Letter n°62

Should we fear a new global recession?

"Society abhors pain and misfortune; it fears them just as it does diseases,"
Balzac in The Wild Ass's Skin.

After the contagions of Covid, a new crisis is alarming and gives new relevance to Balzac's word above.

- ***From a geopolitical point of view***, the assumption is that the conflict in Ukraine will continue, and that the Russians will face difficulties because they seem to be short of men and ammunition. But war is not just military, it is also economic. After more than 5 months of war, Putin is playing for attrition, an increase in dissension within the Western camp, and a weakening of European governments struggling with the population angered by the inflation of energy and food prices. The war is expected to cost $1 trillion in 2022 according to the Economist Intelligence Unit as global growth expectations have fallen from 3.9% to 2.8% and the question is who will be more resilient between Russia (GDP expected at -8%, inflation at nearly 16%) and the Western camp.

- ***From an economic point of view***, inflation erodes the purchasing power of the middle class because the accumulation of savings during Covid has mainly benefited the wealthier group. Recently, the good news is that the bottlenecks have been removed, the bad news is that companies' inventories are swelling. Certainly, industry represents a small component of the GDP in developed economies, 22% in Germany and Sweden, half as much in the United States, Great Britain and France. Nevertheless, held back by rising interest rates, caught between rising production costs and falling purchasing power, growth is being hampered and at the end of the year, recession is threatening. A recession that is supposed to be brief and small in scale. The increase in the world's energy bill was on a trend of $5 trillion compared to 2019, or nearly 5% of the world's GDP. But the recent decline in oil prices is a game changer.

- ***From a regional point of view***, the most vulnerable to a slowdown are not the OECD countries but the emerging countries, such as Brazil and South Africa, because the rise in rates has been much stronger.

  To better understand the risks of a global recession, let's look at the outlook in the major regions.

United States: **reasons for hope**.

- ***Growth***: *countering the prevailing pessimism*.

  Since 1945, the country has recorded a dozen recessionary phases and today fears of recession in the next 12 months are heightened by rising rates.

  After exceptional GDP growth of 5.7% in 2021, the slowdown is marked. GDP fell by 0.9% in the 2nd quarter at an annualized rate after -1.6% in the 1st quarter, indicating a technical recession. This is the 4th recession since 2000, after 2001 (8 months), 2007 (18 months) and February 2020 (2 months). The IMF forecasts growth of 2.3% in 2022 and 1% in 2023. Should we therefore be worried?

  The rebound in industrial production in July, the increase in the ISM services index to 56.7 are reassuring signs for the economy, as is the trend in employment, the low level of real interest rates and the number of new business.

- ***The labour market remains dynamic***:

  Unemployment trends are always a lagging indicator of economic conditions, but on average over the 12 post-war recessions, the unemployment rate has risen by 3.5 percentage points and is now on average above 9%. Where do we stand?

  Most of the 22 million jobs lost during the Covid crisis have been recovered, the unemployment rate at 3.5% is at its lowest in 50 years, wages in July grew by 5.2% over 1-year, and unfulfilled job offers, 10.7 million, are almost double the number of people looking for a job, 5.9 million in July. These are all reassuring indicators.

- ***Consumption supported by savings and employment*** :

  Consumption rose by 1% in the 2nd quarter, benefitting from the drop in the price of a gallon to $4 after a record $5.02 in mid-June and from a further rise in household confidence in August. In addition, households had accumulated $2.7 trillion in savings during the pandemic and, according to Moody's, $2.5 trillion would remain.

- ***The fiscal situation has improved rapidly***:

  In the first ten months, the budget deficit was largely reduced from $2.5 trillion in 2021 to $726 billion. The passage of the $370 billion climate bill and the approval by Congress of a $280 billion plan to support and develop the semiconductor sector are factors supporting growth.

- ***Real estate impacted by rising rates***:

  Here is the sector most impacted by the rise in interest rates: housing starts fell by nearly 10% in July compared to June, housing sales decreased by 5.9% in July over a month.

  Nevertheless, if inventories increase, the 30-year mortgage rate has just fallen to 4.99%, far from the 5.88% in June, and may give some reasons for hope.

Europe: **concern**.

There are many reasons for concern: a political crisis in Italy with elections on 25th September, an economic crisis in Germany, a fear of Russian gas shortages this winter, and rising energy prices, especially electricity (+500%).

The rise in energy prices and food prices cost the Eurozone €400 billion in trade balances.

