The Telegraph

Goldman Sachs sees near-zero risk of UK recession despite market tantrum

Tell-tale signs of late-cycle excess have yet to emerge in the US or Europe. There is plenty of economic slack and credit growth is muted

Goldman Sachs invites you to jump on the bull, if you dare. The real economy is not yet close to buckling Photo: AP

By Ambrose Evans-Pritchard

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242 Comments

Britain is extremely unlikely to face an economic recession over the next two years and is on safer ground than any other major country in the developed world, according to a new crisis-study by Goldman Sachs.

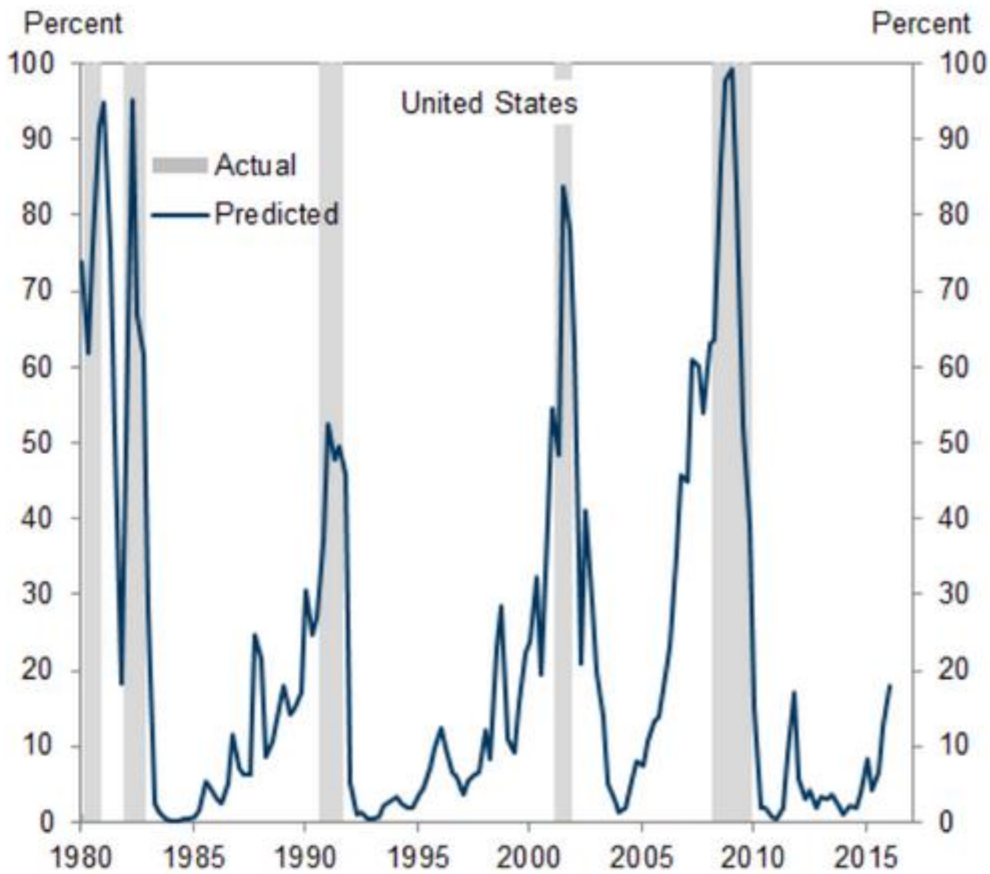
The US investment bank said the global stock market rout and the credit tremors this year are sending off false signals, insisting that underlying indicators of economic health show little sign of a sudden rupture in Europe, the US or across the OECD bloc of rich states.

An array of “alarm” indicators - based on the experience of 20 countries since 1970 - suggest that the current business cycle is still in full swing and far from exhaustion, even if risks have been ratcheting up over recent months.

Credit ratios are high but they have not been spiking higher in most OECD states, and there is still plenty of slack left in the economy. This allows central banks to take their time before having to slam on the brakes – the time-honoured cause of recessions.

Jan Hatzius, Goldman’s chief US economist, cited a string of episodes where markets were gripped by fear and emotion yet the storm passed without doing much damage.

