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Is a Global Recession likely in 2023?
(as at 15 June 2023)

2023 has been characterised by a more optimistic outlook than last year. Central banks have been forced to revise previously gloomy prognoses for their economies, with rising activity in most major countries. Easing inflationary pressures, the reopening of China and the surprise strength of countries such as Japan have been galvanising forces for the global economy and the prospect of recession has receded.

In particular, supply side factors have improved economic fortunes. Energy and food prices have eased, supply chains have unclogged, and labour shortages have normalised. The services sector has revived after significant weakness during the pandemic, as consumers across the world have started to travel, eat out, and shop. Major spending programmes, from the Inflation Reduction Act in the US, to RePower EU in Europe, have also helped compensate for tightening monetary policy.

However, some worrying signs have emerged more recently. There have been tentative indications of sliding economic activity across Europe and the US, with deteriorating Purchasing Managers' Index (PMI) data and consumer weakness. Europe's goods sector has been a particularly vulnerable spot. Fulcrum's estimates suggest an annualised growth rate of only 0.2% for the Eurozone.

Germany's industrial weakness

Germany's once-resilient industrial sector has been at the heart of this decline. According to PMI business surveys, this sector has now clearly moved towards recession, and is dragging the national economy in the same direction. While this was understandable amid an energy crisis, its weakness has not reversed as commodity prices have dropped. It is contending with a toxic combination of imported cars from China (stealing market share from German auto manufacturers), the legacy of high energy costs, and the impact of US government subsidies for specific sectors.

The German industrial sector has previously been a bellwether for the world economy, providing clear signals of major turning points in the global business cycle. While hard data on manufacturing output and new orders has been less worrying, they have also declined recently.

The picture emerging from the US also challenges the generally benign environment that dominated in the first half of 2023. The widely followed Atlanta Federal Reserve 'nowcast' (a prediction created from very recent data) for annualised GDP growth in the second quarter fell from 2.9% to 1.9% in a single week in May as it started to pick up deteriorating economic conditions. Activity growth has dropped to 1.1%, down from about 2% in April[1].

Credit conditions

Lending surveys indicate there has been a significant tightening in credit markets. Demand for credit from non-financial companies has fallen from 2022 levels and is now at a level usually only seen during recessions. While this has not yet morphed into a systemic financial crisis, it represents a downside risk to the central economic outlook.

Equally, while the banking crisis may have been averted, it may leave an impact on banks' willingness and capacity to lend. Banks were already reducing credit prior to the crisis. Weakening availability of credit is likely to be felt in the real economy in the near term, constraining spending ambitions for companies and consumers.

Many major economies are still contending with rising interest rates, which operate with a lag. It is not yet clear how far through the process of adjustment they are, and the ultimate consequences of the sudden reversal.

Recession?

There are other factors that suggest a recession is less likely. The labour market continues to be a source of strength, for example. While it is clearly beginning to cool in the US and Europe, it remains relatively tight, which continues to exert a protective effect for consumers against the effect of rising interest rates.

There are also pockets of regional strength in the global economy. China's revival may have been tepid, but Japanese activity growth seems to have picked up markedly in the past month. Fulcrum's latest nowcast estimates suggest annualised growth of 0.7%, a reversal of the negative rate in April.

It is also worth noting that in aggregate, global PMIs remain robust, and some distance away from recessionary readings. The flash (whole economy) PMIs for May reported readings of 54.3 in the US[2] and 52.8 in the Euro Area[3] – both still clearly in solid growth territory.

As such, while there are signs that the economic tide is turning, it does not yet point to a marked slowdown in activity, still less a nosedive towards recession. While overall growth rates have dipped below trend, especially in the Euro Area, the buoyancy of the labour market has been a bulwark. The period of large upside surprises to global data prints, which dominated the first quarter, seems to be over for now, but it is a major leap to suggest recession is now imminent.

What's priced in?

The diminished expectation of recession has brought renewed confidence to equity markets, which have seen meaningful gains since the start of 2023. Bond and equity markets continue to price in relatively low chance of recession.

For the bond market, this means it is reflecting a more hawkish monetary policy for the remainder of this year. The December 2023 Fed funds contract indicates a policy rate of 5.0%, up from 4.5% a month ago[4]. The resolution of the debt ceiling problem, at least temporarily, has driven rate expectations higher. Equity markets also reflect this optimism, which leaves less wiggle room should data start to deteriorate more vigorously.

This period of positive risk sentiment across asset markets could end in any one of several different ways. As such, investors need to be on alert for a sharper economic slowdown. This would be consistent with models that place an emphasis on the lagged effects of monetary tightening and the inverted yield curve. For the time being, these models appear too pessimistic about the end game in the current cycle, but there are some clouds gathering.

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Sources:

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