# Letter n°110

## Is a global recession on the horizon?

***"Prediction is a difficult art, especially when it concerns the future" Pierre Dac.***

In this quote from the humourist Pierre Dac, there's a touch of tautology, but also a grain of truth that reflects the hesitations and questions of investors.

- ***The evolution of commodity prices indicates a slowdown***:

Since January, the price of iron ore, which was at $135 per ton, has dropped by one-third. In May 2021, it was even at $230 per ton, near a record high. The cause of this decline is the Chinese real estate crisis, which is hurting steel demand.

Copper prices have just fallen by 20% to $9,000/ton, after a record high of $11,000/ton in May, as Chinese stockpiles are at their highest since 2020, and the manufacturing PMI is down.

Finally, oil prices have recently dropped significantly as, in July, China, a major importing country, imported 12% less than the previous month and 3% less than a year earlier. The IEA is forecasting a global demand increase of only 0.9 Mb/d, with no more than 0.180 Mb/d additional demand from China, a figure that has been revised downward.

- ***Volatility is increasing, and sharp corrections in markets or individual stocks are being observed***:

Should we be worried? Is this related to economic developments? Does it reflect profits? The Dow Jones fell below 20,000 at the start of COVID, and now it's at 41,000. Within the S&P, the "Magnificent 7" contributed to 60% of the performance in 2023 and more than 40% of the performance since the beginning of this year. However, recently, there has been a shift in interest from high P/E stocks toward more defensive ones, such as "consumer staples" like Coca-Cola or Colgate, which are seen as more defensive investments.

- ***The markets are wavering***:

Faced with these indicators, bond managers are anticipating a recession and a 2-point rate cut in the next 12 months, while equity investors remain confident, as profit growth is still strong and corporate margins are at record levels. It is difficult to distinguish between these different investors, as the signals are not aligned and are sometimes ambiguous.

In the United States, is the end of the yield curve inversion a premonitory sign of a recession? Will the rate cuts come too late, after more than a year with rates between 5.25% and 5.50%?

Or should the beginning of the rate cuts be seen as the dawn of stronger economic growth?

Between these opposing views, there is another, more moderate approach: the observation of a relative insensitivity of the economy to rate movements. Since, the significant and rapid rise in rates has not broken global growth over the past two years, why should the rate cuts stimulate it? Supporting this approach are companies and households now able to secure long-term, low-rate financing for real estate mortgages or business loans, and companies that are less dependent on credit than they were a few years ago.

To assess the likelihood of a recession, we should observe the evolution of growth in different regions of the world, followed by changes in consumption and employment, inflation and rates, and finally, the markets and valuations.

**What is the evolution of growth?**

To have a clear view, let’s consider the major growth regions of the world. According to the IMF, global GDP in 2024 is composed of 27% from the United States, 17% from the EU and China, 11% from the Asia-Pacific region excluding China and Japan, 4% from Japan, India, and the Middle East, and 3% from Africa.

Since the beginning of 2022, half of the OECD economies have experienced two consecutive quarters of GDP decline at some point. This has been the case for the United States at the beginning of 2022, followed by Germany, the United Kingdom, Sweden, and New Zealand.

Nevertheless, in the second quarter of this year, the real annualised growth of OECD countries was 1.8%, partly due to an average budget deficit of 4.4% of GDP.

- In the ***United States***, second-quarter growth figures were revised upward from 2.8% to 3%. Therefore, a recession seems far off. Growth is expected to be 2.3% this year and 2% in 2025.

  The stimulus plans implemented by Biden, and the acceptance of unprecedented budget deficits in the midst of an economic growth cycle – deficits twice as high as the average since 1945 – have amplified growth.

- In ***Europe***, growth remains disappointing, estimated at 0.8% for this year and 1.3% for next year according to the European Central Bank.

  Among all major countries, Germany has been undeniably the most affected, due to its dependence on Russian gas and exports to China. After a recession in 2023 (-0.3%), growth forecasts have been revised to 0% for 2024, down from 0.4% just a few months ago. The German GDP unexpectedly declined in the second quarter, as exports – more than 50% of GDP – were hurt by weak demand from China and the U.S. slowdown, and have not regained momentum. Exports fell by 3.4% in June. Industrial production, which accounts for 22% of GDP, has decreased by 4.1% over the past year.

  Another country with weak growth is the United Kingdom, but this is no surprise. The country is bearing the consequences of Brexit. Economic trade with the EU has not declined, but the UK has lost the benefits of the single market.

- In ***China***, growth has been slowing year after year. While GDP growth was 10.6% in 2010, this year it will approach 4.7%. Structurally, it is expected to continue declining in the coming years. This is due to high debt levels, which hinder the financing of stimulus measures, and the country’s rapidly aging population, with an anticipated population decline.

  Despite rate cuts to historic lows, domestic consumption remains weak. The country is struggling to stabilise the major real estate players facing over-indebtedness and overcapacity.