Exhibit 6: Recession Risk Mostly Below Average

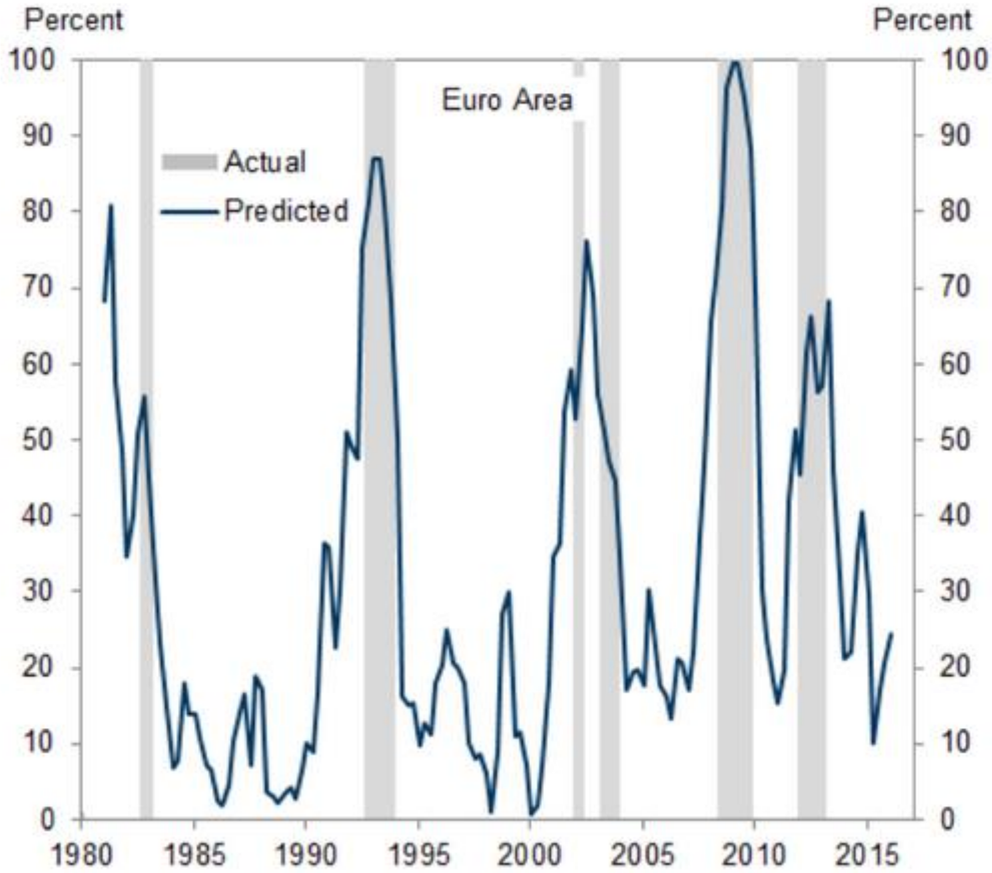


These included the 1987 stock market crash, the 1994 bond rout, Mexico’s Tequila crisis, the failure of the giant hedge fund Long-Term Capital Management and the Asian crisis in 1998, the corporate credit squeeze from 2002-2003 at the onset of the Iraq War and the eurozone sovereign debt crisis.

“In each case, at least some financial markets were priced for significant recession risk, if not an outright slump,” he said.

Yet Goldman cautioned that it would be a “grave error” to ignore the latest market tantrum altogether. The US Federal Reserve was able to slash interest rates and flush the international financial system with liquidity to weather the 1987 and 1998 storms, something that would be much harder to pull off today.

Mounting worry over China – and its linkages through the commodity nexus - has put everybody's nerves on edge this time. “Financial markets now signal a high probability of another recession. High-yield spreads are at levels almost never seen outside of recessions,” said Mr Hatzius.



“The message from the equity market is less clear-cut, but there are only a few non-recessionary instances over the past three decades in which the S&P 500 (index of US equities) performed as poorly as it did over the past year,” he said.

That said, Britain appears rock-solid under the Goldman Sachs model with a mere 3pc risk of losing its footing over the next eight quarters, followed by Sweden, Denmark and South Korea.

The country most at risk is deemed to be Switzerland, with a 95pc likelihood of recession within two years. The commodity-based economies of Canada and Norway are close behind.

A big rise in the ratio of credit to GDP is a key warning sign of trouble two years ahead, and on this score Britain looks well-behaved.

Exhibit 5: Estimated Recession Risk Over Next Four Quarters

	Latest Recession Probabilities					
	1Q		4Q		8Q	
	Current	Average*	Current	Average*	Current	Average*
Australia	**4**	14	**13**	23	**21**	35
Canada	**55**	19	**84**	35	**93**	58
Switzerland	**76**	28	**90**	45	**95**	62
Denmark	**2**	24	**9**	40	**16**	55
Euro area	**7**	19	**24**	33	**38**	49
Japan	**8**	22	**42**	39	**62**	57
Korea	**1**	8	**8**	12	**18**	18
Norway	**50**	14	**81**	33	**88**	48
Sweden	**1**	18	**6**	25	**14**	35
UK	**1**	14	**3**	19	**3**	26
US	**7**	15	**18**	24	**23**	34
DM	**9**	17	**25**	28	**34**	41

* 1980-2015

Source: Goldman Sachs Global Investment Research

Data from the Bank for International Settlements **show that** (core) private credit has fallen by 37 percentage points to 156pc of GDP since late 2009, despite worries about the London property boom.

