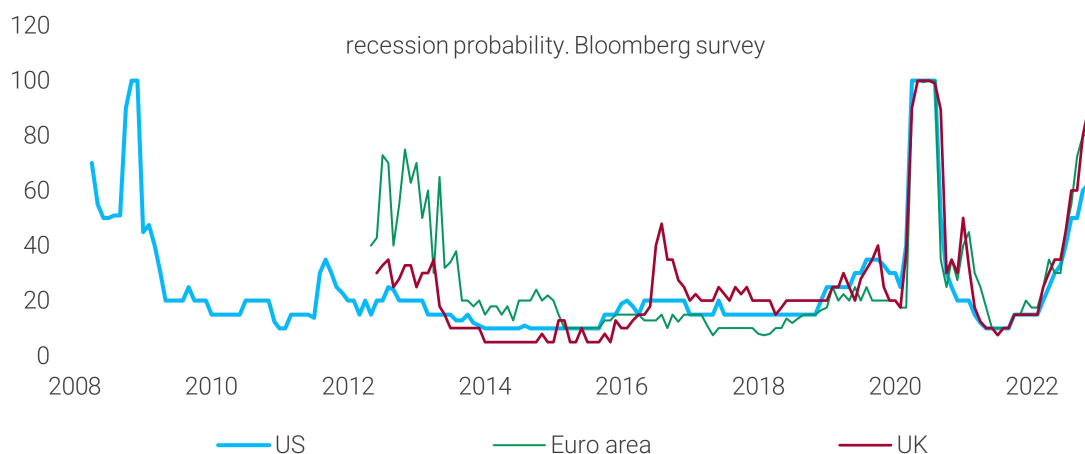
Macro Picture

IS THE 2023 CONSENSUS WRONG?

Dario Perkins

Given the massive distortions and uncertainties in the global economy, it is odd there is so little dispersion in views about 2023: the consensus expects stagnant growth (or mild recession), lingering inflation and tighter-for-longer monetary policy. To be a contrarian, you need to forecast either a much deeper downturn or Goldilocks' return (however fleeting).

Chart 1: The consensus expects a global recession



Source: Bloomberg, TS Lombard

FOLLOW THE HERD

Consensus forecasts are huddled around the same basic outlook for 2023: a stagnant global economy, lower (but above-target) inflation and tight monetary policy. Despite yield inversion, most economists have accepted the central bank mantra of "higher-for-longer" interest rates, which "mild" recessions would not derail. The consensus urges a defensive asset allocation.

DEEPER DOWNTURN?

Central banks have a surprisingly good record when it comes to forecasting recessions, but they always underestimate the depth and duration of the downturn. Since recessions can be highly reflexive and non-linear, it is possible they – and everyone else – is making that mistake again. Housing markets are the clearest vulnerability, particularly in the more indebted economies.

THE NO-LANDING SCENARIO

With consensus forecasts skewed towards mild stagflationary outcomes, there is a decent chance the global economy outperforms in 2023 – especially because temporary forces have raised inflation and undermined growth during the past 12 months. While any return of Goldilocks is likely to be fleeting, it would provide at least some respite for battered financial markets.

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IS THE 2023 CONSENSUS WRONG?

Given the intense debate about whether the US economy is facing a recession – and the huge uncertainties surrounding the broader global economy – we might have expected a lot of dispersion in consensus forecasts for 2023. But no, every sellside "year ahead" is basically just a somewhat different take on the same overarching theme: stagnant growth, lower (but above-target) inflation and tight monetary policy. And according to the economists who come up with these projections, there is not a lot of variation across the different parts of the world either. Everywhere, it seems, is suffering the same malaise of mild stagflation. Thus, consensus forecasts are not only for a continuation of what happened in 2022 but also for a scenario eerily in line with what central bankers have told them will happen. Economies will deteriorate, perhaps to the point of "mild" recession but not sufficiently to prompt the authorities to ditch their current "tighter-for-longer" policy plan. Despite the deeply inverted yield curve, few economists think central banks will be willing to ease monetary policy significantly in 2023 – mainly because they have swallowed the official line of "keeping at it". Understandably, this glum outlook demands a "defensive" asset allocation. Most strategists warn that 2023 will be another difficult year.

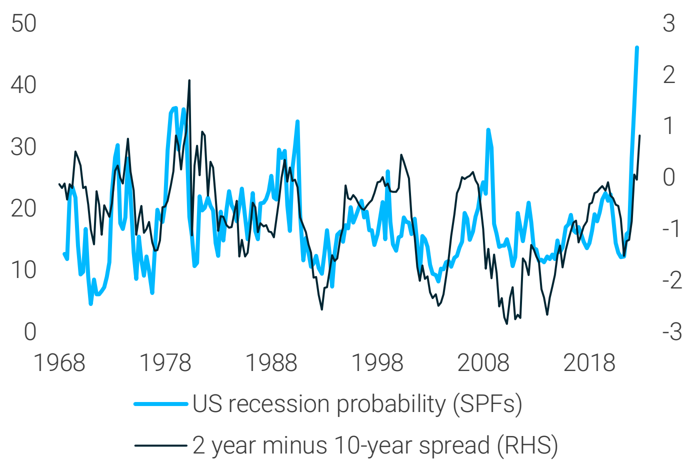
Consensus forecasts for 2022 performed poorly – spectacularly so. With broad stagflation and rapid policy tightening, we ended up with the exact antithesis of the Goldilocks scenario that was popular 12 months ago. Given these failures and the lack of dispersion in the consensus, it is worth looking for potential surprises in 2023. One possibility is that everyone is underestimating the depth and duration of the downturn. Recessions come with strong reflexivity, which is why economists – including at central banks – always end up chasing GDP and employment lower with a succession of downward revisions. Job losses in one systemically important sector will often reduce spending and corporate revenues in other sectors, triggering further redundancies and a general loss of confidence. Or sometimes something "breaks" in financial markets, prompting a more precipitous decline in asset prices. Currently, the property sector is the most likely trigger for a consensus-busting recession. Tighter monetary policy has already caused widespread destruction and it is possible central banks are underestimating the cumulative impact of their actions (which come with a lag). Yet, with a few exceptions, the risks associated with the property sector look muted compared with previous recessions – especially subprime.

While it is possible consensus forecasts are underestimating the severity of the downturn, the universally pessimistic tone of market participants suggests a deeper recession would not be "that" surprising. In fact, there is a good chance all the gloom about the outlook is already overdone. One point we have emphasized all year is that this is not a normal business cycle. Instead, massive distortions – first from the pandemic and then from the war in Ukraine – have created a stagflationary environment that was always likely to fade as those same distortions unwound. In the context of the 2023 outlook, this reversal could mean both lower inflation and stronger real economic activity than any investor currently dares to contemplate. And it would be wickedly ironic if something resembling a mild Goldilocks environment returned just when every policymaker had finally lost hope (although they would, of course, claim credit for such an outcome). Naturally, we are not talking about a return to the Great Moderation of the pre-COVID era. Owing to the continued imbalances in labour markets, there would still be medium-term risks to inflation, which central banks would need to address by resuming their tightening cycles. But the return of Goldilocks, even if fleeting, would at least buy some time for policymakers and provide some respite for markets, which have had their most difficult year in more than a century.