  The only remaining growth driver is exports. While the trade surplus reached a record $90 billion last month, China is increasingly facing protectionist barriers from both Northern and Southern countries. Additionally, there are the effects of nationalism and Xi Jinping's policy to replace Western brands with local products. Numerous warnings have been issued by Western companies, complaining about the obstacles to their expansion in the Chinese market and the intensified competition from Chinese firms, which are unfairly supported by government subsidies to dominate internationally.

  In summary, weak growth in Europe, a disappointing recovery in China, but still growth above 2% in the United States – so no recession.

**What are the trends in employment and consumption?**

In recent months, there has indeed been an increase in unemployment in a few countries: from 3.5% to 4.2% in the United States, from 3.6% to 4.4% in the United Kingdom, and from 3.5% to 4.1% in Australia. However, there is nothing alarming, as employment continues to grow, and participation rates are high.

- In the ***United States***, consumer confidence in September is at its highest since May. Over the past year, the consumption growth rate of 2.9% is likely unsustainable, as the savings rate fell to 2.9% in July, and incomes increased by only 0.3% in the same month. Factors supporting confidence include the low unemployment rate of just 4.2%, which is expected to rise to 4.5% by the end of the year, still a relatively low level. Another positive factor is the reduction in the poverty rate in 2023 to 11.1%, or 36.8 million people with an income below $31,000/year.

- ***Elsewhere, in OECD countries,*** the average unemployment rate does not exceed 5%, the participation rate is at a historic high, and wages are increasing by more than 4%, a rate finally higher than inflation, ensuring gains in purchasing power.

- In ***China***, job creation is insufficient, youth unemployment exceeds 21%, consumer confidence is therefore low, and consumption represents less than 40% of GDP, a figure far lower than the 70% observed in the United States. But it is not a recession.

**What are the trends in inflation and interest rates?**

Cumulative inflation, which was very low in the 2010s, reached 18% in the United States and 21% in the United Kingdom between December 2020 and the end of 2023.

Today, inflation is decreasing everywhere, interest rates are easing, and bond markets are benefiting. Since the beginning of the year, U.S. government bonds have appreciated by 4.7%, and corporate bonds by 5.9%. In Europe, government bonds have risen by 2%, and corporate bonds by 3.4%.

In the U.S., the inflation peak was 9.1% in July 2022 due to stimulus checks given to households. In Europe, inflation hit 10.6% in October 2022, driven by energy shocks (for example, gas prices are still 4 to 5 times higher than in the U.S.). Today, inflation is at 2.5% in the U.S. and 2.2% in Europe (even as low as 1.6% in Italy). The only factor preventing further rate cuts is core inflation remaining above 3%.

***In the United States***, after 11 rate hikes since early 2022, we are entering the 4th phase of rate cuts since 2000, following those in 2001, 2007, and 2019-2020. Investors are expecting a total reduction of 2.5 points in interest rates by the end of 2025, with 1 point to be cut this year and 1.5 points in 2025.

Long-term rates, which peaked at 5%, have fallen back to 3.7%. Two-year rates have dropped below ten-year rates, which some interpret as a sign of a potential upcoming recession. Companies are taking advantage of this easing by increasing "investment-grade" bond issuances before the November elections. While IG rates were 5.6% in early July, they are now down to 4.8%.

***In Europe,*** overall inflation fell to 2.2% in August. The main obstacles to faster rate cuts are core inflation still at 2.8% and inflation in services at 4%. In the coming months, energy price inflation is expected to decline, but food price inflation may rise slightly. Interest rates, currently at 3.5%, may decrease again in October as the ECB lowers its growth forecasts.

***In Switzerland,*** inflation has dropped to 1.1%, and producer prices have decreased by 1.7% over the past year. The unemployment rate recently rose from 3.7% to 4%, indicating the possibility of two rate cuts by the end of the year to 0.75%.

***In China,*** the situation is different from that of Western countries. Deflation is a threat, production prices are falling, and although inflation increased in August, it is only +0.6% year-on-year, a figure below expectations. To assist indebted companies and provinces, the central bank is trying to manage the yield curve and ensure that long-term rates remain higher than short-term rates. It is selling long-term bonds on the market and buying short-term bonds.

New supply shocks may emerge, but structurally, inflation is not expected to rise.

***In Japan,*** the context is yet another. For months, the central bank has been considering abandoning its low-interest-rate policy, but such a shift could be problematic, as the central bank holds more than half of Japan's public debt, equivalent to 125% of GDP – more than five times what the Fed holds as a percentage of U.S. GDP. The bank wants to stop the artificial cap on 10-year rates at 0.9%, but doubling this rate would raise the debt burden to 17% of the budget compared to less than 9% today.

As a consequence of the onset of rising rates, there has been a vigorous appreciation of the yen, reaching 139/$1, reflecting a 13% increase over three months, following records of weakness.

Ironically, this easing complicates the public finances of many states, as it hinders the improvement of debt ratios. However, it allows companies to refinance their loans and obtain more favourable conditions.

**What is the evolution of markets and valuation?**

This year, the top-performing markets are once again the United States and India, followed by Japan, Asia (excluding China and Japan), and Europe. The Chinese market is down again.