The IMF estimates the impact of the energy shock at 1.8 percentage points on growth, a cost less than the 2008 financial crisis and a cost that will be reduced with the development of substitutes for Russian hydrocarbons. If there is a recession, it will be temporary.

The IMF expects the Eurozone to grow by 2.6% in 2022 and 1.2% in 2023, figures that are likely to be revised downwards but nevertheless higher than the potential growth of the medium period. The Commission has revised its forecast from 2.3% to 1.4% for 2022 for the EU, including 1.4% for Germany, 2.4% for France, 2.9% for Italy, 4% for Spain and 4% for Greece.

In the 2nd quarter, growth, except in Germany, was better than expected, +1.1% in Spain, +1% in Italy, +0.5% in France. The worst-case scenario would be an interruption of Russian gas deliveries next winter, but Russia has little alternative to sell its production. The 150 billion m3 sold to Europe cannot be sold elsewhere due to a lack of facilities and China only absorbs one tenth of Russian gas.

Great Britain: **the most affected of the major economies**.

Since Brexit, the situation has not been very bright, an exception compared to the other major countries. GDP contracted by 0.1% in the 2nd quarter. In response to inflation, 10.1% in July and the highest in the OECD countries, households are using more credit as wages are only rising by 4.7%. The trade deficit worsened to £27.9 billion in the 2nd quarter.

Mrs Tuss is expected to become Prime Minister and is considering tax cuts, but the country now needs investment more than tax cuts or deregulation measures, especially to reduce regional divides. Business investment is weak, 9% lower than in Q4 2019, and this is a consequence of Brexit and the uncertainty that accompanied it.

China: **the authorities have to deal with multiple constraints**.

- ***Cyclical difficulties***:

  In July, the manufacturing PMI fell to 49, manufacturing output rose only 3.8% year-on-year, retail sales by 2.7% and the small change in imports, +2.3%, corroborates the weakness of domestic demand.

  The drought in Sechuan (a population of 84 million) and Hubei has lowered the level of dams by 40 to 50%, forcing power cuts and penalizing industrial production and lithium production, and hence batteries. This is in addition to the disruptions caused by the recent lockdowns. Li Keqiang has asked six provinces to support the economy, both consumption and investment, through $220 billion in issues, but recovery looks to be difficult.

- ***The 9 obstacles to stimulation***:

  It is difficult to stimulate credit, given the difficulties of certain banks, the high level of corporate debt (1.5x GDP) and local government debt ($4.5 trillion in debt).

  It is difficult to stimulate real estate, a traditional engine of domestic growth, given the number of unfinished projects and the outstanding real estate debts estimated at $6.8 trillion in unsold inventory, 30 million held by developers and 100 million owned by speculators. Inventory which, according to Capital Economics, could accommodate 340 million people. Over the year, sales prices have fallen by an average of 1.6% in the 70 largest cities, sales by the 100 largest developers have fallen by almost 40%, the number of developer defaults has worsened, accounting for a third of the country's total, and there is still no restructuring of Evergrande's $300 billion of debt and no finalization of an 80 billion Yuan public fund to complete halted projects. The developers are expected to repay $13 billion in foreign currency in the second half of the year, or 13% of the foreign currency debt, but there is cause for concern.

  It is difficult to expect an improvement in household confidence when their main investment, 70% of their wealth, is thus weakened.

  It is difficult to lower rates in view of the risk of capital flight to the $ and a possible depreciation of the Yuan.

  It is difficult for the government to ask banks to be flexible when it comes to unpaid debts because many have accumulated bad debts.

  It is difficult to get angry with the United States because the US trade deficit with China, up by nearly 30% over one year, reached a record $200 billion in the first half of the year, as US imports increased by 20% in the meantime. Moreover, despite the sanctions, Americans are exporting a lot of technology to China and in 2021, there was an increase in Chinese investment projects in the US. 5 Chinese groups including PetroChina and Sinopec want to delist from the US within a month.

  It is difficult to counter the decline in the population announced by the Ministry of Health from 2025 because the unemployment rate of 16-24-year olds is approaching 20%, the integration of 10.7 million new university graduates promises to be difficult and these difficulties are reflected in the decrease in the number of marriages, which is at its lowest in 30 years, and the fall in births.

It is difficult to be angry with the West because the engine of growth is exports, +18% over 1 year, at $333 billion.

It is difficult to bet on the Silk Road because, after spending $930 billion over the last ten years according to the BIS, China has been weakened by the growing list of its clients, from Pakistan to Sri Lanka, Iran, Angola, Zambia, etc., who are insolvent and unable to pay it back, and investments have thus fallen to $28 billion in the first half of 2022.

