

# RESTRICTIVE POLICY AND GEOPOLITICAL RISKS RAISE THE ODDS OF A GLOBAL RECESSION

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What a difference a year makes. 2022 saw the “reopening” of markets from the COVID-19 pandemic evolve into a “[recession](#).” Margaret Thatcher put it succinctly on February 27, 1981—“The lesson is clear. [Inflation](#) devalues us all.” [Monetary policy](#) has been on the most pronounced tightening campaign in decades as inflation progressed from being transitory to potentially permanent due to the energy crisis.

## Politics Is Driving Economics, Not the Other Way Around

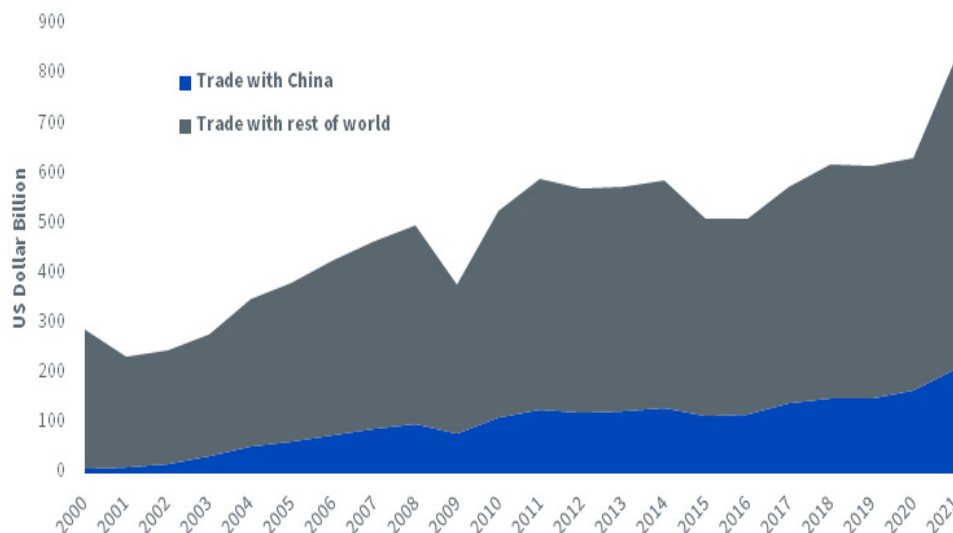
In the pre-war global economy, globalization was an important source of low inflation. A large amount of global savings had nowhere to be deployed, rendering [interest rates](#) lower on a global basis. However, post-war, global defense spending has risen to a level not seen in decades as national security consumes governments’ agendas. There will be vast opportunity costs tied to the increase in world military spending. We expect the rate of globalization to take a back seat as Europe would never want to be as dependent on Russian energy as it is today. In a similar vein, the U.S. does not want to fall for the same mistake Europe made and will aim to strengthen ties with Taiwan in order to ensure the smooth flow of chips.

## National Security Is Inflationary

We are in the midst of a war in Europe, owing to the brutal battle being waged by Russia in Ukraine. While the war is centered in Ukraine, the reality is that we are all paying the price of this war by allowing it to continue. There is another war brewing in the background that we must not ignore: the United States’ deepening ties with Taiwan are aggravating China.

The Taiwan issue remains sticky. Taiwan’s role in the world economy largely existed below the radar until it came to prominence as the semiconductor supply chain was impacted by disruptions to Taiwanese chip manufacturing. Companies in Taiwan were responsible for more than 60% of the revenue generated by the world’s [semiconductor](#) contract manufacturers in 2020.<sup>1</sup> Tension between Taiwan and China could have a big impact on global semiconductor supply chains. The United States’ dependence on Taiwanese chip firms heightens its motivation to defend Taiwan from a Chinese attack. The desire to control technologies, commodities and straits is paving the way for economic wars ahead.

## Figure 1: China Makes Up the Largest Share of Taiwan’s Trade



Source: Taiwan Ministry of Finance, as of 12/31/21. Past performance is not indicative of future results.