1. FOLLOW THE HERD

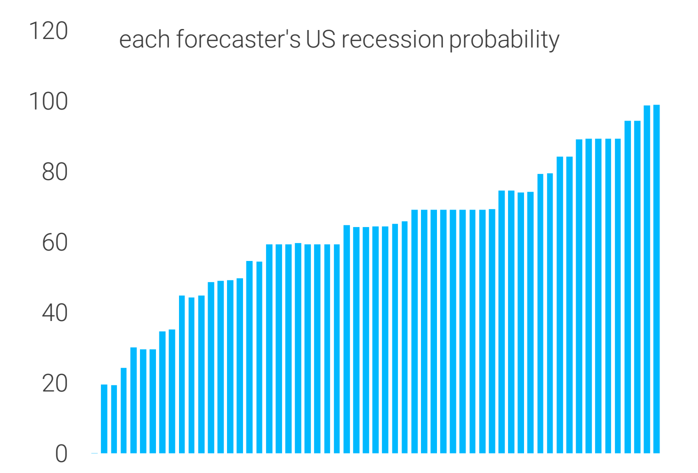
Arguably, the global economic outlook is more uncertain today than at any time in the past 50 years. After the massive distortions associated with the pandemic – which is still driving macro trends in some parts of the world – investors have had to contend with the acute stagflationary fallout from the war in Ukraine, plus a central bank response that has just delivered the fastest and broadest episode of monetary tightening in history. There is even profound uneasiness about the longer-term trajectory of the global economy, as evidence mounts of a "secular turning point" and a new era of massive structural change – deglobalization, climate change and a geopolitical power struggle unlike anything we have seen since the Cold War. The neoliberal supercycle seems to be in retreat, and there is even talk of a profound "polycrisis" as various systemic risks begin to interact in dangerous ways. Yet anyone who expected to see these uncertainties appear in consensus forecasts is likely to be surprised. Once again, there is an eerie conformity in market expectations. Economists and strategists, it seems, find comfort in the crowd.

Chart 2: Probability of recession never been higher



Source: Survey of Professional forecasters, Bloomberg

Chart 3: US recession is totally consensus

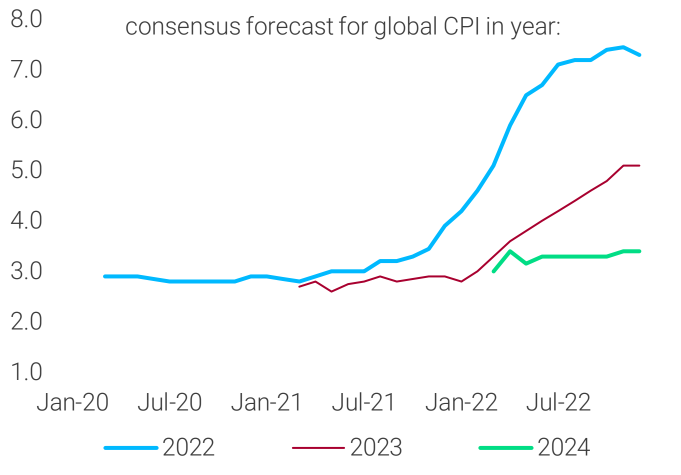


Source: WSJ survey of economists

The 2023 consensus

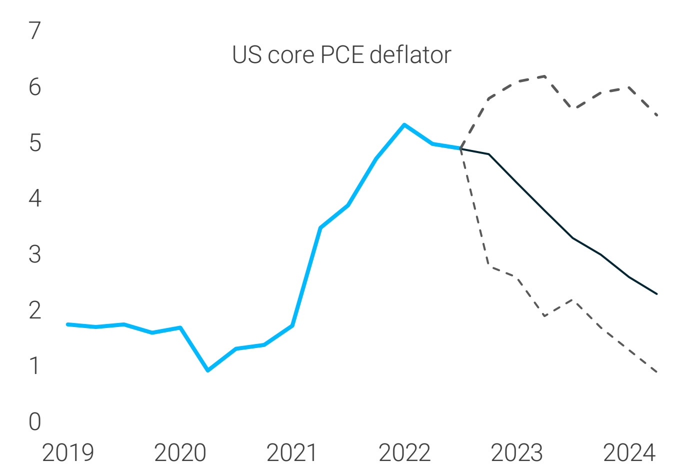
This is the time of year when most sellside economists have just published their marquee "year ahead" publications with views and forecasts for the upcoming 12 months (Sometimes these reports are still relevant by the middle of January...). Naturally, there is always pressure on sellside economists to make bold predictions, and they often deploy large marketing teams to ensure that their view stands out from the pack. But after reviewing around a dozen of these reports, we are struck – not by the boldness of the forecasts – but by the general lack of dispersion on offer. As far as we can see, every sellside economist is expecting a somewhat different version of the same overarching theme, often with just a change of emphasis and some marketing spin. One person's "mild recession" is another's "softish landing". And even the gloomiest forecasters are expecting a downturn that would be incredibly tame by every historical comparison. Most telling, the view that comes out of this analysis is more or less the same as the one central banks have been peddling for at least the past three months. In short, there is not a great deal of forecasting creativity out there.

Chart 4: Biggest surprise of 2022



Source: Bloomberg consensus, TS Lombard

Chart 5: US inflation stays above Fed target

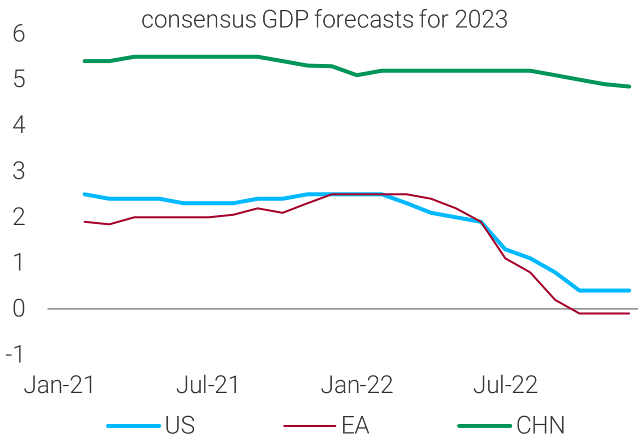


Source: Bloomberg consensus, TS Lombard

To summarize where things stand – and to save TS Lombard clients a lot of unnecessary reading over Christmas – we can distil the entire sellside view (and the view of central banks…) as:

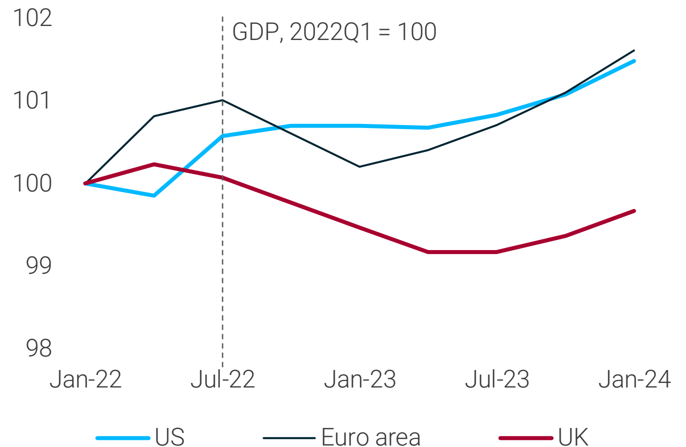
- Inflation has peaked or will peak in Q1 and then decline during 2023. Global goods prices are already showing signs of disinflation and services prices will follow, albeit with a lag. The important point, however, is that progress will be slow. Most central banks could still be looking at inflation well above their targets for the next 12 months, possibly even longer. In the US, the consensus has inflation exceeding 3% by yearend, staying above 2% in 2024. Inflation expectations for the euro area are generally higher. So, sellside economists see a somewhat stickier CPI outlook than do bond markets.
- US economic stagnation: Most forecasters expect broad stagnation, or "mild recession", in the US. In practical terms, there is not a great deal of difference between the two. Even those economists who use the recession label to stand out from the crowd are invariably predicting one of the mildest downturns in history. To illustrate, the average rise in US unemployment during recessions is 3 percentage points. There is not a single economist in the Bloomberg consensus that expects an increase of that magnitude by the end of 2024. In fact, the smallest increase in US unemployment during any official recession was 1.9 percentage points (1961) and only 4/55 forecasts are for something as bad over the next two years. Indeed, according to last week's SIFMA survey, while 80% of respondents expected a recession in 2023, more than 90% thought it would be mild compared with past downturns.
- Economic weakness elsewhere: While a majority of sellside economists expect a recession in the US, they apply this label even more freely to the euro area and the UK – in part because many believe these economies are already beginning to buckle. Yet a comparison of GDP forecasts shows there is not a great deal of transatlantic variation in these expectations. The overwhelming consensus is one of broad stagnation, rather than a precipitous decline in output and employment – in part because universal labour shortages should discourage companies from shedding workers. Looking at other major economies, China is another country expected to struggle. Most analysts see only a gradual and partial reopening of the economy after COVID, while deep structural problems – especially its property slump – continue to weigh on China's performance.

Chart 6: Big downward revisions since the summer



Source: Bloomberg consensus, TS Lombard

Chart 7: Broad stagnation in 2023



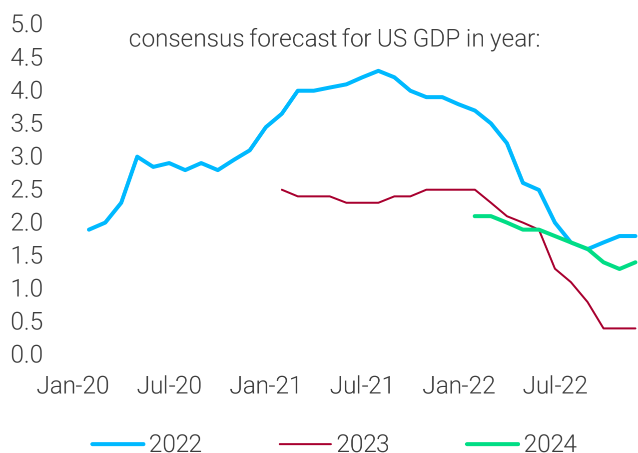
Source: Bloomberg consensus, TS Lombard

- Tighter for longer: With mild recessions only and inflation staying above central banks' targets throughout 2023, most sellside analysts have readily accepted the idea that the authorities will not be able to ease monetary policy much – if at all – over the next 12 months. Instead, central banks will raise interest rates a bit more during the first few months of 2023 and then remain in a holding pattern for much of the rest of the year. There will be a "pause" but no genuine "pivot", at least not for some time. The latest Blomberg consensus has the Fed peaking at 5-5.25%, the BoE at 4-4.25% and the ECB at 3% in Q1 and the possibility of token rate cuts in the final months of the year.
- Caution on risk assets: Market pricing is (just about) consistent with the mild recession economists are forecasting. Perhaps the biggest discrepancy is in the pronounced inversion in bond markets, which points to a more rapid succession of rate cuts in 2023 (the Fed funds curve currently assumes around 75bps of cuts and options data suggest investors are positioning for an even larger move). One explanation for this divergence is that economists pay too much attention to central banks' official policy guidance, which can be slow to adjust at major turning points (in fact, central banks often deny the possibility of rate cuts right up until they make their policy move.) But there is still a strong consensus among strategists that yields have peaked. Meanwhile, lower long-term interest rates should ease the recent pain in global stock markets. But the overall tone of sellside advice on risk assets remains cautious and "defensive". Most year ahead publications warn of potential earnings disappointment in a mild recessionary scenario, with profits set to take over from valuations as the main risk for equity markets.
- Peak dollar: In FX markets, there is a strong consensus that the Fed pause will end the 2022 theme of dollar appreciation, providing a degree of relief for global FX markets (in effect, ending the "reverse currency war") and easing the pressure on international dollar debt markets. Sterling, the euro and the Yen should all stabilize.

While the consensus outlook seems reasonable – perhaps it is the most likely scenario for 2023 – it is important to remember that sellside forecasts have not performed well in recent years. Twelve months ago, these same year ahead publications were full of references to Goldilocks and "gradual policy tightening" and we ended up with the complete antithesis – stagflation and a rapid succession of rate hikes. Financial markets have just recorded their worst performance in more than a century. Worse, sellside economists have a rather disturbing tendency to believe

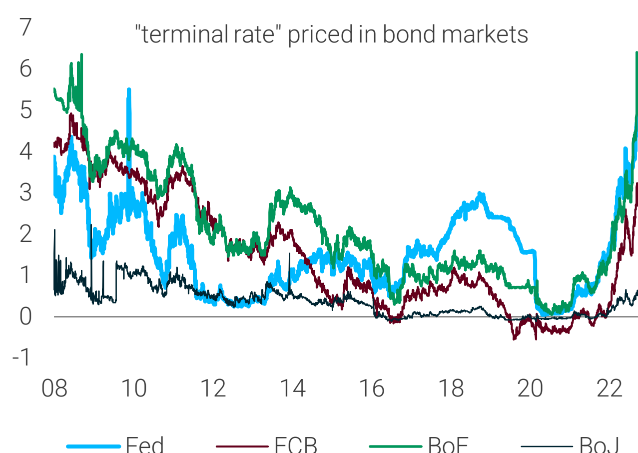
whatever message central bankers are peddling. When the authorities told us inflation would never be a problem and rates would stay at zero forever, we believed them. When they told us inflation was transitory, we believed them. Now they want us to believe in a "softish" landing or, in the worst case, a mild recession, and this is the new consensus. Given the errors these forecasters have made and their tendency to huddle around a unitary view, it is important to look at the risks to these forecasts. Is the sellside getting it wrong again? And in which direction?