It has dropped by 16 points in the US and three points in the eurozone. By contrast, it has risen 21 points in Switzerland, where massive intervention by the central bank to hold down the franc led to an internal property bubble. In that respect it is a mini-China.

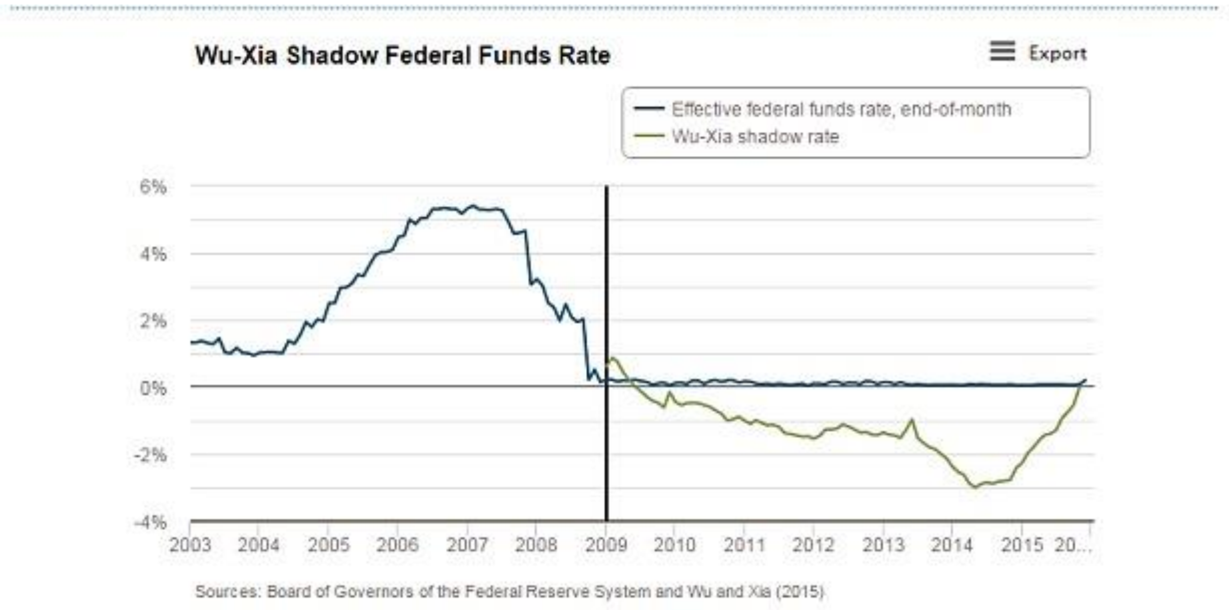
The Goldman model shows that falling house prices can be “powerful recession indicators” but the property market has yet to roll over in the US, the UK, the eurozone or even Japan.

The model captures where economies stand in the business cycle, not whether they are fundamentally in good shape or making a hash of their geopolitical and strategic affairs. It does not weigh the Brexit risk at all.

A report by Citigroup over the weekend said there is a 20pc to 30pc chance of British withdrawal from Europe, possibly “creeping up” to 40pc. Brexit would have “large and painful effects” if it happens, leading to a sterling crash, a severe crisis in the City and an 18pc fall in London house prices.

It would also set off demands for a fresh referendum in Scotland and perhaps lead to a push by Wales and Northern Ireland to leave the UK, the bank claimed. Mayhem on this scale would obviously change the nature of the recession risk.

Critics of the Goldman Sachs model argue that the tapering of quantitative easing in the US and the first rate rise in December amount to an entire tightening cycle in the current deflationary world. The stock of debt is so high that markets are acutely sensitive to any shift in monetary policy. If so, historic models dating back to 1970s may be almost useless or actually highly misleading.



A recent report by the Atlanta Federal Reserve **suggested** that tapering was equal to 325 basis points of tightening, or 13 rate rises. This alone would explain the global market turmoil in a highly-dollarized system.

What is clearly true, however, is that economic expansions do not die of old age. Goldman Sachs argues that what matters is whether the “output gap” has been closed and whether economic slack has been used up, not how many years the cycle has been running.

For those “brave enough to defy Mr Market’s gloomy prognosis”, this may be an ideal time to jump back into the stock market, said Mr Hatzius. Brave is certainly the word.