Russia: between Charybdis and Scylla

- ***A recession by 2022***:

  Putin, initially convinced of a lightning victory, has to deal with the economic consequences of the sanctions: inflation at 17%, a deep recession, a disengagement of many Western companies and a feeling of isolation.

  GDP fell by 4% in the 2nd quarter. Inflation is at 17%. The IMF forecasts a recession of 6% in 2022 and 3.5% in 2023, even if the country benefits from high hydrocarbon prices.

  Russian oil exports, 3.5Mb/d, are close to pre-invasion levels. Hydrocarbon revenues doubled in the 100 days of the conflict.

- ***Increased difficulties beyond 2022***:

  According to Yale University, companies that have left the country account for about 40% of GDP and the country is struggling to obtain spare parts and some technology.

  Oil accounts for 40% of budget revenues, but the lack of access to Western technology will hamper the development of new high-quality oil fields in the North at Vostock near the Arctic.

  In addition, within 2 to 3 years, Russia will lose its main source of export revenue and must invest massively to redirect energy flows because the Europeans will certainly end up depriving themselves of Russian hydrocarbons and it will take time for Russia to build pipelines to Asia and reduce its dependence on the EU. Work on the 2nd pipeline to China through Mongolia, "Power of Siberia 2", 2600 kms, could start in 2024 and be completed in 2030.

Emerging countries: **an increase in defaults**.

The countries most at risk in Asia are Sri Lanka, Bangladesh, Laos and Pakistan. The latter has less than $10 billion in reserves, faces an inflation of 25%, a depreciating currency and will have to support a 23rd IMF aid program.

Brazil suffers from positive real rates as the official rate of 13.75% exceeds inflation at nearly 12%. As a result, growth is low, 1% in the 2nd quarter, and unemployment is high at 9.8%. In ***Mexico***, the same is true with rates at 8.5% in a context of inflation at 8.1% in July.

Turkey, with inflation still high at 80% in July and a currency still down 25% this year, is another case as the central bank's recent policy of lowering rates to 13% is a heresy.

Argentina's economy continues to face 65% inflation, probably peaking at 90% in the 3rd quarter, a weak currency, and an inability to repay the $44 billion loan the Macri government took out from the IMF only two years ago.

Conclusion*: "Things are never as good or as bad as we think"* Talleyrand.

- ***Legitimate concerns***:

  Cyclically, many indicators point to the possibility of a recession. Whether it is the one-quarter drop in copper prices, the decline in oil prices, the easing of long-term interest rates or the loss of consumer confidence, all the indicators seem to be pointing in the same direction.

  The war in Ukraine is to blame, but so are more restrictive monetary policies, the erosion of household purchasing power undermined by inflation, and China's management of Covid with its repeated lockdowns.

  From a monetary point of view, the central bankers' meeting in Jackson Hall on 27 August will bring some clarifications on their respective intentions, but we expect interest rates in the United States to peak in early 2023 at around 4% as inflation falls and activity slows. The only country that will continue the rate cut is China which is still facing an economic slowdown.

  The most fragile countries are the emerging countries because, on average, the public debt of low-income countries will reach 70% of GDP. Interest rates are higher than in developed countries, thus penalizing growth. The risk of default by several of them is not negligible. The IMF estimates that 41 countries, accounting for 7% of the world's population, are at risk, such as Laos, Sri Lanka, Turkey, Tunisia... Unsurprisingly, the five coups d'état in Sahel countries are partly the result of economic difficulties.

  More fundamentally, the low productivity observed in recent years is the result of very accommodative fiscal and monetary policies that have protected the weakest companies and reduced default rates despite the sometimes more marked recessions, but at the same time have reduced business start-ups, favored concentration and rents, and reduced the number of companies listed in the United States by 50%.

- ***Reasons for optimism***:

  In the short term, let us not be alarmed by a recession that would last two to three quarters, let us not worry about continued wage inflation because real wages have been falling for 18 months and because wage increases will make it possible to bring back people who have left the labour market.

  Let's not overestimate China's ability to rebound because Covid is not under control, the recovery in investment is modest, the real estate crisis is not yet under control, youth unemployment is high and consumers are cautious.

  The brakes on this recession are the persistence of excess savings in the United States and Europe, a windfall to support consumption, a dynamic labour market, the resilience of business investment spending, the prospect of a fall in inflation with gasoline and food prices already easing.

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