Chart 8: Limited US growth in 2023 and 2024



Source: Bloomberg consensus, TS Lombard

Chart 9: Terminal rates have stayed high



Source: Bloomberg, implied from yield curves

2. DEEPER DOWNTURN

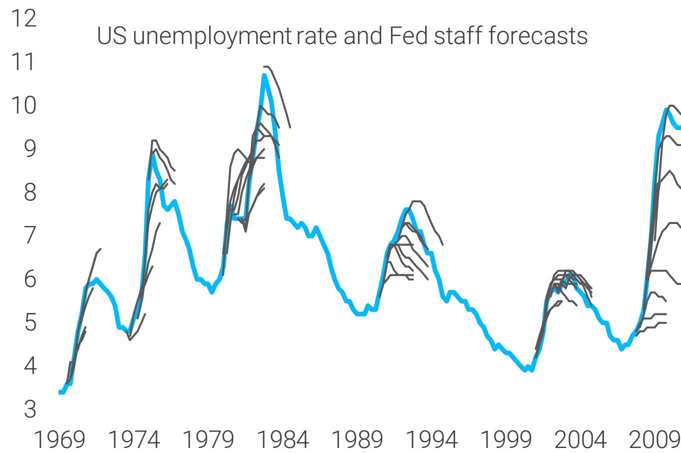
There are good reasons to believe central bankers when they tell you the economy is facing recession. After all, the authorities have the tools to generate such a downturn if – as seems to be the case today – they believe a recession is necessary to tame inflation. Central bankers have their reputations to think about; and, as we have explained elsewhere, most officials believe allowing a mild recession now could prevent a greater economic calamity in the future, which is what would be necessary if "price stability is lost". But can we really trust the authorities to micromanage the economy with a policy tool as blunt as short-term interest rates? What if central banks – and, by extension, the whole of the consensus – are underestimating the severity of the impending downturn. Recessions are often reflexive and non-linear, which means that once they get going, they can be difficult to stop. And there are often long lags in the transmission of monetary policy, which does not help when the authorities are obsessed with some of the macro indicators that lag the most.

A taboo is broken

The Fed and the BoE are forecasting higher unemployment in 2023. In making these predictions, both central banks are, in effect, predicting a recession, even if only the Brits are prepared to use this label. Many investors find these forecasts unsettling – they are used to central banks acting as cheerleaders for their economies, always downplaying the risks in order to support the public's confidence (take, for example, the ECB: euro area officials are still not acknowledging the region's recession threat, despite growing evidence to the contrary). Yet, interestingly, this is not the first time central bankers have forecast recessions; rather, it is simply the first time the authorities have published such gloomy predictions. Remember, most central banks stepped up their

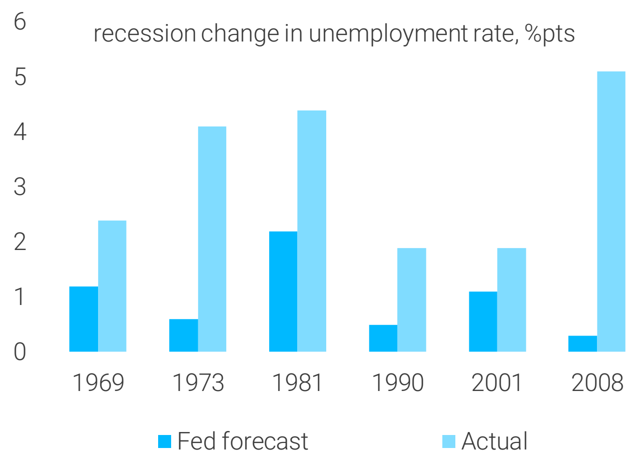
openness only after the global financial crisis. Excluding the impact of the pandemic – which was obvious to everyone in real time – this is the first time the global economy has faced a material recession risk in this new era of central-bank transparency. While 20 years ago it would have been taboo to publish a forecast for higher unemployment, that is not the case today.

Chart 10: Fed does indeed forecast recessions



Source: Philadelphia Fed Tealbook database

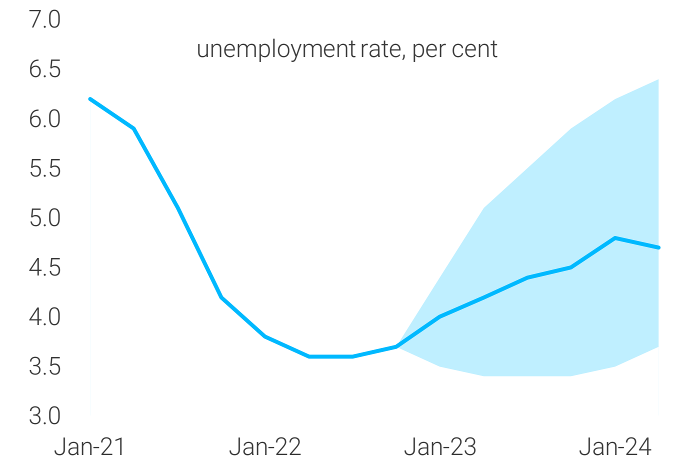
Chart 11: Fed underestimates recession severity



Source: Philadelphia Fed Tealbook database

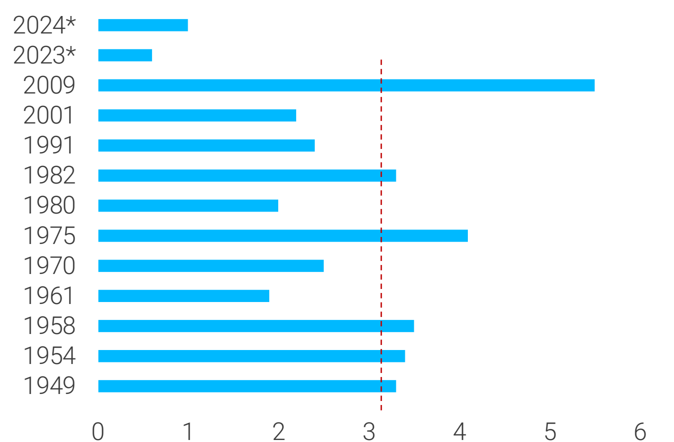
Since central banks' recession forecasts were once a closely guarded secret, it is hard to assess the accuracy of their past projections. But we do have this information for the US because the Fed publishes all its internal analysis and policy deliberations with a lag of five years. The Philadelphia Fed collects this information and keeps it in a helpful online database. Using this data source, Charts 10 and 11 reveal – somewhat surprisingly – that the Federal Reserve has a good track record, at least when it comes to seeing shifts in the direction of the economy at cyclical turning points. Officials have correctly anticipated higher unemployment – the only sensible definition of recession – in every downturn since the late 1960s. That makes Fed officials at least as good at forecasting recessions as the bond market. But what the Fed gets wrong – which is true of economists' forecasts more generally – is the magnitude of these downturns. In every case, unemployment rose faster and reached a higher level than expected. This is worrying because it suggests central banks could be making the same mistake again.

Chart 11: Consensus sees mild US recession



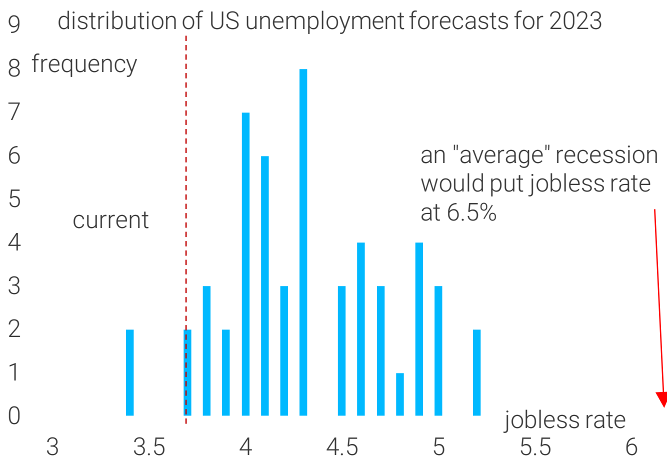
Source: Bloomberg consensus, TS Lombard

Chart 13: The mildest recession in history?



