

On the Edge of Recession

January 2023

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Happy New Year! We wish you a healthy and joyful 2023.

Recession seems to be the dominating topic for 2023. The depth of recession and what may trigger it could be different from country to country. In Canada, rising rates have led to cooling real estate demand as mortgage payments increase. However, we are benefiting from aggressive immigration policy and higher commodity demand. The employment picture is generally solid, which would support a mild and shallow recession (if we do get one).

In the US, the situation is somewhat different. Higher rates have compressed valuations of growth companies that dominate the S&P 500 index and the US economy. We have seen aggressive layoffs in the tech sector, which also have ripple effects to consumption. The Fed has been very aggressive in hiking interest rates and the markets generally believe a recession is unavoidable. The central bank appears to care more about bringing inflation back to 2% than risk of recession. This means if inflation does not cool to 2% before a recession starts, monetary policy will remain tight. The odds of that scenario happening are less than 50% as we expect inflation to cool drastically in the next few months as sellers of products and services lose pricing power and consumers have turned cautious due to negative wealth effect from falling asset prices. The bad news is earnings of US corporations are unlikely to rise meaningfully to justify current valuations multiples.

It is more interesting outside of North America. The risk of Europe running out of natural gas has abated as this winter was warmer than normal. Inventory is healthy and they are getting access to liquefied natural gas (LNG) abroad. As China re-opens, demand for goods out of Europe will likely rise and, with increased demand alone may not be enough to save Europe from recession, it could provide a soft landing, provided that inflation has indeed peaked and the ECB remains relatively dovish. In Asia, Japan has been in a slow growth/recession trend for decades as a consequence of their aging population. Japan has had a deflation problem for decades and finally saw some inflation in 2022. The Bank of Japan welcomed some inflation, and it was the only major central bank that did not hike rates in 2022. This has led to a dramatic decline in the value of yen versus other currencies.

Last but not the least, China. Due to a long enforced zero-covid policy for literally three years, China's economy has slowed, most noticeably in domestic demand. In 2023, demand for Chinese goods (i.e. exports) may fall marginally due to the thread of recession, but the "slack" will be more than offset by the local demand as zero-covid has been dropped. We are seeing consumers' eagerness of consumers to spend supported by record household savings. Traffic of travel booking websites has risen dramatically as people just want to go out. It will be a very interesting year for China as it is late in the game to go through what the rest of the world experienced re-opening in 2021.

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