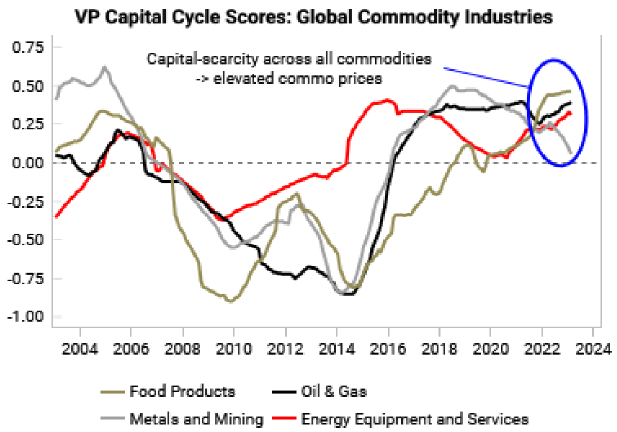
- Our all-commodity forecast model remains weighed down by bad global liquidity and growth LEIs. But supply-side conditions are positive, confirmed by VP capital cycle scores (top charts).

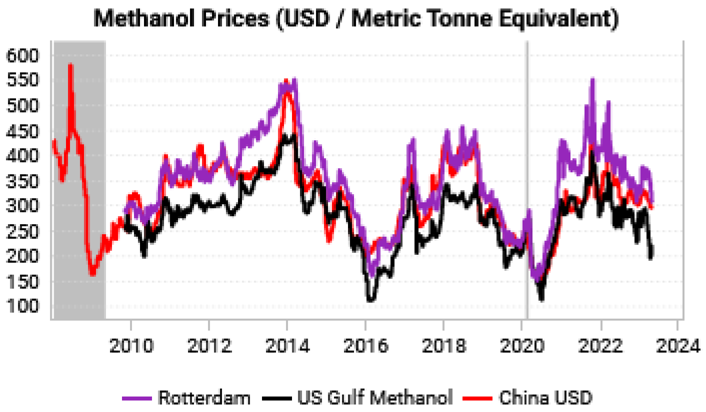
- Chemical prices have plunged recently as the global manufacturing downturn deepens (bottom left chart).

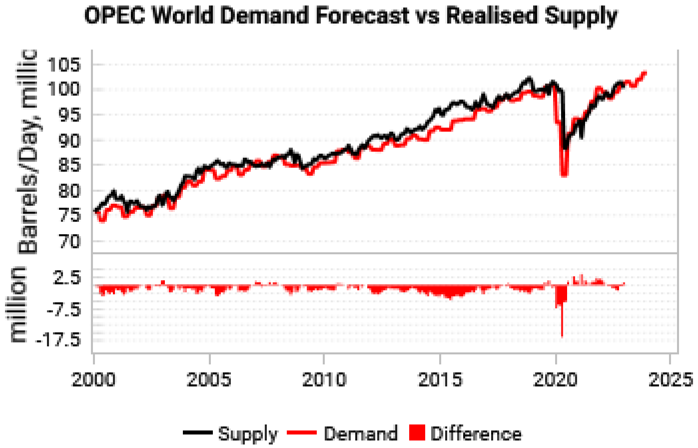
- Oil demand forecasts are optimistic (bottom right chart). Even with the latest dip in oil prices, we are not cyclically bullish on oil. A US recession is the key downside risk to oil for the rest of 2023.

- On a multi-year view, we remain in a high oil price regime. Global E&P capex is still lower than the depths of the 2014-crash, keeping the capital cycle supportive for energy producers.