In the ***United States***, from February 2020 to July 2024, U.S. stocks have returned 9.6% annualised, adjusted for inflation, while bonds have lost 5% annualised.

In the second quarter, S&P 500 companies reported a revenue increase of 5.2%, lower than the average of 6.7% over the past five years. However, profits, bolstered by cost-cutting measures, increased by 10%, and the market recently reached a record level for the Dow Jones, exceeding 41,000. The price-to-earnings ratio is at 21x, compared to an average of 18x over the past ten years. Volatility has increased, and corrections on stocks can now be severe, particularly for the most highly valued ones. This has been seen recently with Nvidia, which has $125 billion in revenue but a $3 trillion market capitalisation, as well as luxury goods companies. In recent months, many investors are choosing more defensive stocks like consumer staples – Coca-Cola, Heinz, Procter & Gamble, Walmart, and Colgate – but we should monitor their pricing power.

What can we anticipate? Certainly, the first rate cut in the United States is not always followed by an appreciation of the S&P 500 within 12 months. After September 2007, the market fell by 17%, but we were facing a major global financial crisis. Previously, after January 2001, the market declined by 13% in one year, but the bursting of the tech bubble, an unprecedented phenomenon, left market participants somewhat bewildered. In contrast, if we look at a longer timeframe, the Fed is about to initiate its 14th rate cut phase since its establishment in 1913, and in 12 out of 14 cases, the market was higher one year later. Recently, one year after July 2019, the market appreciated by 8%, and earlier, after July 1995, it increased by 21%.

***In Europe,*** the market's price-to-earnings ratio is more modest at 15x, but the outlook is less promising. As Mario Draghi bitterly notes in his report, in the past 50 years, no company with a market capitalisation exceeding €100 billion has been created from scratch in Europe, while in the United States, six new companies have market caps over $1 trillion! Moreover, nearly a third of unicorns – young companies with a valuation over $1 billion – have relocated, mostly to the United States.

***In China,*** the market remains disappointing, with foreign investors selling $12 billion in securities since early June.

***The ounce of gold,*** priced at $2,585, is at an all-time high, up 25% this year, reflecting geopolitical uncertainty, concerns over the rising public debt worldwide, the prospect of interest rate cuts, and gold purchases by central banks. This level is still far from the historical peak of 1980, which was $850 per ounce, equivalent to about $3,400 per ounce when adjusted for inflation.

**Conclusion**: ***"What heights will he not scale?" motto of Nicolas Fouquet.***

Market volatility is increasing, and many investors are feeling anxious about the risks of a recession. However, taking profits now seems premature, so we will adopt the motto of Nicolas Fouquet, even if, ironically, he did not end his life well.

- ***From a geopolitical perspective,*** neither the war in Ukraine nor the conflict in the Middle East has pushed the global economy into recession or hindered market appreciation. There were concerns, such as a spike in grain prices during the invasion of Ukraine and increases in gas and oil prices at the onset of each of these conflicts. Fears about global trade arose with the temporary blockage of grain exports in the Black Sea and the Houthi attacks at sea, but Russia still seems unable to secure a victory in Ukraine; there has been no general conflagration in the Middle East, and trade volumes are once again on the rise. As for Taiwan, the status quo appears to prevail. For now, one can dream of a victory for Kamala Harris.

- ***From a monetary perspective,*** while the COVID crisis and the war in Ukraine have revived inflation that had briefly disappeared, we are gradually returning to normality. Inflation peaked at 10% in the OECD in 2022 but has recently dropped to 2.6%, allowing for anticipated interest rate cuts. Although inflation caused a loss of purchasing power for households, it did not lead to a recession. Central banks had to abandon their zero interest rate policies. Everywhere, particularly in emerging countries, interest rates have risen rapidly, and credit has been constrained. Yet, there is still no recession.

- ***From an economic perspective,*** the world is facing a real estate crisis in China, increasing tensions between China and OECD countries, and a growing number of protectionist measures. Still, there is no recession. Certainly, global growth is slower, and interest rates are higher, but global PMI indices remain positive, corporate margins are at their highest, and there have not been any notable sovereign defaults in the last two years. The current trend of rate cuts will facilitate a relaxation of the dollar and alleviate tensions on the debt of emerging countries.

  A re-election of Trump could change the situation, as he seeks to challenge the independence of the Federal Reserve, provoke a decline in the dollar, escalate taxes on China, and continue to show disdain for international institutions, particularly the WTO. In other words, some may worry about increased fragmentation of the global economy, worsening protectionism, and rising inflation in the U.S. fuelled by immigration restrictions and import taxes.

- ***From a stock market perspective,*** U.S., European, and Japanese markets are at or near their highs, with valuations often elevated in terms of price-to-earnings ratios, raising questions about the catalyst for further appreciation. However, the risks of decline are mitigated by the level of margins, the abundance of liquidity in the money market, productivity gains driven by the spread of AI, and the prospect of rate cuts that will particularly benefit bank stocks, utilities, and real estate stocks.

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