August 2023

Goldilocks is keeping the bears at bay

The global economy was supposed to be in the midst of a deep recession by now. Last October, Bloomberg ran an online article with the headline “Forecast for US recession within a year hits 100% in blow to Biden,” citing inflation and the Federal Reserve’s hawkish stance as the main protagonists.

Fast forward to today and most economists are frantically revising up their 2023 GDP expectations including the Fed’s own research department, which formally dropped their recession call last month. This begs the question, can this resilient growth backdrop continue to underpin equity markets or has a sharp downturn simply been delayed?

Headline GDP prints have certainly surprised on the upside this year. The US economy grew by a better-than-expected 2.4% annualised in the second quarter, whilst Chinese GDP expanded at a 6.3%y/y rate despite continued weakness in the property sector. UK and European economies have stagnated in recent months, but they are not suffering the severe contraction most expected, meaning World GDP is on track to grow by around 2.6% this year, just shy of the rate it averaged during the 2010s.

Yet beneath the hood, many parts of the economy are under immense pressure. Job losses and corporate bankruptcies are becoming a notable feature in the industrial and trade-focused sectors. The JP Morgan Global Manufacturing PMI index has been declining for a year. Whilst it appears to be bottoming out, overcapacity issues remain as the collapse in pandemic demand for “stay-at-home” products left behind a glut of inventories of durable goods and other big-ticket items. As consumption has fallen, retailers have opted to bleed down these excess stockpiles instead of raising new orders, causing manufacturing production lines to run dry.

This destocking cycle has triggered a wave of recession-like activity in many parts of the supply chain, including the logistics sector. In the US, domestic trucking firms’ earnings have collapsed. This culminated in Yellow, one of the country’s oldest and largest freight carriers, filing for

bankruptcy. International goods transit has also tumbled. The cost of shipping a container from Shanghai to LA is down over 80% from its 2021 high.

Typically, such weakness in these "old economy" areas would all but guarantee a broader recession, but headline GDP continues to grow thanks to a resilient services sector.

It would be a stretch to say households are spending prodigiously; especially in China, which has seen a tepid recovery from Covid restrictions. In 2022, lockdown measures saw Chinese consumption fall to just RMB 1trn, around a third of its 2017-19 average (source: Gavekal Dragonomics) and, whilst sales grew at a robust 8%y/y during the first half of this year, they remain well short of the pre-pandemic norm.

The Western consumer is playing a key role in shoring up global demand. Although European retail sales are dwindling due to surging borrowing costs, in the UK and US material declines in energy prices have more than offset tighter credit conditions. British retail sales gained a solid 0.7%m/m in June, whilst US consumption grew at a healthy 3.2% annual pace over the first half; consumers in both economies have benefited from 25-30% declines in forecourt prices, although any significant rebound in energy costs from current levels would soon curtail disposable incomes and retail activity.

This wide dispersion in sector trends has not been lost on equity markets. Consumer-focused tech stocks have dramatically outperformed more cyclical sectors this year. To the end of July, the Nasdaq index was up 37% (U$ terms), helping it recoup around two-thirds of the recent bear market losses. Over the same period, the resource-heavy FTSE 100 posted a capital gain of just 3% (£ terms).

So can a 2023 global recession be completely ruled out or will a nasty downturn still emerge and derail the "risk on" mood? Given the relatively benign near-term outlook for US consumption and renewed efforts by the Chinese authorities to support economic growth, it looks increasingly likely that recession fears can be kicked into next year.

UK and European consumers may continue to falter over the coming months as the impact of softening labour markets and elevated borrowing costs intensify, but these headwinds are less pronounced in the US economy as American households can still rely on the savings they accumulated from the government's Covid handouts.

The firehose of fiscal measures deployed by the US authorities since early 2020 helped excess personal savings reach a U$2.1trn peak in 2021. These reserves have since fallen sharply, as consumers have used savings to fund day-to-day spending, but the total still stands at a formidable U$500bn (source: SF Fed): equivalent to almost an entire month's worth of all US retail sales. At the current depletion rate, this nest egg will run out some time in 2024, but it should remain a key driver of consumption for a few more months and, with the labour market stabilising after an earlier surge in tech-sector layoffs, the immediate threat to US consumer spending power appears low.

