MARKET COMMENTARY

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World economy: risk of a new recession

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All leading indicators are flashing red. A new global recession looks almost inevitable, in Germany, in Europe and worldwide, a little more than two years after the Covid-recession. In 2020 the world's real GDP has shrunk by 3.1%. Another decline is a realistic possibility even though the latest forecasts of OECD and IMF continue to predict a positive rate of growth for 2023 (OECD +2.2% y/y). All new numbers are lower than the previous ones. The worst performers are expected to be Germany (-0.7%), the euro area (+0.3%) and the US (+0.5%).

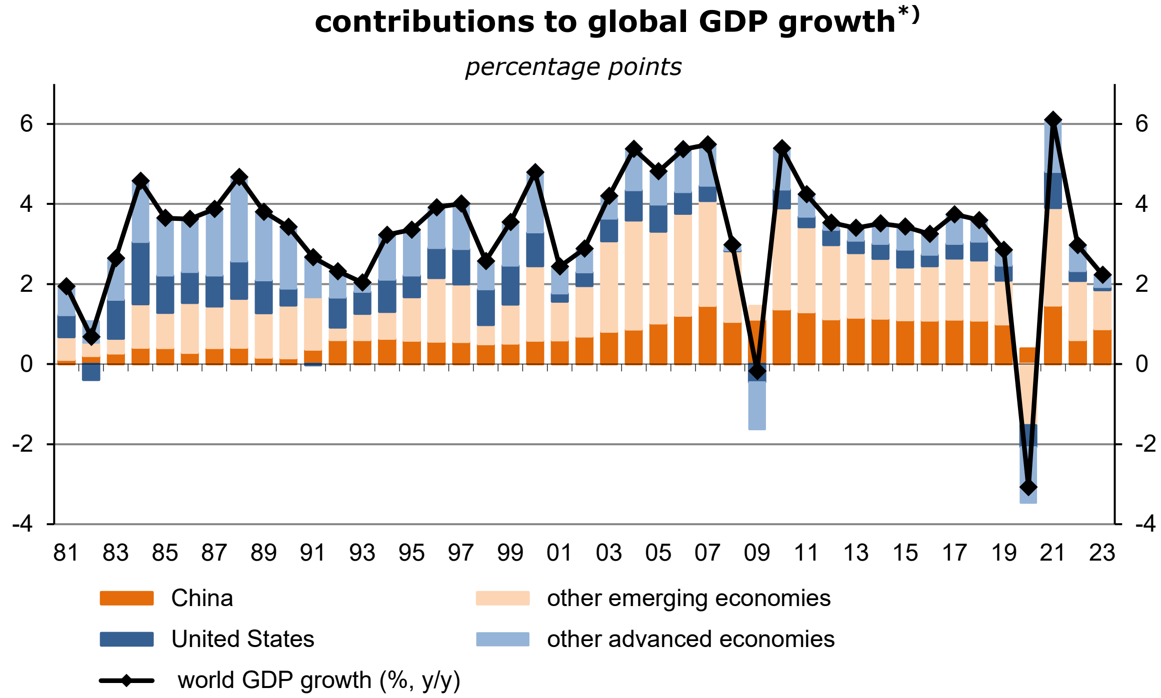
The new trigger is different from 2020: it is the explosion of energy prices after Russia's invasion of Ukraine. For households in countries which depend on imports of fossil fuels the high prices for gasoline, heating and, most importantly, of gas mean they have much less money left for other goods and services, even for those that are not directly affected by energy price inflation. While consumer prices are generally up by 8 to 10% from last year, household incomes have only increased by between 3 and 5%. Going by recent industrial producer prices, consumer price inflation is bound to rise further before it declines again: Germany's PPI, for instance, were a shocking +45% y/y in August. Firms must pass on those very high input prices to their clients. For many the alternative would be bankruptcy. Gas prices in particular have increased by a factor of about 10 from one year ago. Germany's CPI inflation will soon reach double digits.

