Equity Research
April 7, 2022

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US / EU

Economy

Monetary Policy errors have raised the risk of recession by 2024

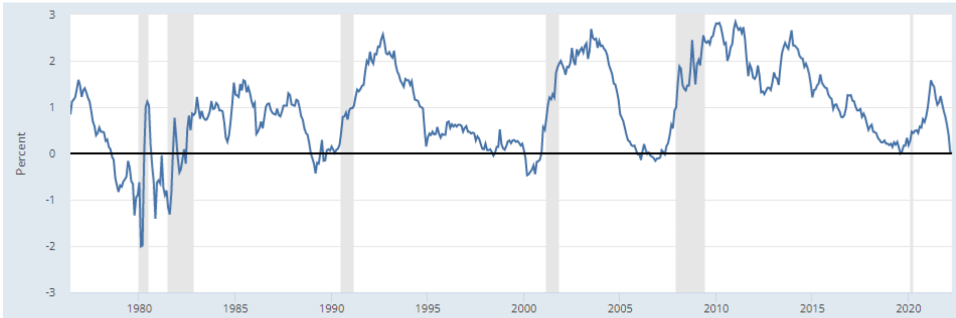
- The best predictor of US recessions, the 10Y-2Y treasury yield spread, turned negative (i.e., the yield curve inverted) on 1st Apr'22 and remained negative the following trading day. A US recession has invariably followed within 24 months of the time this yield curve inverts. Despite the current strength of the US economy (with the unemployment rate at 3.6% in Mar'22, levels only exceeded in 3 months of the last 50 years), a US recession is near-certain by Mar'24. A key reason why bond markets are predicting recession is because of the Fed's policy error in persisting with QE until Feb'22 despite a tightening labour market, 5.7% real GDP growth in CY21, and inflation more than double the official target of 2% YoY for core PCE.
- Unfortunately, the ECB is currently engaged in the same policy error. With headline CPI inflation at 7.5% YoY in Mar'22 (far above the ECB's target of 2% YoY headline CPI inflation), the ECB pledged at its meeting on 10th Mar'22 to persist with more bond-buying in each of the next 3 months. While the incoming vice chair of the US Fed, Lael Brainerd (known to be a dove on monetary policy) predicted that the FOMC would 'reduce the balance sheet at a rapid pace as soon as our May meeting". We expect 50bp hikes at each of the next two FOMC meetings, and expect the ECB to also be obliged to scale back its balance sheet and raise interest rates by Q3CY22. Consequently, we expect developed economies' real GDP growth to decelerate to 2% in 2022 (with the EU growing just 1.5%), and world real GDP to decelerate to 3% growth.
- We expect global trade volume to decelerate to 6% growth in 2022 (from an estimated 11% in 2021, with UNCTAD estimating trade value to have increased 25% last year). Since exports of goods and services were expected to be the key driver of India's growth in H1FY23 (Apr-Sep'22), with domestic demand gradually kicking in only later in the year, we are lowering our estimate of India's real GDP growth in FY23 to 8.2% (from 9% prior to the Russia-Ukraine war).

The 10Y-2Y (10-year minus 2-year) Treasury yield spread is the best predictor of US recessions. That yield curve has inverted (i.e., the yield spread has turned negative) 6-24 months before each US recession in the 77 years since the end of World War II; in the past 50 years, a US recession has begun every time within 7-24 months from the first day that the yield curve inverted. On Friday, 1st Apr'22, the yield curve did invert, ending the day at -0.06pp, and it remained inverted at the end of trade on 4th Apr'22. The US economy is thus likely to go into recession by Mar'24 – induced by the policy error that the Federal Reserve made in continuing to aggressively expand its balance sheet even as the US economy returned to full-employment (NAIRU, or the non-accelerating-inflation rate of unemployment) by Nov'21. NAIRU is usually reckoned to be 4.5%; the US unemployment rate decisively fell below that (to 4.2% in Nov'21) and has moved steadily lower since, to 3.6% in Mar'22.