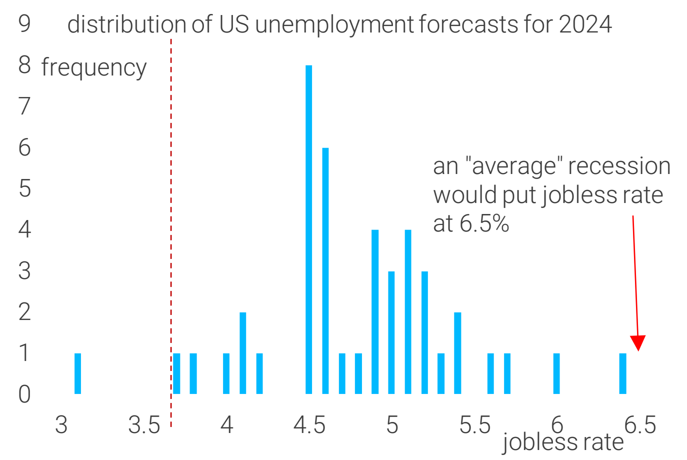
Source: BLS, *Bloomberg consensus, TS Lombard

Chart 12: Nobody sees a genuinely deep recession



Source: Bloomberg consensus, TS Lombard

Chart 13: The point of maximum pain

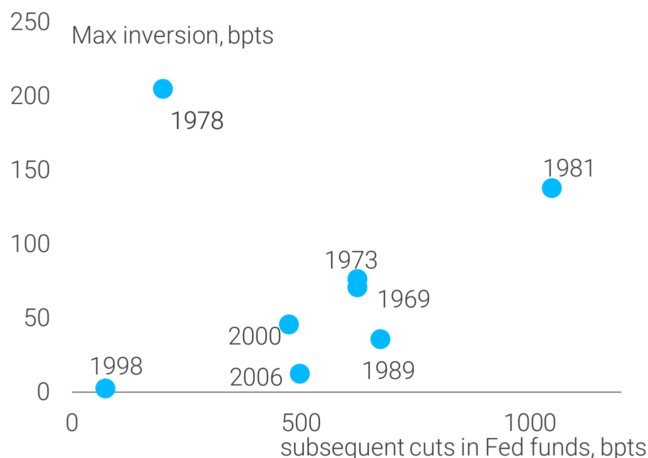


Source: Bloomberg consensus, TS Lombard

Reflexivity kicks in

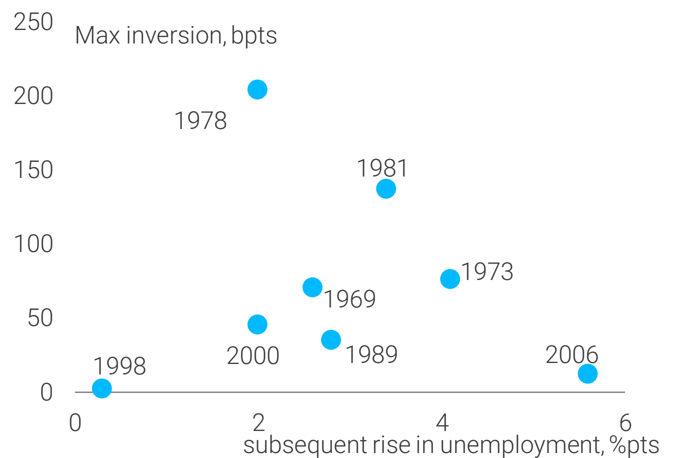
Economists often miss the severity of recessions because as the economy deteriorates, it kicks off a highly reflexive and non-linear dynamic, where weakness feeds on itself. The reflexivity can come from various sources, including financial markets, confidence/sentiment and interactions between different sectors of the economy. These dynamics were particularly powerful during the 2008 recession, which is when central bankers made their biggest forecast errors. The subprime crisis triggered both a financial crisis and a deep housing recession – two sectors that were systemic to the global economy. So far, reassuringly, we have not seen similar dynamics this time around. Financial markets have struggled in 2022 and asset prices have plunged, but the weakness has been orderly – that is, without anything obviously "breaking". And while there is certainly the risk of a more disorderly move in 2023, the traditional banking system looks far more resilient than it did a decade ago. Today, in fact, the gravest financial risks appear to be in the "non-bank" sector – the domain of institutional investors and capital markets. But as the UK's recent pension-fund crisis illustrated, the fallout is likely to be closer to dotcom than subprime.

Chart 16: Inversion doesn't predict size of cuts



Source: Bloomberg, TS Lombard

Chart 17: Inversion depth doesn't predict severity



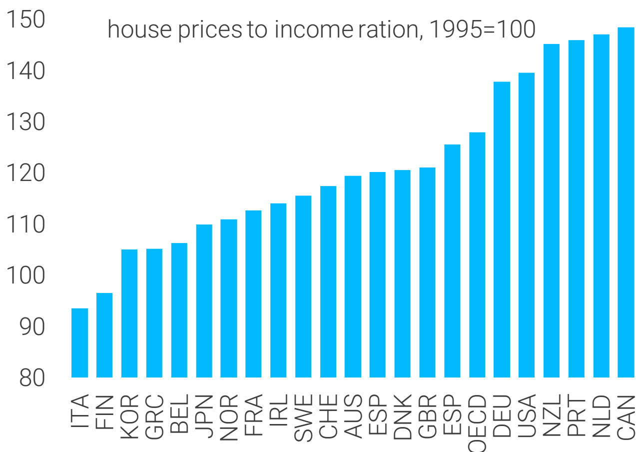
Source: Bloomberg, TS Lombard

Monetary lags

In terms of systemically important sectors, housing is probably the biggest threat to the global economy in 2023. Mortgage rates have increased dramatically, which has already had a huge impact on housing transactions, homebuilding, construction activity and demand for durable goods (household furnishings, electrical goods, etc.). It is possible that large job losses in these sectors will be the next stage of the housing recession, which could spill over into other parts of the economy, causing a decline in aggregate demand and employment. There are always lags in the monetary transmission mechanism; and by keeping interest rates high and focusing on the current resilience of the economy, central bankers may be underestimating the cumulative impact of their monetary tightening – something that will not become clear until 2023.