Moreover, monetary policies in the entire OECD region are increasingly pro-cyclical (with the exception of Japan). Central banks are hitting the brakes as inflation rates are generally far above target. They aim to reduce the demand for goods and services by aggressively raising policy rates – because they are concerned about their reputation and rising inflation expectations.

Further large rate hikes have been announced almost everywhere. In the present environment this pushes up both the short and the long end of yield curves. In normal circumstances the coming recessions would push down inflation expectations and thus long-term interest rates. Not this time! This has at least two negative effects on growth and employment: for one, target rates of return on new capital expenditures will rise which reduces the pool of viable projects, in addition high discount factors (long-term interest rates) lead to lower present values of future cashflows and profits which tends to lower stock prices – the negative wealth effect is another factor which slows down spending intentions of households and business.

At the same time major structural reforms of the economies are under way. Because fossil fuels have become so expensive, processes, equipment and products which have relied on these must be either discarded or written down – which reduces profits. Many specialized workers lose their jobs. A new structure is needed but initially there will be a scarcity of reliable suppliers and specialists. Initially, this creates so-called frictional unemployment.

In normal times this would be the hour for expansionary fiscal policies. Its task is to lower taxes and adjust spending in a way that minimizes social problems and channels resources into sectors which will do well. That's easier said than done because government debt has increased a lot already in the wake of the last recession. Conservative politicians favour reducing the debt mountain rather than adding even more debt. Fiscal policies are not much of a help in the fight against recessions.



*) at PPP; 2022, 2023 based on OECD projections

sources: IMF, OECD, own calculations; design & research: Uwe Richter

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In the past, China used to be a stabilizing factor of the world economy: it is a huge country with a lot of catch-up needs, and a very high national saving rate. Until recently its output had steadily increased at annual rates of more than 8% and its contribution to global GDP growth had averaged 28% per year on average (US 10%). China was the world's growth engine. This is no longer the case. The real estate crisis, Covid lockdowns and problems on major export markets have led to a reduction of trend growth to something between 4 and 5%. In the near future China will no longer be the importer of last resort.

America's GDP has declined slightly in the past two quarters while the Fed's policy rates are being raised quickly and in large steps. Just as in the countries of the euro area, annualized growth rates will be less than 1% between now and the second half of 2023. The question is from where and how the next recovery will start. OPEC countries, Russia, Norway and Texas, the winners of the present crisis, are too small to have a significant impact. A recession, or at least a significant slowdown are unavoidable in the OECD region and China.

And the bottom line for financial investors? They should stay away from stocks – the end of weakening markets is not yet in sight. Contrarians should not be impressed by that suggestion, just as those conservative investors who invest a monthly fixed amount of money into equities no matter how cheap or expensive they are. Long-term they can be sure that they earn a so-called risk premium of 3 or 4 percentage points over a riskless bond portfolio. Another proposal is to reduce the duration of the portfolio as long as central banks keep raising rates. And, last but not least: Japanese securities. For quite a long time, market participants have neglected them, in my mind for no plausible reason. Not to forget: the Yen is hugely undervalued.

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About Wermuth Asset Management

Wermuth Asset Management (WAM) is a Family Office which also acts as a BAFIN-regulated investment consultant.

The company specializes in climate impact investments across all asset classes, with a focus on EU “exponential organizations” as defined by Singularity University, i.e., companies which solve a major problem of humanity profitably and can grow exponentially. Through private equity, listed assets, infrastructure and real assets, the company invests through its own funds and third-party funds. WAM adheres to the UN Principles of Responsible Investing (UNPRI) and UN Compact and is a member of the Institutional Investor Group on Climate Change (IIGCC), the Global Impact Investing Network (GIIN) and the Divest-Invest Movement.

Jochen Wermuth founded WAM in 1999. He is a German climate impact investor who served on the steering committee of "Europeans for Divest Invest". As of June 2017, he is also a member of the investment strategy committee for the EUR 24 billion German Sovereign Wealth Fund (KENFO).