Chief Economist:

Prasenjit K. Basu
prasenjit.basu@icicisecurities.com
+91 22 6807 7622

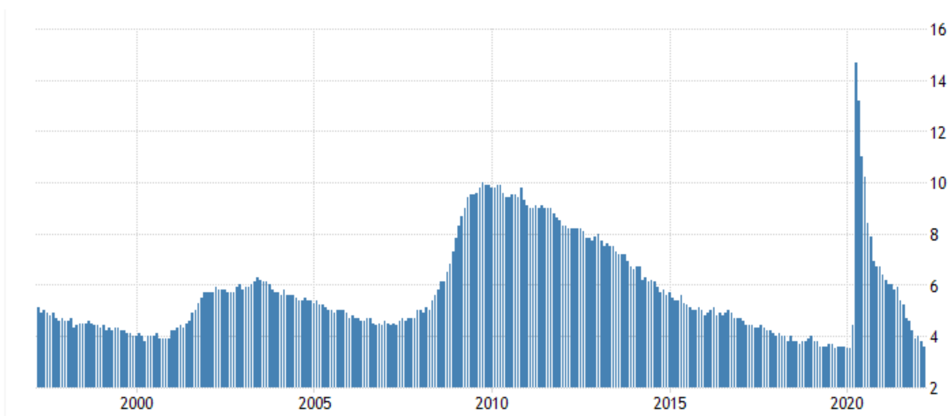
Chart 1: US 10Y-2Y Treasury yield curve inversions lead recessions by 12-24 months



Source: FRB-St. Louis. Shaded areas represent recessions.

The last recession in the US was extremely short-lived – lasting just two months (Mar-Apr'20). This would not normally have qualified it as a recession (which requires two consecutive quarters of economic contraction). But the severity of the 2-month downturn (and its longer-term impact on the labour market) made it a genuine recession, especially given that the unemployment rate remained unusually high for a protracted period (6% or higher for 13 months), even after the economy began expanding MoM and QoQ. That recession had been predicted by a brief inversion of the US 10Y-2Y yield curve in the second half of Aug'19 – although the actual recession arrived a bit earlier than expected, precipitated by the covid pandemic. Importantly, however, the US unemployment rate fell below 6% by May'21, but the Fed persisted with quantitative easing (QE) until Feb'22. The unemployment rate in Mar'22 moderated further to 3.6% -- a level it has fallen below only in 3 months (two of them being Jan-Feb'20) during the last 50 years.

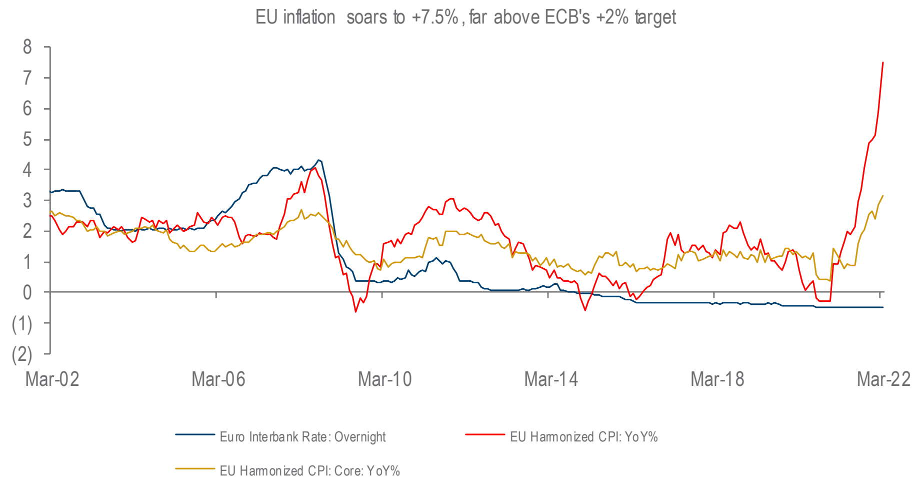
Chart 2: US unemployment rate lower than current levels only in 3 months over last 50 years



