

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 pandemic evolve into a 'recession'. Margaret Thatcher put it succinctly on 27 February 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, globalisation 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 defence spending has risen to a level not seen in decades as national security consumes government's agendas. There will be vast opportunity costs involved, tied to the increase in world military spending. We expect the rate of globalisation 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 US does not want to fall prey to 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 centred in Ukraine, the reality is 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 fail to ignore. The United States' deepening ties with Taiwan is 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 percent of revenue generated by the world's semiconductor contract manufacturers in 2020. Tensions 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 for control of 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 31 December 2021.

Historical performance is not an indication of future performance and any investments may go down in value.

China needs to get its house in order

The economic headwinds that China faces are multifaceted. Unfortunately, policy easing from China in H1 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 growth².

The property markets continue to deteriorate. The problem stems from a lack of financing among many developers that is needed for 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 lockdowns, 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 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 towards a consumption-driven economy, rendering China to remain more addicted to export-led growth. However, export demand has begun to weaken as the rest of the world slows.

US is in the early innings of a recession

The US economy appears a safe haven amidst the ongoing energy crisis as it is less exposed to the vagaries of Russian oil supply. It also recovered faster from the pandemic compared to the rest of the world. The labour market remains strong as jobs continue to be added, wages accelerate, consumption has continued 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

Source: Bloomberg, National Bureau of Economic Research, WisdomTree as of 30 September 2022.

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Earnings in 2022 have reflected the challenging environment being faced by US corporates with earnings growth for companies grinding down to 3.17%³. 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 are in deeply negative territory suggesting 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 compared to goods and transport inflation. The stickier high services inflation reflects strong labour market dynamics as services are labour 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 centre 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 mobilisation after a rather successful Ukrainian counter-offensive. These higher energy prices are squeezing real disposable income out of consumers and raising costs higher for corporates, causing further curtailment of output. The energy driven surge in headline inflation to 10.7% year on year⁴ 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 REPowerEU strategy. However, crucial energy policy decisions have been taken by EU countries at national level. In an effort to shield European consumers from rising energy costs, EU governments have earmarked €573 billion, of which €264 billion 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 selected EU countries to shield households and firms from rising energy prices and their consequences on the cost of living.

Figure 3: European governments earmarked and allocated funding

Source: Bruegel, WisdomTree as of 31 October 2022.

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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 rate⁵ increase in a row 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 which more rate hikes are coming. If Eurozone inflation continues surprising 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 both in 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, growing cost pressures, 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. The risk of a recession to a certain degree is being priced into European equity markets.

Figure 4: Global equity market valuations

Source: Bloomberg, WisdomTree as of 28 October 2022.

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Conclusion

In our view, the global economy is projected to avoid a full-blown downturn; however, we expect to see a series of individual country recessions take shape at different points in time. Evident from recent data, the downturn in the US is expected in the second half of 2023 whilst the Eurozone and United Kingdom will 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, investors may look to consider US and Chinese equities, whilst potentially reducing weighting towards European equities. Across factors, we continue to tilt to the value, dividend, and quality factors given the expectations for weak economic growth, higher rates, and elevated inflation.

1 Source: Taiwan Ministry of Finance.

2 Source: Bloomberg as of 25 August 2022.

3 Source: Bloomberg, S&P 500 Index as on 4 November 2022.

4 Source: Eurostat as of 31 October 2022.

5 Source: As of 27 October 2022.

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