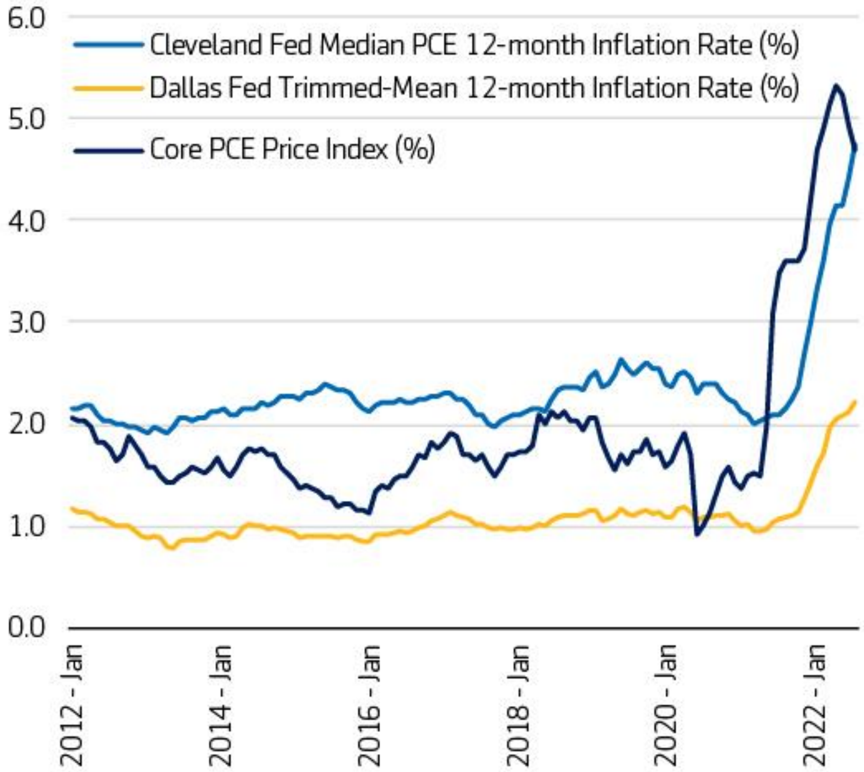
2022 Mid-Year Outlook: Recession Risk on the Rise

Heading into the back half of the year, Aegon AM has a heightened concern of recession risk given how central banks are 'Volckerized' (i.e., primarily focused on taming inflation rather than moderating growth). We see the federal funds rate ending '22 at 3.5% on a way to a peak rate of around 4% in early '23. This is a very restrictive level of policy as we see the neutral rate in the 1.75% - 2% range, but necessary given the driving factor is stopping inflation.

The bar for monetary authorities to make a dovish pivot is quite high, as evidenced by recent statements by Chair Powell, et al. Even if there was a pivot later this year it would still imply a decent moderation in growth which makes for an uphill trek for risk assets, especially on a risk-adjusted basis.

Inflation has been the main boogeyman for the Fed. While it is finally starting to show some moderation, it is not nearly enough to ease the Fed's consternation that inflation expectations could become unanchored. Case in point—while the core personal consumption expenditures price index (PCE) is starting to moderate, the trim means readings remain high suggesting that the broadening of inflation hasn't moderated as much (exhibit 1). Overall, we concur with the market that inflation will eventually get under control, though the adjustment process will likely be painful. This is the symptom of fighting inflation that was caused by a negative supply shock. Aggregate demand has to be reduced to bring the economy back into equilibrium at the lower aggregate supply level.

Exhibit 1: US Inflation



Sources : Cleveland Fed, Dallas Fed, BEA, HAVER. As of May 2022.

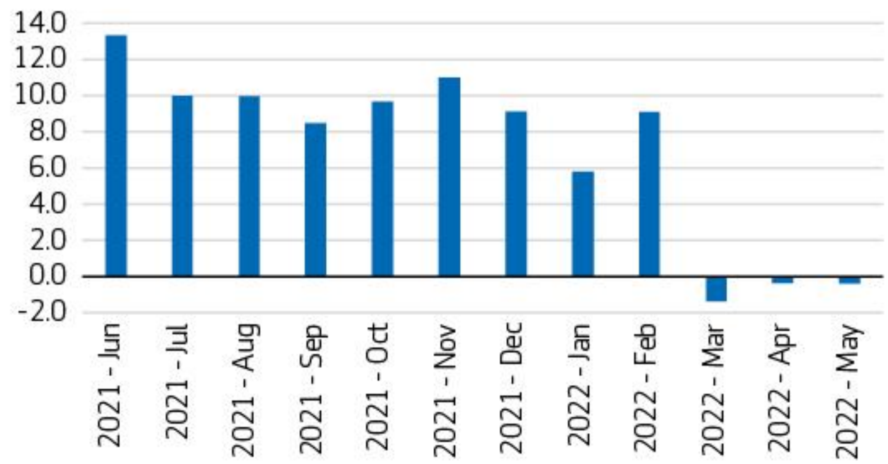
Demand Destruction. The primary victim of a Volckerized Fed is private demand, both consumer and corporate. This is already occurring in the housing market as demand is contracting as mortgage financing rates surge (exhibit 2).