The most surprising development this year has been how immune consumers and businesses have been to the spike in interest rates. This is because most borrowers are still benefiting from the ultra-low rates they locked in, on long-term deals, when yields collapsed during the early stages of the pandemic. This means few have needed to take out new loans at these much higher rates.

Take the US mortgage market, for example. Before the 2008 crisis, a vast number of households were exposed to variable rates that reprice as soon as market yields change, but now around 85% of all US mortgages are priced on a 30yr fixed rate (source: The Washington Post). There was a surge in demand for this product during 2020-2021, when the 30yr mortgage rate fell below 3%, so few US households are exposed to the rate now averaging above 7%. This explains why there has been no collapse in the US housing market or a resulting negative wealth effect that would hit consumption. On a related note, US corporate borrowers are also benefiting from an extended maturity schedule but, unlike households, there will be a spike in refinancing needs within the next couple of years. All things equal, that will likely trigger a major squeeze on corporate cash flows but until then, high borrowing costs are unlikely to elicit a sudden economic crash.

Turning to China, the economy has lost momentum in recent months, albeit after a decent first quarter. As noted above, consumer activity is recovering, but external demand remains soft and the housing market has suffered a relapse with sales declining sharply since the spring. This has triggered another bout of financial distress amongst the property firms with Dalian Wanda last month joining a growing list of developers struggling to honour its dollar-based debts.

At face value, a weak China is a problem for markets but its economic challenges are no longer news and the authorities are becoming increasingly assertive in their efforts to resurrect growth. Central bank monetary easing and targeted support to “new economy” initiatives complements a burst of traditional fiscal measures aimed at boosting the infrastructure and property sectors. The recent four-year extension of a tax break that sparked a surge in electric vehicle sales evidences China’s commitment to green energy policies and its desire to establish a consumer-led growth model.

With China experiencing a mild wave of deflation, stimulus announcements will likely be a constant feature as we head towards year-end. This is a net positive for the world economy and markets as there is slim chance of a major downturn for as long as the Chinese are striving to reflate. Global recession risks may well resurface in 2024 as the effects of inflation and rate hikes are yet to fully unfold but, for now, the odds favour a continuation of this slow growth “goldilocks” economy that has supported risk assets. As such, any equity pullbacks should be relatively contained and the stage is set for some of the more beaten up cyclical stocks to enjoy a spell of outperformance.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high-level guide on where we stand at this time.

12-24 Month view	Equities	Bonds	Alternatives
+	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds	Inflation-linked US Treasuries Short-dated Paper	Gold, Volatility Strategies
–	European	European Japanese	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31st July 23	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2835	1.0%	2.1%	5.5%
CHF	1.1470	2.7%	2.6%	9.2%
AUD	0.6717	0.8%	1.5%	-3.8%
JPY	142.2900	1.4%	-4.2%	-6.3%
EUR	1.0997	0.8%	-0.2%	7.6%
BOND YIELDS (10 yr)				
UK	4.31	-0.08	0.59	2.44
US	3.96	0.12	0.54	1.31
Germany	2.49	0.10	0.18	1.68
Australia	4.06	0.04	0.72	1.00
Japan	0.60	0.21	0.21	0.42
EQUITIES				
US. S&P 500 (USD)	4,588.96	3.1%	10.1%	11.1%
UK. FTSE 100 (GBP)	7,699.41	2.2%	-2.2%	3.7%
MSCI Eur ex UK (Local)	1,662.36	1.2%	0.7%	10.8%
Japan. Topix (JPY)	2,322.56	1.5%	12.9%	19.7%
China. Shangai Comp (RMB)	3,291.04	2.8%	-1.0%	1.2%
HK. Hang Seng (HKD)	20,078.94	6.1%	0.9%	-0.4%
Australia. All Ords (AUD)	7,622.16	3.0%	1.6%	6.3%
MSCI Pac ex Jap (USD)	1,341.33	4.3%	1.4%	1.8%
MSCI World (USD)	3,064.30	3.3%	8.1%	11.6%
MSCI World (GBP)	2,383.18	2.1%	5.7%	5.6%
COMMODITIES				
Oil (WTI)	81.80	15.6%	8.0%	-4.3%
Gold	1965.09	2.4%	-1.3%	11.3%

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29 Queen Anne's Gate, London SW1H 9BU, England
Tel +44 (0) 20 7222 8081, Fax +44 (0) 20 7227 8440, Email UK@bentleyreid.co.uk
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