

## The Infamous “R” word: A US Recession looks unlikely

Last week has been striking for financial markets. There have been wild moves in the Yen and that coupled with weak employment data in the US has led to tremors in global equity markets. The infamous “R” (Recession) word is back to haunt the financial markets.

I have staunchly maintained over the last 2 years that this global economic cycle is very different than any other previous cycle and a US recession is off the table. We continue to maintain that it is very unlikely that US economy will slip into a recession at this point of time. There are no economic indicators to support US recession.

In fact, economic or financial crises are a necessary condition for the U.S. economy to fall into recession. This is because financial or economic crises often freeze up economic activities, forcing businesses to liquidate assets and lay off workers. In the meantime, consumers tend to save more and spend less as job losses surge and a self-feeding vicious circle usually takes hold, causing aggregate demand to contract. There are no such signs or economic indicators in the US economy; so, the backdrop preceding an economic recession is missing.

The argument in favour of those expecting a US recession has been that in a typical economic cycle the US fed tends to overtighten causing moderation in inflation and growth paving the path for the US economy to slip into the recession. The fed has done huge tightening in this cycle as well and has probably overshot.

There is always a risk that the damage is already done, but so far there is no convincing evidence that Fed policy is choking off economic activities. The fact that the Fed is only a month away from easing at a time when the economy remains resilient (2.8% GDP growth for Q2) suggests that the economy has so far skirted a recession.

The genesis of the huge spike in inflation and subsequent moderation in this cycle has to do with the massive supply side dislocation that happened during the Covid pandemic and the huge resurgence in pent-up demand that occurred post-covid. The initial supply dislocations and demand-supply mismatch caused the huge spike in inflation. The US fed does not control the supply chain and had limited control over pent up demand. As a result, as the pent-up demand abated and the supply chain normalised, we have seen inflation has moderated in US and on a month-on-month basis is tracking closer to US fed targets since May 24. While the US fed has increased rates sharply by 5% in 15 months from March 22 to June 23, there is perfect back drop for them to start easing rates aggressively.

There has been question about consumer stress in US and rising credit card delinquencies. There is no question that the consumer credit card delinquency rate has risen noticeably in recent months in response to higher rates, but this should not come as a surprise. The Fed's monetary tightening should cause certain interest rate sensitive sectors to retrench and those with excessive credit card debt are stressed. However, credit card debt is a very small portion of total consumer debt, only 6.3%. The delinquency rate for overall consumer debt remains very low at 4%. To say that U.S. consumers as a whole are seriously stressed is factually incorrect.

There is no sign of financial disintermediation. Lending institutions seem to be in good shape and banks are beginning to lend money again. Expanding bank credit in US is not consistent with an economy that is about to drop into a recession.

As far as the labour markets are concerned, since the beginning of the year, unemployment has increased by 895K, out of which 419K is from an increase in re-entering job seekers. The rising labour force participation rate for prime aged workers, together with a large number of undocumented workers, have both contributed, either directly or indirectly, to the increase in the unemployment rate. There are no wide scale firings in US and in fact, there are pockets of economy across services economy – restaurant visits, air travels, retail sales, hotel stays, which are strong and still reeling under labour shortages. The US cannot have a recession with labour shortages.

Thus, the conditions precedent for a US recession seems absent. Of course, this does not guarantee that there will be no financial shocks coming out of blue, but so far, it is not apparent and there isn't any particular sector that is in severe financial stress.

While many strategists are looking for a recession next year, we believe that the world economy already experienced one in 2022. Our rationale is that both the 2020 pandemic and subsequent recovery were atypical, representing a five-sigma move in both directions. In 2022, when the U.S. economy tried to resettle back to its steady state after the post-pandemic boom, a technical recession happened, with GDP contracting for two consecutive quarters in a row, corporate profits falling by 10%, commodity prices dropping by 35% and tech sector layoffs skyrocketing.

At it looks apparent, the US economy should skirt a recession this time. The falling interest rates in US over the course of 2025 should give enough room for EM central banks to start their own easing cycle. Fed easing and a U.S. economic “soft landing” are a Goldilocks combination for EM assets. There could be volatility in financial markets going ahead as the monetary cycle pivots, yen carry trades unwinds and there is rotation with in markets and asset classes. But the bull market in Indian equities should remain intact, despite volatility.

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