Source: Trading Economics

The Fed is not alone in its policy error. The European Central Bank (ECB) displayed remarkable hubris at its last meeting on 10th Mar'22, merely "scaling back" (i.e., "tapering") its asset purchases over the next 3 months, continuing to buy €40bn in Apr'22, then 'reducing' its net bond-buying to €30bn in May and €20bn in Jun'22 (a level of bond-buying that was previously expected to continue until Oct'22). However, this extraordinary level of persistent bond-buying seemed to take no cognizance of the fact that Eurozone CPI inflation had already reached 5.1% YoY in Jan'22 and 5.9% YoY in Feb'22 (chart 3) – figures that were known to the ECB before its March meeting. Unlike the US Fed (which has *core* PCE inflation as its main inflation target), the ECB targets headline CPI inflation, not core. But it is nonetheless instructive that even core CPI inflation in the Eurozone has been consistently above 2% YoY since Oct’21, providing ample signals for the ECB to consider altering its monetary policy approach by the start of CY22 (which it failed to do). Unsurprisingly, headline CPI inflation soared further to 7.5% YoY in Mar’22 (and even core-CPI inflation to 3.2% YoY), and both will likely rise further in Apr’22.

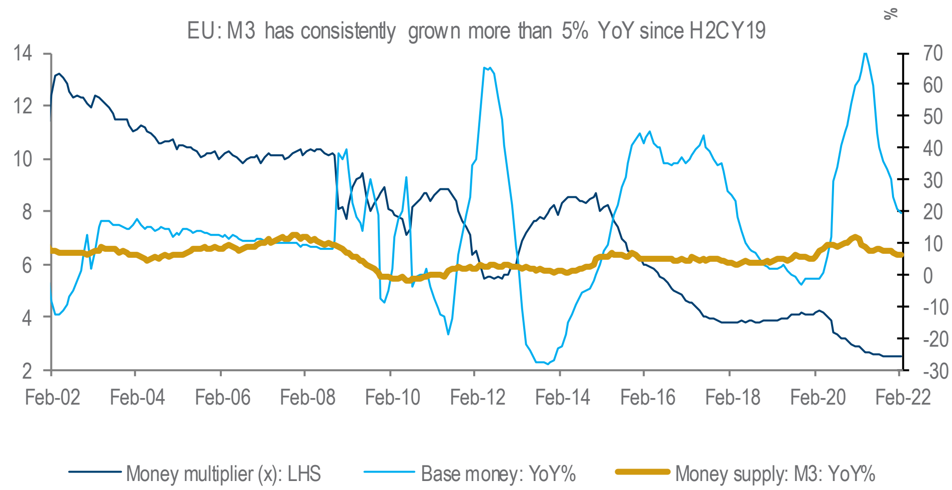
Chart 3: Eurozone inflation was far above target in Jan-Feb’22, and soared to 7.5% in Mar’22



Source: I-Sec, based on data from CEIC

The M3-growth target was abandoned just before inflation revived. After the creation of the euro (1st Jan’99), the ECB had adopted a “twin pillar” approach – the key goal being an inflation target of 2% (later altered to “below, but close to 2%”), which was to be achieved through the twin pillars of economic and monetary analysis. An implicit secondary pillar of monetary policy in the Eurozone (in order to attain the primary target of 2% inflation) was an M3-growth target of 4.5% YoY. The second, monetary pillar was however progressively abandoned by 2019, as the ECB’s primary goal became to fight deflation rather than inflation. Now, the failure to keep an eye on M3 growth has resulted in an inflationary surge. Ironically, M3 growth was far below the 4.5% target in 2009-11 (while Trichet headed the ECB), then slowly gathered pace during the Draghi presidency (which began Nov’11), albeit only exceeding 4.5% YoY after mid-2014. While CPI inflation was below 2% (until Jun’21), it was appropriate for the ECB to retain its ultra-loose policy – but it should have begun reviewing it by Oct’21, when headline CPI inflation rose above 4%.

Chart 4: M3 growth consistently above 5% YoY since Jul'19; now spurring inflation



Source: I-Sec, based on data from CEIC

Lowering our forecast of India's real GDP growth to 8.2% for FY23 amid the expected slowdown in developed-economy growth and global trade volume. We expect global trade volume to decelerate to 6% growth in 2022 -- from an estimated 11% in 2021. UNCTAD estimated trade value to have increased 25% last year, and India rode that wave to outperform the world with 41.6% growth in merchandise exports in 2021. Since exports of goods and services were expected to be the key driver of India's growth in H1FY23 (Apr-Sep'22), with domestic demand gradually kicking in only later in the year, we are lowering our estimate of India's real GDP growth in FY23 to 8.2% (from 9% prior to the Russia-Ukraine war, and the exacerbated policy error by the Fed and ECB amid the inflationary surge).

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