Exhibit 2: Monthly interest portion of mortgage payment (USD $400k, 20% down)

Sources: Bloomberg, Aegon AM. As of July 8, 2022.

The consumer is also being hit as their real spending power has declined as nominal wage growth is being outpaced by inflation. This pinch in spending power is showing up in declining retail sales (mostly goods) and slower growth in service consumption (exhibit 3).

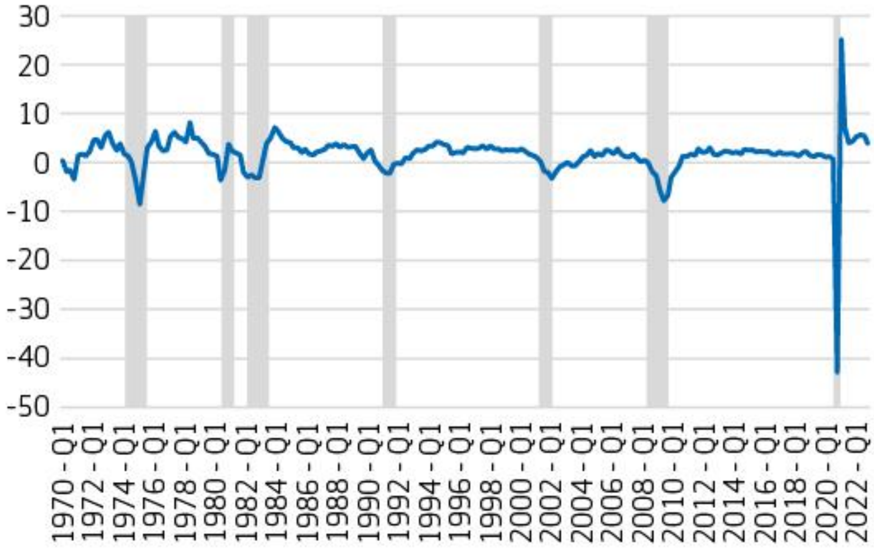
Exhibit 3: Real retail sales and food services
Percentage change – year-over-year, SA USD June 2021 – May 2022



Sources: Census Bureau/Bureau of Labor Statistics/Haver Analytics. As of May 2022.

It is our view that labour markets will hold the key to how the macro picture plays out. So far, the labour markets have been quite resilient, growing roughly 4% year-over-year (YoY), but employment data is a lagging indicator. Typically, as recession nears, the labour market gradually slows, but given the heightened pace of Fed hikes, it could occur much faster this time around (exhibit 4). This is what occurred in the early ‘80s during the actual Volcker Fed (in ’81 private payroll growth went from 3.8% annualized to negative in a mere three months).

Exhibit 4: All employees: Total private payrolls 1Q1970-2Q2022



Sources: Bureau of Labor Statistics/Haver Analytics. As of June 30, 2022.

Overall, given the level of hawkishness by the Fed, Aegon AM sees significant economic slowing in the back half of ’22 which creates a sub-trend growth outlook in ’23 and a relatively high probability of recession (exhibit 5). This outlook could be alleviated by a dovish Fed pivot, but for that to happen the inflation data would have to materially slow down in the coming months.

Exhibit 5: Aegon AM’s economic forecasts

	2019	2020	2021	2022E	2023E
GDP (Real %, YoY)	2.3	-3.4	5.7	2.0	1.0
Unemployment (%)	3.7	8.1	5.4	3.5	4.0
Core PCE	1.7	1.4	3.2	4.5	2.7
Fed Funds-Upper Bound (%)	1.75	0.25	0.25	3.50	3.00
Tsy10 (%)	1.92	0.92	1.51	2.85	2.25

Source: Aegon AM. As of July 4, 2022.

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