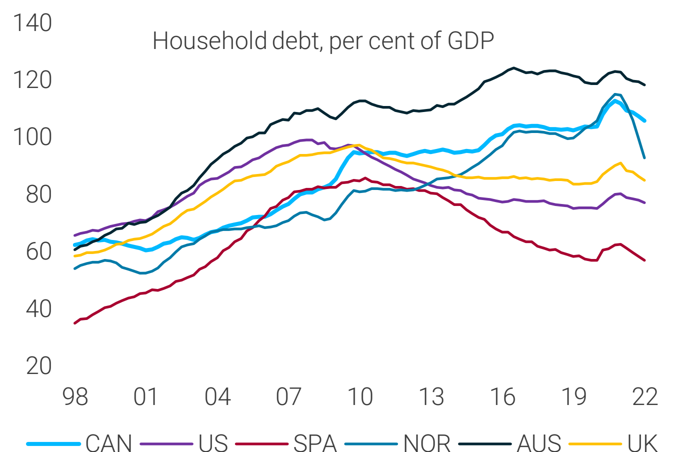
The good news, however, is that the housing market has a much smaller economic footprint than a decade ago. Because the latest boom happened so quickly – concentrated during the pandemic period – we have not seen the same misallocation of resources as that during the long housing bubbles of the early 2000s. Homebuilding accounts for a smaller share of GDP in most economies, and the real estate sector constitutes a much smaller proportion of employment. Even more important, the financial risks associated with the property sector look nowhere near as dangerous as during the subprime years. Leverage is generally lower, the quality of lending is higher and most borrowers – particularly in countries that suffered a crisis in 2008 – have pivoted into fixed-rate mortgages. For most economies, there is no ticking mortgage timebomb. .

Chart 14: Are house prices the macro threat?



Source: Dallas Fed database, TS Lombard

Chart 15: Some economies look vulnerable



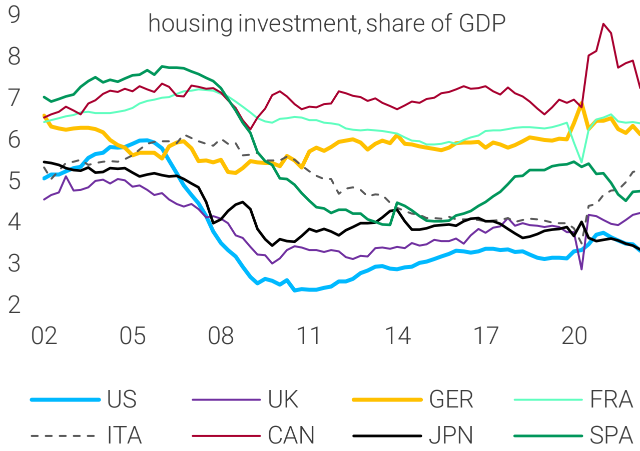
Source: BIS, TS Lombard

Housing vulnerabilities

A further large deterioration in property markets would be the most compelling reason to think the consensus is underestimating the severity of the downturn. But for most parts of the world, we are not talking about a situation anywhere near as dangerous as what happened in the early 2000s. The exceptions – meaning the economies that could face much nastier recessions – are those that did not experience a housing bust during the global financial crisis, especially if they are strongly dependent on adjustable-rate mortgages and have continued to experience rapid debt growth and further house price appreciation. Our recent analysis of private-sector debt vulnerabilities identified the main problem areas –namely, Canada, Australia, New Zealand, the Nordic countries and the UK. The US and most of the euro area look far less exposed. Adjustable-rate mortgages are particularly dangerous because they ensure that monetary tightening has

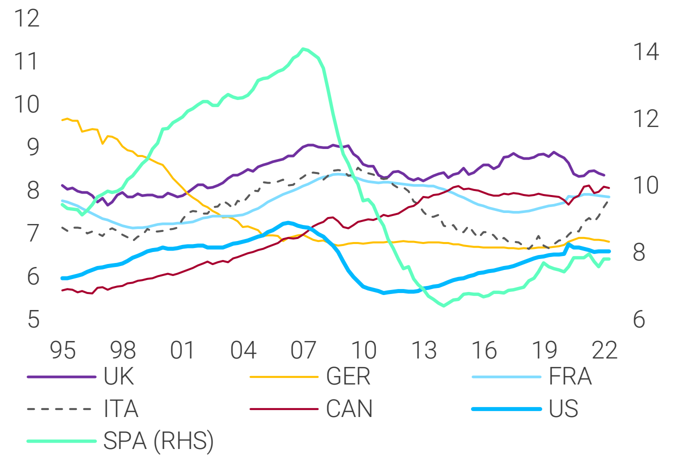
both “flow” effects (an impact on new transactions) and “stock” effects (an impact on existing debt holders). For the danger economies, higher rates not only kill new demand for property; they also squeeze existing debtors, which can lead to deeper recessions, default and financial distress.

Chart 16: Few economies are very exposed



Source: OECD, TS Lombard

Chart 17: Not systemic for most?

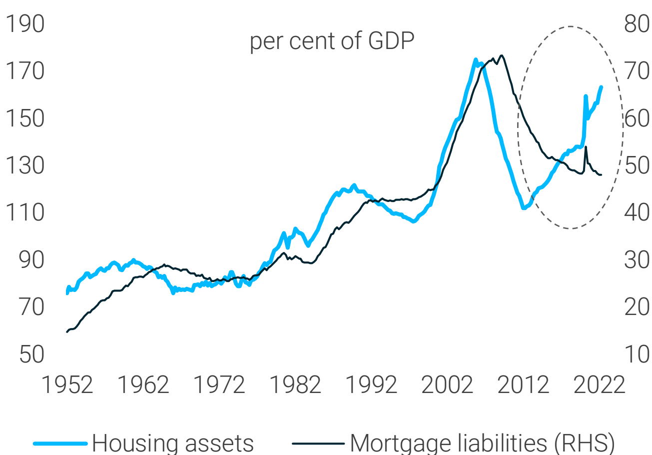


Source: OECD, TS Lombard

Recession impact on markets

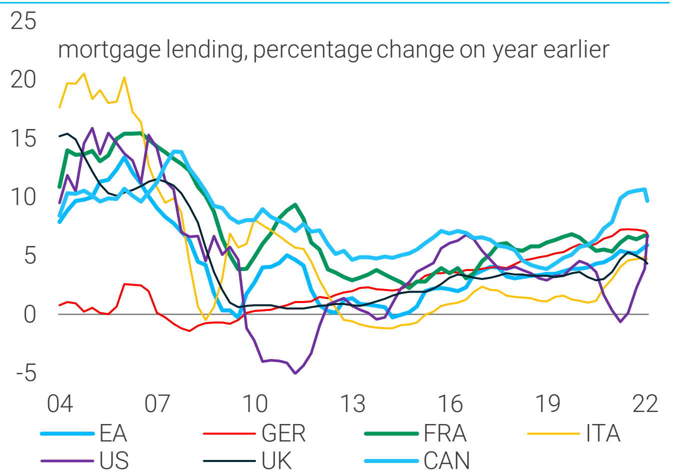
If the consensus is underestimating the depth and duration of the global recession, there are some potentially serious implications for financial markets. The impact on bond markets seems reasonably clear: central banks would cut interest rates and yields would plunge. Right now, of course, the authorities have every desire to talk down the chances of a genuine monetary pivot. Their economies have not yet cracked, and they are fighting an inflation problem – that is, they are not even thinking about the possibility of rate cuts and need to keep financial conditions tight. But if their economies were to deteriorate more quickly, they would immediately capitulate to plunging rate expectations. Falling employment, an obvious recession marker, is not something any central banker can ignore, irrespective of their current bravado and determination to learn the lessons of the 1970s. Unlike in the 1980s, there is no political appetite for large job losses. Similarly, we see clear implications for credit markets, where spreads have remained narrow