### China Needs to Get Its House in Order

The economic headwinds that China faces are multifaceted. Unfortunately, policy easing from China in Q1 2022 has been insufficient to arrest the extent of the slowdown. Of late, China's State Council stepped up its economic stimulus further by announcing a 19-point stimulus package worth \$146 billion (under 1% of [GDP](#)) to boost economic growth.<sup>2</sup>

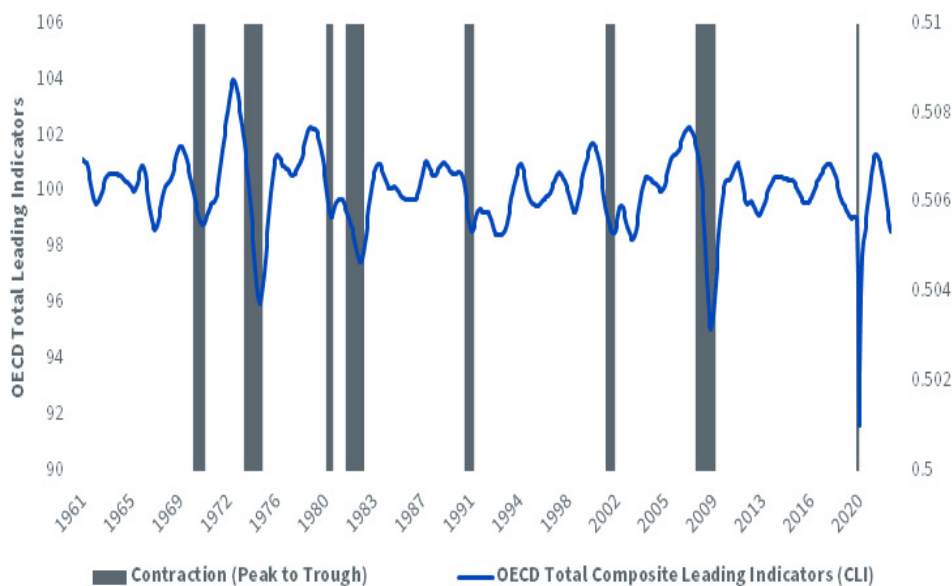
The property markets continue to deteriorate. The problem stems from a lack of financing needed by many developers for the construction of their residential projects. All of this came about from the central government's decision in 2020 to introduce the "three red lines" policy to rein in excessive borrowing in the real estate sector. Vulnerable property developers are struggling to secure capital to sustain their businesses. Alongside demand for housing has deteriorated due to intermittent COVID-19 lockdowns, a weakening economy and doubts over developers' ability to deliver completed housing units.

However, the weakness in China's economy extends beyond the property sector, with rising unemployment and energy shortages. Chinese earnings growth since Q3 2019 has lagged behind the rest of the world. China has also suffered significant capital outflows owing to its adherence to "COVID zero." This has set back its rebalancing toward a consumption-driven economy, rendering China more addicted to export-led growth. However, export demand has begun to weaken as the rest of the world slows.

### The U.S. Is in the Early Innings of a Recession

The U.S. economy appears a haven amidst the ongoing energy crisis, as it is less exposed to the vagaries of the Russian oil supply. It also recovered faster from the pandemic than the rest of the world. The labor market remains strong as jobs continue to be added, wages accelerate, consumption continues to grow—albeit more slowly—and unemployment remains at a five-decade low. Despite the recent upswing in GDP growth caused by noise in the foreign trade numbers and technicalities in inventory data, the big picture of a slowing economy in the face of aggressive monetary tightening remains intact. There are mounting signs of slowing, too, especially in the housing sector, owing to the rapid rise in mortgage rates.

**Figure 2: The Decline of [Leading Economic Indicators](#) Reignites Recession Concerns**



Sources: Bloomberg, National Bureau of Economic Research, WisdomTree, as of 9/30/22. **Past performance is not indicative of future results.**  
 Composite Leading Indicators (CLI): designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long term potential level. CLIs show short-term economic movements in qualitative rather than quantitative terms.

Earnings in 2022 have reflected the challenging environment being faced by U.S. corporations, with earnings growth for companies grinding down to 3.17%<sup>3</sup>. The more value-oriented sectors, such as Energy, Industrials and Materials, continue to outperform. Looking ahead, earnings revision breadth for the S&P 500 Index is in deeply negative territory, suggesting the downside is coming from an earnings growth standpoint.

Core inflationary pressures remain concerning, especially housing rents and medical inflation—components that are typically much stickier than goods and transport inflation. The stickier high services inflation reflects strong labor market dynamics as services are labor intensive and housed domestically. The [Federal Reserve \(Fed\)](#) appears unwilling to declare victory in its war against inflation. As we look ahead, it's clear that the Fed's role in quelling inflation without tipping the economy into recession will take center stage.

