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# The Risk of Recession

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As inflation and geopolitical tensions rise, so too does the specter of recession. We review the catalysts for a US and European recession in 2022 as well as our outlook on China-US relations now further complicated by Russia's war in Ukraine.

- In the US, we peg the probability of recession in the next 1-½ years at three out of eight, more than double the unconditional probability in the post-World-War-II record.
- We put the probability of recession in the Euro area within the next 1-½ years at near 50 percent.
- The expected future growth of Chinese firms has been hit hard, but Chinese equities may find some support in the near term as the People's Bank increases policy accommodation.

## Catalysts for a US recession in 2022

The foundation of the US expansion is shaky. The coronavirus is not behind us, as reflected in the lingering hesitancy of some people to return to the workforce and to engage in person-to-person market activity. The former is putting upward pressure on wages in a market where job vacancies outpace the unemployed by a 1-¾-to-1 margin. The latter poses an ongoing drain on the service sector, which historically represents two-thirds of economic activity. While the federal budget remains large and supports the level of aggregate demand, it is shrinking, implying a net drag on the growth of demand this year absent legislative action. We think that, with a midterm Congressional election looming, the absence is almost assured. The federal government and the household sector piled on considerable debt during the Pandemic Depression and its aftermath, and debt relief for the latter mostly took the form of forbearance, not forgiveness, which will strain balance sheets as interest rates rise and relief programs roll off.

The Russian invasion of Ukraine worsens a difficult situation by further impeding global supply chains and withdrawing key commodities from the market, adding to cost pressures and elevating uncertainty and risk aversion. These additional cost pressures will push inflation further above the goal of the Federal Reserve (Fed), a pre-existing problem that officials have belatedly recognized with their recent pivot to firming. While Fed officials assert that the economy is robust enough to weather the removal of accommodation, those plans are predicated on an optimistic reversal of inflation as additional supply fills in as firms work around trade-chain disruptions and people feel more at ease with the health situation. In the more likely event that these do not fully eventuate, more abrupt rate hikes will be needed to quell inflation. Even in the Fed's hopeful case, the plane that is the US economy will be flying slower and closer to the ground. That is, it is more vulnerable to shocks, including pilot error.

Shocks abound beyond a too-abrupt turn toward tightening by the Fed, including a broadening of the Russian-Ukrainian war, a sharp correction in financial prices worsened by adverse market dynamics, and an outbreak of inflation jitters. The path of the coronavirus, of course, remains as a wild card in the outlook. As a result, we peg the probability of recession in the next 1-½ years at three out of eight, more than double the unconditional probability in the post-World-War-II record.

## Catalysts for a European Recession in 2022

Pre-existing conditions make the economic situation in Europe more perilous than that in the US. Coping with the coronavirus has been decidedly uneven, with the Omicron variant sending the confirmed caseload rate well above that of the US, especially so in its largest economy, Germany. Supply disruptions, evidenced in markedly higher energy prices, contribute to pushing Euro area inflation higher. Indeed, staff of the European Central Bank (ECB) predict that annual inflation will run at 5.1 percent in 2022, considerably above goal. Real economic growth has been slowing and some balance-sheet strains of the private sector have been showing.

The Russian invasion of Ukraine makes matters worse. Europe trades more with Russia, has larger banking exposures, and the European Union is the likely destination of the lion's share of the staggering number of Ukrainian refugees. Moreover, the impairment of global trade bulks larger in trade-centric Europe. We put the probability of recession in the Euro area within the next 1-½ years at near 50 percent.

Why? The experience of the past two years cautions that the coronavirus poses an outsized risk to any economic forecast. In addition, the ECB was already pivoting toward removing monetary policy accommodation before the invasion. That shock adds to their woes, with its staff forecasting that a material deterioration in the situation would add 2 percentage points to already high inflation. Monetary policy reversals are always challenging, especially if inflation jitters break out, and whether the ECB navigates these choppy waters is in doubt. The extension of the Russian-Ukrainian conflict along its current trajectory will drain confidence, in part because it ramps up the pressure to ratchet up economic sanctions. The drag on export volumes will weaken aggregate demand, as will the associated firming of financial conditions that is already in the pipeline from what the ECB has in store.

As for physical pipelines, Europe relies on Russia for one-third of its energy needs. Moving away from that dependence will hamper economic activity and add to costs. Here, circumstance may darken. If Russia moves unilaterally to tighten that tap, a real possibility, the European economy will have another reason to slip into recession.

## Outlook on US-China Geopolitical Tensions and Effects on China's Stock Market

The outlook for Chinese equity values is poor, absent a material, encouraging, and surprising change in the current world order.

Russian President Putin's attempt to redraw the political map of Europe has led other governments to choose sides. In between will be a high wall of approbation in the form of direct sanctions, the indirect reach of those restrictions to third parties, and market stigma to those seen as breaching the barrier. For now, China has chosen to be on the opposite side of the US and other major powers. A distrust of Chinese global intent was already a bipartisan feature of the US and its important allies, and recent events only add to that camp's conviction and ranks.

Global trade has been set back and reoriented so as not to cross the wall. This will be especially so for technology. Finance is being similarly bifurcated, including the currency composition, clearing, and settlement of transactions. By siding with Russia, China will have more assured access to important commodities and a client for the use of the yuan, but not much more. The export market of Russia is small for China, and it was already Russia's largest creditor post-Crimea, with a problematic loan book as a result. True, there are Russian assets available at fire-sale prices, but their recovery value in the new world order is suspect, as is their potential as ongoing entities located in a nation with a nationalist bent and few friends.

The expected future growth of Chinese firms has been hit hard as they will interact with a smaller global market and have less access to innovation from the other side of the wall. Their market value will be impaired as foreign investors deal with them at a greater arm's length.

The extent of the discount to prior equity valuations depends on how tightly the Chinese government clings to Russia. The status quo is not sustainable, in that Russia will be increasingly dependent on China and the rest of the world increasingly hostile. (This would be especially so if China aids the military ambitions of the Russian government.) A better outcome would ensue if Russia reigned in its territorial ambitions or the Chinese leadership distanced itself from the aggressor, but neither seems immediately likely. And the longer it lasts, the less likely there will be a return to the situation ante bellum.

Even with these serious medium-term reservations, Chinese equities may find some support in the near term as the People's Bank increases policy accommodation given that economic growth appears well short of the Central Committees 5-½ percent goal. This represents an opportunity to reduce exposure before a long winter sets in.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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