Economic outlook.

Third Quarter 2022

Hard times

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SEI recently released its third-quarter Economic Outlook. A summary of the conclusions is provided below:

- The United Kingdom, under the newly installed Truss government, has been especially aggressive in its tax-reduction and spending proposals; it is paying the price in the form of a sharp interest-rate spike across the maturity spectrum in its sovereign bonds and a decline in sterling to record-lows against the US dollar (Source: "UK bond prices collapse after sterling hits record low." Reuters. 26 September 2022).
- Risk assets more generally have come under pressure following the US Federal Reserve (Fed) more aggressive talk and actions.
- The Fed has finally acknowledged that inflation will not fall back towards its 2% target without a substantial tightening of monetary policy and some degree of economic pain.
- Other central banks, in both advanced and emerging economies, are adopting similar policies aimed at creating the economic slack necessary to push inflation down.
- A global recession is appearing on the horizon, with Europe and the United Kingdom more vulnerable to a downturn than the United States in the months immediately ahead.
- Similar to the COVID-emergency of 2020, fiscal policy is once again being used by European governments to lessen the pain, this time to shield households and businesses from the full impact of the energy crisis.
- We expect further up-and-down volatility across asset classes. We would not rule out another relief rally in the equity markets, given the extent of bearish sentiment currently prevailing and an oversold condition that matches what was seen in mid-June.
- Short-term gyrations notwithstanding, the primary trend in risk assets still appears to be negative. The Fed may still be underestimating the extent to which it needs to raise its policy in order to slow the economy and produce slack in the labor markets.
- Inflation in the US has probably peaked, but we do not expect it to fall as rapidly or as far as the Fed is projecting. We look for wage growth to be sticky because labor markets are still very tight. The drop in productivity this year is an aggravating factor, but also a puzzling one that economists have yet to resolve.
- The Fed historically has stopped raising rates close to the time the economy enters a recession. The central bank usually begins to cut its policy rate aggressively as the recession deepens and unemployment climbs.
- The Federal Open Market Committee's most recent projections call for a federal funds rate that rises to the 4.4%-to-4.9% area in 2023, holding at that higher level before easing a percentage point or so in 2024. If realized, it would make for an unusual cycle. Given the severe inflation pressures the Fed is combatting, a higher terminal funds rate and a sharper decline from that peak would be more in keeping with past cycles.
- Corporate profits have held up well in the US, but the coming slowdown should pressure margins lower. We anticipate a mild-to-moderate recession in the US and a more severe downturn in the U.K. and Europe.
- Equity prices are already anticipating an earnings hit, with US large-cap stocks down already some 20% in the year-to-date. Although further stock-price weakness probably lies ahead, it is possible that the worst of the damage to equities may have already occurred.

A full-length paper is available if you wish to learn more about these timely topics.

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