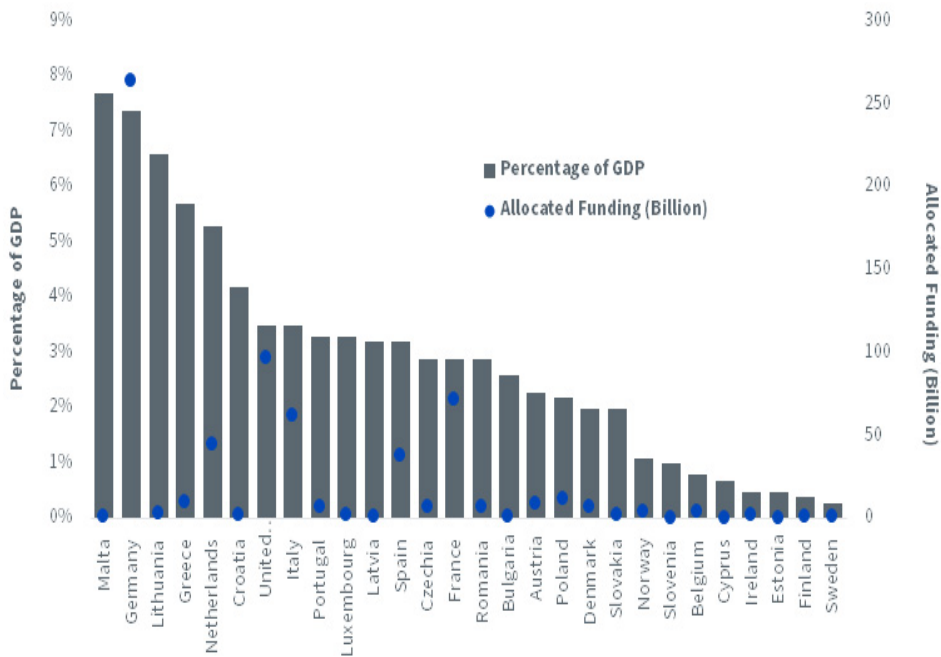
### Harsh Winter Ahead for Europe

Europe is heading for a recession in response to a strong external shock. Gas flows from Russia to Europe have declined substantially to 10% of their levels in 2021, causing gas prices to spike. The Russian war in Ukraine is showing no signs of abating, with Russia deciding on a partial mobilization after a rather successful Ukrainian counteroffensive. These higher energy prices are squeezing the real disposable income of consumers and raising costs higher for corporations, causing further curtailment of output. The energy-driven surge in headline inflation to 10.7% year over year<sup>4</sup> has sent consumer confidence to a record low, leaving Europe in a bind.

### Fiscal Policy in Focus

The European Union (EU) aims to define the direction and speed of Europe's energy policy restructuring through its [REPowerEU](#) strategy. However, crucial energy policy decisions have been taken by EU countries at the national level. In an effort to shield European consumers from rising energy costs, EU governments have earmarked 573 billion euros, of which 264 billion euros has been set aside by Germany alone. In most European countries, both energy regulation and levies are set at the national level. The chart below illustrates the funding allocated by select EU countries to shield households and firms from rising energy prices and their impact on the cost of living.