Chart 18: Latest housing boom was unleveraged



Source: Federal Reserve, TS Lombard

Chart 19: No 2000s-style mortgage bubble

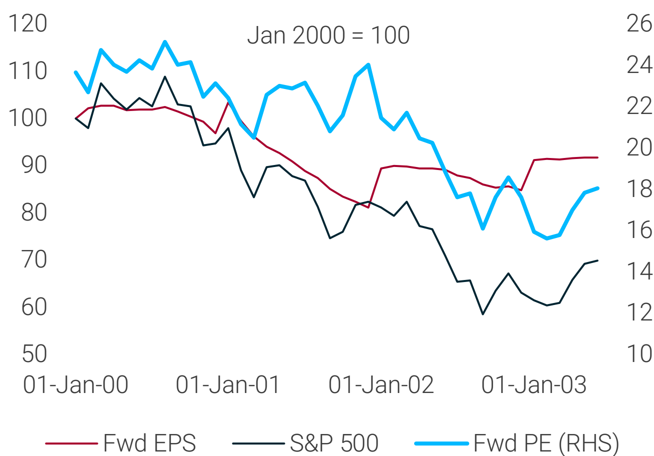


Source: National sources, TS Lombard

despite the consensus for an economic downturn. If a true recessionary dynamic kicks in during 2023, credit spreads will widen materially – which is what always happens during downturns.

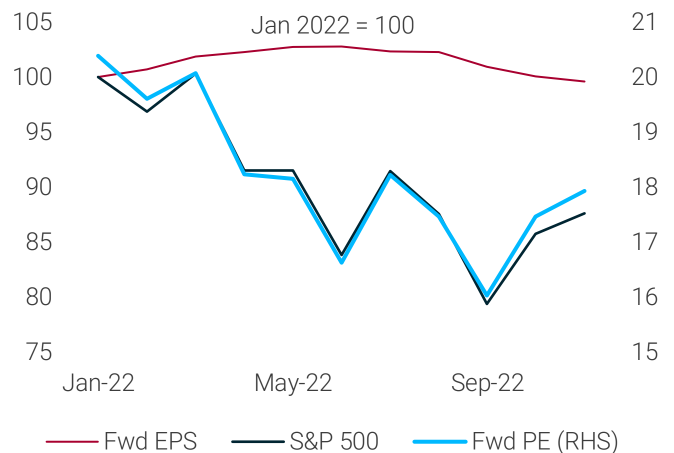
The more difficult challenge is for investors to figure out what a deeper recession means for equities. The conventional view is that stock prices would plunge to reflect deteriorating earnings. Indeed, the consensus appears to expect a scenario similar to what happened in the early 2000s. Broadly speaking, the dotcom crash happened in two phases – a quick reduction in valuations followed by a further decline in equity prices in response to deteriorating corporate earnings as the US economy entered recession. Since 2022 has already seen a big reduction in PE ratios – and all the pressure on stocks came from pure valuation effects, not earnings revisions (see Chart 25) – there could soon be a second stage of the bear market.

Chart 20: Dotcom – valuations, then earnings



Source: Bloomberg, TS Lombard

Chart 21: Valuations have driven S&P 500 decline



Source: Bloomberg, TS Lombard

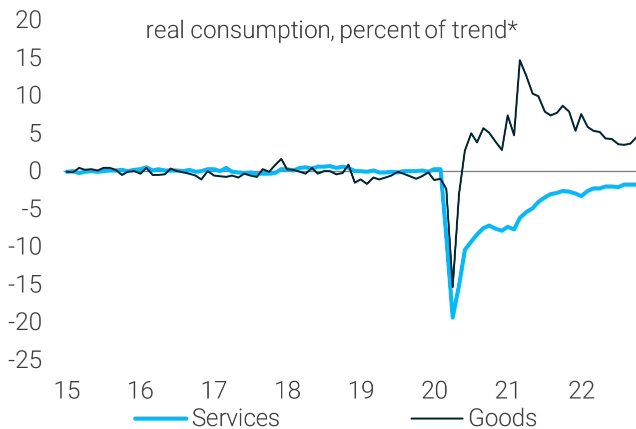
But while this is the consensus expectation, based on the traditional behaviour of stock markets during recessions, there are several reasons to think it might be too gloomy. First, speaking to investors it is not clear that anyone does, in fact, believe consensus earnings expectations for 2023 – most TS Lombard clients think they are wildly optimistic. Second, as we discovered during COVID-19, it is important to recognize that the stock market is not the economy. In fact, the US stocks that have suffered most during the past 12 months are those that are relatively insensitive to the latest macro developments – long-duration US tech and the FAANGs. For these companies, which make up a greater proportion of the S&P 500 than ever before, the discount rate arguably matters more than GDP or employment. While from a secular point of view we think "value" sectors will outperform "growth", a deeper recession could temporarily reverse this trend in 2023, reflating the more speculative parts of the market. A last hurrah for meme stocks?

3. THE NO-LANDING SCENARIO

Although it is possible the economic downturn in 2023will be deeper and more protracted than everyone expects, we are struggling to identify the triggers for the sort of collapse that would totally undermine the basic consensus narrative. Indeed, there are good reasons to think the risks are, in fact, skewed the other way – in the direction of greater economic resilience. While everyone is focused on the debate about whether there will be a "hard landing" or a "soft landing",

we could even see a "no landing" scenario, in which economic activity improves. And while this would mean underlying inflation pressures linger, perhaps forcing central banks to resume their policy tightening later in the year, it could provide at least some respite for battered financial markets. Sounds too good to be true? Perhaps, but this is no ordinary business cycle.

Chart 22: COVID distortions nearly unwound



Source: BEA, TS Lombard

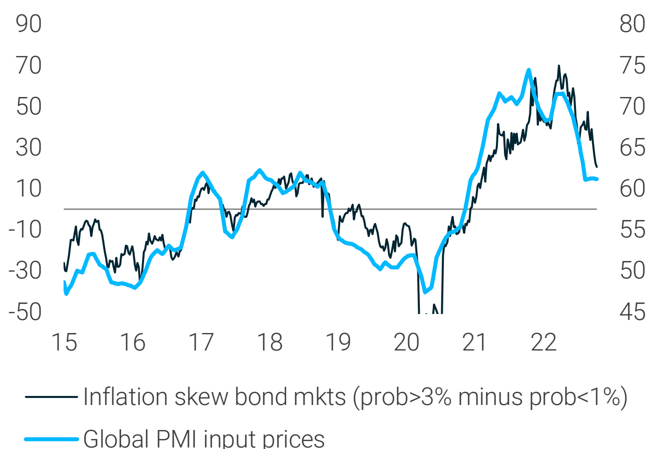
Chart 23: Supply chains almost back to normal

Source: New York Fed, TS Lombard

The fake recession scare

Twelve months ago, in our "Is the 2022 consensus wrong?" publication, we warned that the world economy could be facing a recession scare. Back then, most economists were optimistic about the outlook, forecasting sustained above-trend global growth that might continue for many years – remember the Roaring 20s or YOLO economy? Our warning about the recession scare was not a reflection of any underlying pessimism but rather an observation that the world was not experiencing an ordinary business cycle. Several big distortions set to unwind in 2022 had the potential to spark a fake recession dynamic. The biggest distortion, of course, was the way in which consumer spending patterns had changed during the pandemic. Goods demand had surged and created a boom in global manufacturing and world trade. As we exited the pandemic, these trends would reverse, causing a crash. Since most leading indicators are based on manufacturing trends – traditionally the most cyclical sector – this would give the (false) impression that the world was facing a material economic downturn.