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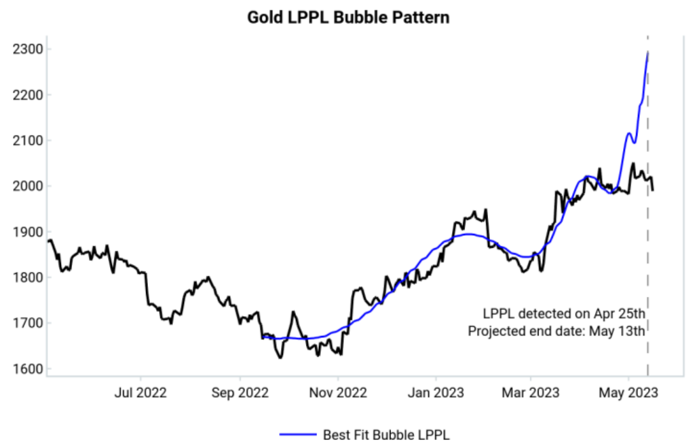
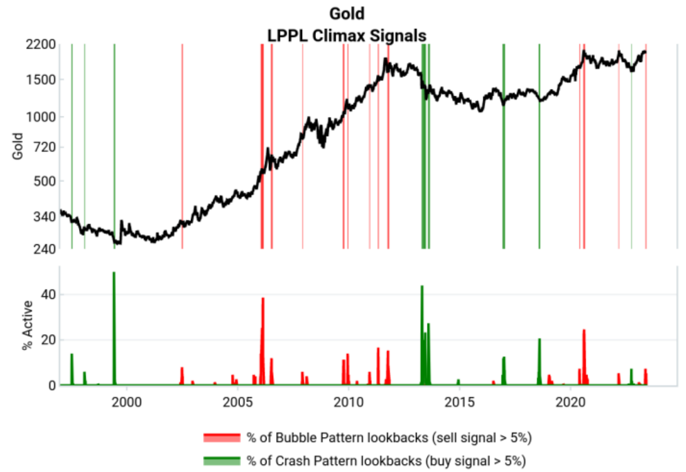
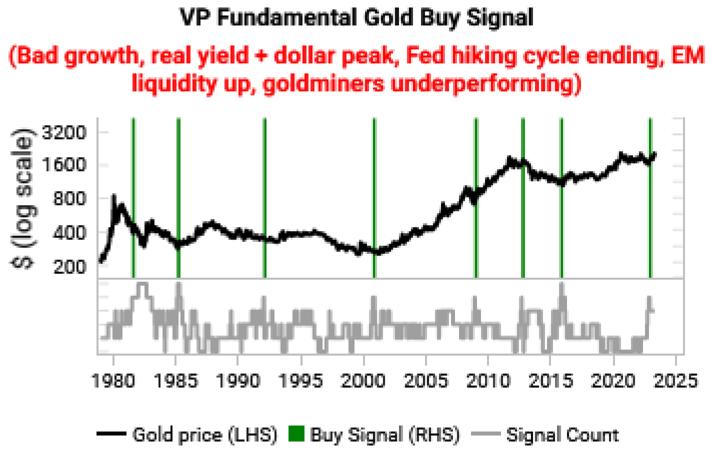
Gold: LPPL bubble over

- **An LPPL bubble pattern was detected in gold in late April, suggesting a blow-off top before tactical weakness** (top left chart; see VP tactical cookbook 2.0 for more on LPPL methodology).
- Usually LPPL bubbles mark tops in assets. With gold we observe that previous LPPL bubbles have triggered through the stages of major gold bull markets (e.g. lots of bubble patterns detected in 2005-06, then again in 2010-11).
- We expect more tactical weakness in gold, which would present an opportunity to buy dips given the very positive structural backdrop.
- Our fundamental gold signal triggered at the end of 2022, leading us to buy gold aggressively after the initial rally off November lows.







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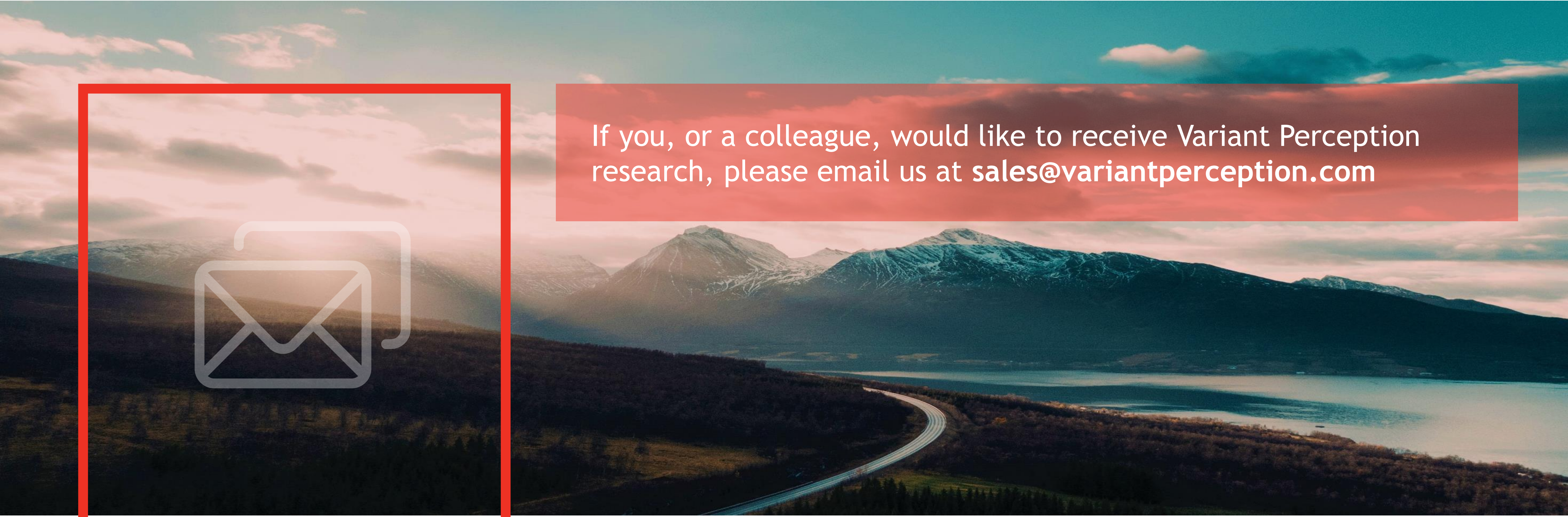

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