**Figure 3: European Governments' Earmarked and Allocated Funding**



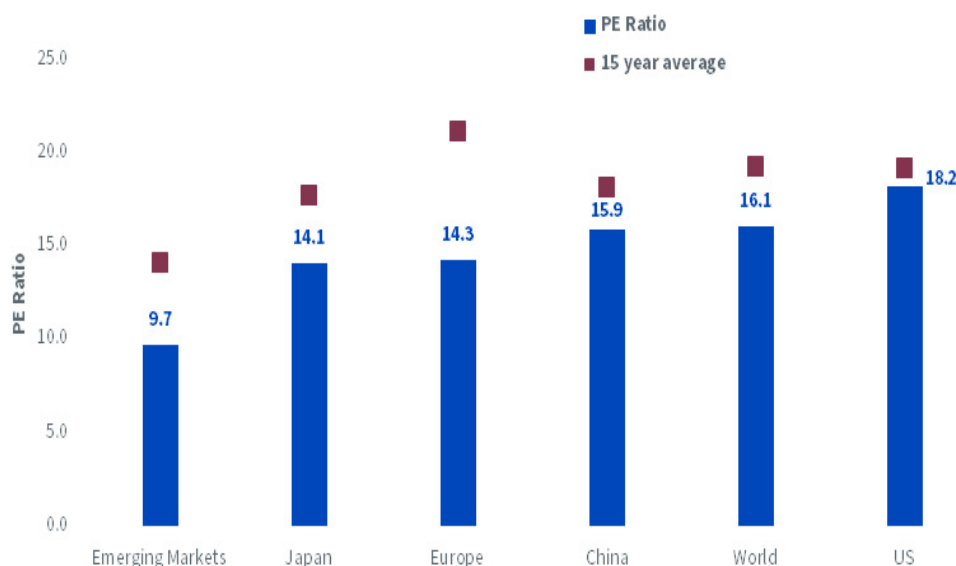
Sources: Bruegel, WisdomTree, as of 10/31/22. Past performance is not indicative of future results.

### No Pivot Yet from the ECB

We experienced a decade of almost no inflation and quantitative easing in Europe. We have now entered a phase in which the European Central Bank (ECB) has gone ahead with its third major policy rate<sup>5</sup> increase this year, thereby making substantial progress in withdrawing monetary policy accommodation. The ECB remains eager to have policy choices dominated by risks rather than the base case. Owing to this, more rate hikes are coming. If Eurozone inflation continues to surprise to the upside, the ECB will have to continue raising rates and determine when to activate the [Transmission Protection Instrument \(TPI\)](#) to support the periphery. We expect the ECB to take the deposit rate to 2.5% by March as it continues to see risks to inflation tilted to the upside in both the short and long term.

A tightening cycle into a slower-growth macro landscape has never been helpful for equities. European equities are faced with an extremely challenging backdrop, ranging from high energy prices and growing cost pressures to negative earnings revisions estimates and cooling growth. Amid the sell-off in equity markets in the first half of this year, European equities currently trade at a [price-to-earnings ratio](#) of 14.3x, marking the steepest discount versus its long-term average of 21x compared to other major markets. To a certain degree, the risk of a recession is being priced into European equity markets.

**Figure 4: Global Equity Market Valuations**



Sources: Bloomberg, WisdomTree, as of 10/28/22. Historical performance is not an indication of future performance, and any investments may go down in value.

## Conclusion

In our view, the global economy is projected to avoid a deep downturn. However, we expect to see a series of individual country recessions take shape at different points in time. As evident from recent data, the downturn in the U.S. is expected in the second half of 2023, while the Eurozone and United Kingdom will likely enter a recession by Q4 this year. Contrary to the rest of the world's key central banks, China and Japan are expected to keep monetary policy accommodative, which should help buffer some of the slowdown. Given the highly uncertain environment, we believe that maintaining an equal weight position in U.S. and Chinese equities alongside an under-weight in European equities would be prudent. Across factors, we continue to tilt to [value](#), [dividend](#) and [quality](#), given the expectations for weak economic growth, higher rates and elevated inflation.

Aneeka Gupta is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s parent company, WisdomTree Investments, Inc.

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## **DEFINITIONS**

**Recession** : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

**Inflation** : Characterized by rising price levels.

**Monetary policy** : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Interest rates** : The rate at which interest is paid by a borrower for the use of money.

**Semiconductor** : A semiconductor is a material product usually comprised of silicon, which conducts electricity more than an insulator, such as glass, but less than a pure conductor, such as copper or aluminum. Their conductivity and other properties can be altered with the introduction of impurities, called doping, to meet the specific needs of the electronic component in which it resides.

**Gross domestic product (GDP)** : The sum total of all goods and services produced across an economy.

**Leading indicator** : A piece or set of economic data that may correspond with a future movement or change in the economy.

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**REPowerEU** : A European Commission proposal to end reliance on Russian fossil fuels before 2030 in response to the 2022 Russian invasion of Ukraine.

**Transmission Protection Instrument** : Meant to deal with unwarranted and disorderly moves in credit curves across the Eurozone and both dimensions are assessed by indicators

**Price-to-earnings (P/E) ratio** : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

**Dividend** : A portion of corporate profits paid out to shareholders.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.