Quarterly market update: NFPs and the risk of a recession

By Perpetual Private Insights
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Given the pressure higher inflation and interest rates put on consumers, investors and NFPs, it makes sense to ask whether we're heading for recession. In this article we canvass the forces at play.

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September Quarter 2022: What happened?

- Seeking to trim an inflation rate running at over 6%, Australia's central bank (the RBA) lifted the cash rate three times in increments of 0.5%. They slowed that cracking pace in October, when the rate hit was just 0.25%. But that recent moderation may be small comfort to borrowers. In April, the cash rate was 0.10%. Now its 2.6%.
- US inflation currently sits at 8.3%. The US Federal Funds Rate started 2022 at under 1%. By September it had breached 3%.
- After a strong start to the quarter, sharemarkets weakened sharply from late August. Global shares were down 4.9% over the quarter and are now down over 20% for the first nine months of 2022. Australian shares rose just 0.45% over the quarter. However they are down nearly 13% for the year so far.
- Global bond markets lost 3.7% over the quarter and are down 9% over the past year. Local bonds are also down over 9% over the past 12 months but were down just 0.6% for

the quarter.

(Indices referenced: S&P/ASX 300 index (price), MSCI AC World Index, Bloomberg Global Aggregate (AUD Hedge). Bloomberg AusBond Composite Index. https://www.macrotrends.net/2015/fed-funds-rate-historical-chart. All performance numbers for September quarter unless otherwise stated.)

The risk of the "R word"

As the numbers above show, central bankers are pulling tightly on the monetary reins and that's having a stinging effect on investment markets. It's also forcing many to ask whether pulling so tightly on those reins risks pushing the world into recession. That's an issue particularly important to a community sector already dealing with the aftermath from Covid and lockdowns. According to Andrew Garrett, Investment Director at Perpetual Private, there are a range of competing forces at play.

The no-recession argument

Many advanced economies face into a rising rate environment bolstered by high levels of employment and with populations flush with cash. In Australia unemployment is just 3.4%, wages are growing at over 2% and economic growth is still chugging along at 3.6% [1]. Even in the US, where rates were pushed up more quickly, the unemployment rate is just 3.7% [2].

Some supply chain pressures appear to be easing. US petrol prices have fallen a dollar a gallon since June. So if central bankers calibrate their tightening correctly, inflation could be brought under control faster than many expected – and without a deep recession and significant unemployment.

The recession risk

If there is a recession in Australia – or around the world – it will be because central banks pushed so hard against inflation that they drove growth out of the economy. The Vice Chair of the US Federal Reserve, Lael Brainard, recently pointed out that across nine different advanced economies that account for half of global GDP, interest rates have risen 1.25% - or more - in just six months[3] .

Perpetual Private's Andrew Garrett says the difficulty for central bankers is the lagged effect of rate rises. It's hard for even the most brilliant central banker to know just when to stop raising rates.

Add monetary tightening to the geopolitical uncertainty and economic fallout of the Russia-Ukraine conflict and you get many reasons for consumers and businesses to cut their spending – and increase the risk of recession.

Will bonds get their old job back?

Since the GFC, the global economy has been running on 'emergency,' super-low interest rates. That was good news for homebuyers. Less so for charities who relied on cash, bonds and term deposits for low-risk income. In the short-term, the 'normalisation' of interest rates in 2022 has meant a capital loss for bond investors as rising rates make bond holdings less attractive. But over the longer-term, it could be good news. With new bonds issued at higher rates, fixed income could resume its traditional role in NFP portfolios.

Which is worse, inflation or recession?

Inflation damages the fabric of an economy, skews the sensible allocation of capital and in many ways punishes rational decision-making. For example, it makes accumulating excess debt more attractive because inflation pays it off for you by reducing the real value of your debt.

But once embedded in the expectations of workers and businesses, inflation is very difficult to eradicate. So it's clear that central banks will keep pushing. As another Federal Reserve Governor, Lisa Cook, said on the 6th of October: "In sum, inflation is too high, it must come down, and we will keep at it until the job is done." That may worry those in the community sector. But here's another thing about inflation – it hurts the poor and vulnerable most. So a mild recession that controls inflation may be the lesser of two evils.

In the September 2022 Perpetual Private Quarterly Market Update we look at how markets and economies reacted to rising inflation and rising rates over the past quarter. We also discuss the performance and outlook for individual asset classes including equities, fixed income, real estate, currency and alternatives.

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[1] Key Economic Indicators, September, RSA

[2] https://www.federalreserve.gov/newsevents/speech/cook20221006a.htm

[3] https://www.federalreserve.gov/newsevents/speech/brainard20220930a.htm

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