

Recession: Everything and all at once?

Macquarie Fixed Income Strategic Forum 2023 | Issue 02



Key takeaways

- **State of play** | The impact of higher rates and monetary tightening is already starting to be felt. As the liquidity tide recedes, we are wary of what could break next. The risk of further credit tightening shouldn't be discounted.
- **Consensus versus financial markets** | Economic consensus anticipates a recession, but financial markets (valuations) are not yet fully pricing this in.
- **What could counter the “consensus”** | There are several factors that may explain why markets' “delayed reaction” continues to exist: the possibility of a central bank pivot, offsetting fiscal policy, the opaque role and proliferation of private credit, and the promise of the artificial intelligence (AI) revolution – although we **remain wary of the likely misplaced optimism**.
- **Everything and all at once?** | As the effects of the long and variable lags of monetary policy and credit tightening as well as liquidity contraction start to eventually materialise, we ponder whether a recession and its impact on financial markets will, as they often do, hit everything, everywhere and all at once.

Investment themes



State of play: Game of musical chairs

- The impact of much higher rates and quantitative tightening (QT) are beginning to be felt and will intensify as the long and variable lags of tighter monetary policy appear.
- As the monetary tide recedes further and the “game of musical chairs” gains pace, bigger things in financial markets are breaking (Silicon Valley Bank, First Republic Bank, Signature Bank, Credit Suisse).
- “Things breaking” in the US banking system has effectively triggered a form of credit crunch, with lending standards and risk positioning tightening considerably.
- The risk of further credit tightening shouldn’t be discounted, and we remain alert for what may break next.



Consensus sees recession, markets not so much?

- Economic forecast consensus anticipates a recession, but it’s not so much the case in financial markets.
- There are several counterpoints to the consensus, which may explain why markets’ “delayed reaction” continues to exist: the central bank pivot, offsetting fiscal policy, the opaque role and proliferation of private credit, and the promise of the AI revolution.
- However, we remain wary of the likely misplaced optimism in financial markets.



Patience – the long and variable lags

- In light of these potential reasons for a more resilient economy and markets, we are reminded by history that both monetary policy and credit tightening work with long and variable lags.
- Liquidity is also forecasted to drain, and the impacts from liquidity contraction are yet to be fully realised.
- As the effects of these pressures eventually materialise, we ponder whether a recession and its impact on financial markets will, as they often do, hit everything, everywhere and all at once.



In the spotlight: Generative AI

- GenAI is a type of AI that can generate new content like a human. Its impacts remain unclear, but we believe it’s on track to be among the greatest of any technological trends in recent decades.
- We point to possible fundamentals implications: 1) increased productivity, but also possibly a deflationary force; 2) uncertain impact on labour markets; 3) corporate margins potentially increasing, albeit with dispersion.
- Implications for investors *may* include: 1) a boost to equities; 2) tighter credit spreads for companies handling this transition well; 3) increased short-term volatility but lower long-term volatility; 4) downward pressure on interest rates.
- Putting it all together, we anticipate credit, industry, and asset class selections (driven by fundamental analysis) to be even more vital as GenAI realities unfold over the next few years.

Investment implications

Our investment outlook

- Our approach dictates caution in a pre-recessionary environment.
- We believe utilising **duration**, **hedging strategies**, and **sector selection** to express that caution is key.
- As tightening monetary policy, liquidity, and credit standards ripple their way through the economy, we remain **positive on bonds** and **more cautious on credit / risk markets**.



Positive: Rates/Duration

We are at or near peak monetary tightening, and duration continues to present **strong long-term value**.

Expect to accumulate more duration if yields rise further, with a long US bias as we believe the US economy requires more and faster rate cuts going forward.



Cautious: Risk markets

Remain **conservatively positioned** as recessionary forces and credit tightening are not yet priced into valuations.

This positioning provides **room to progressively add exposures** on wider spreads.



Constructive: Cash

Important to **maintain ample liquidity** to take advantage of anticipated volatility.



We are **conservatively positioned** given the **long and variable lags** of monetary policy and tightening credit conditions as well as **liquidity contraction**, which we anticipate will impact financial markets.



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Diversification may not protect against market risk.

Important information

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Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

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Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

IBOR risk is the risk that changes related to the use of the London interbank offered rate (LIBOR) or similar rates (such as EONIA) could have adverse impacts on financial instruments that reference these rates. The abandonment of these rates and transition to alternative rates could affect the value and liquidity of instruments that reference them and could affect investment strategy performance.

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SUMM-MFI-SF-2023-ISU2-USR (2934044- 06/23)