Chart 28: Goods prices drive market themes

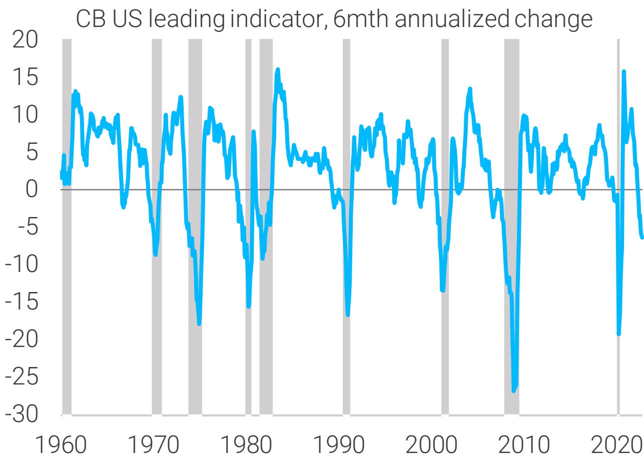


Source: Minneapolis Fed, Markit, TS Lombard

Chart 29: Global manufacturing recession

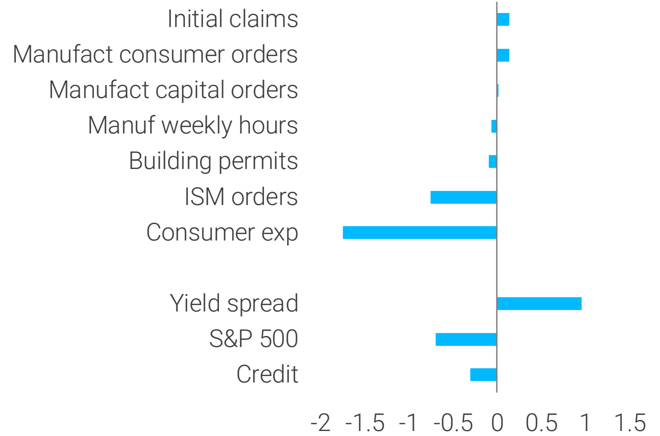
Source: Markit, TS Lombard

Chart 24: Leading indicators have plunged



Source: Conference Board, TS Lombard

Chart 25: Manufacturing drives LI declines

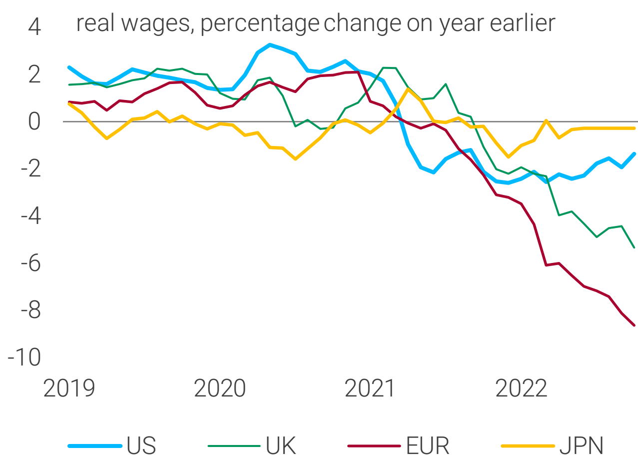


Source: Conference Board, TS Lombard

The end of the big squeeze

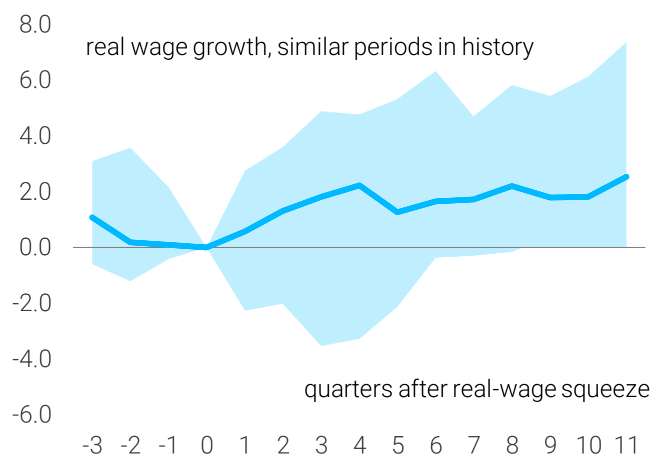
Today, there is no doubt that the recent plunge in global leading indicators – predominantly driven by rapidly deteriorating industrial activity – is compounding investors' recession anxiety. And as the tensions in supply chains ease, we are also seeing a major reversal in the bullwhip inventory cycle. Wholesalers and retailers who built up large inventories in the expectation of permanently higher demand are facing serious whipsaw. Though entirely predictable, this is a dynamic that could produce enormous disinflation in traded goods prices and import prices. And since medium-term market narratives tend to be unduly sensitive to the global industrial cycle – another point we made 12 months ago – investors' focus could quickly shift from inflation risks to the perceived threat of deflation. The crucial point, however, is that this entire move is wildly exaggerated. Weakness in manufacturing does not signal a deep or broad-based economic downturn, especially if there is continued resilience in the services sector and labour markets.

Chart 26: Real income squeeze in 2022



Source: National sources, TS Lombard estimates

Chart 27: Workers usually claw back losses

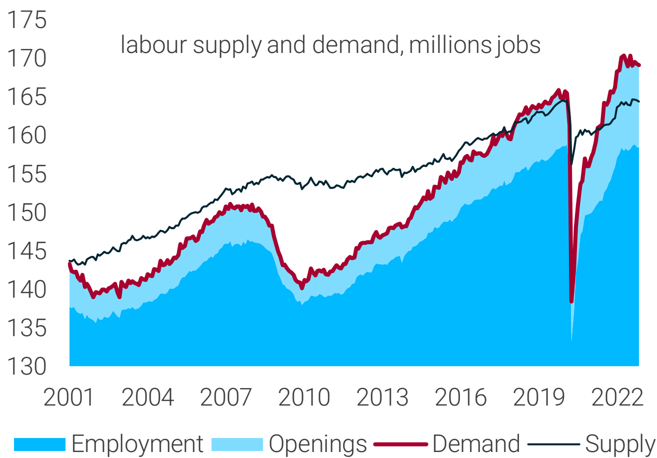


Source: IMF Working paper 2022

In addition to the fake bullwhip recession in the global manufacturing sector, the 2022 economic slowdown is, in fact, due to a large extent to the impact of high inflation. Since prices have comfortably outstripped wages, consumers everywhere have experienced a serious squeeze on

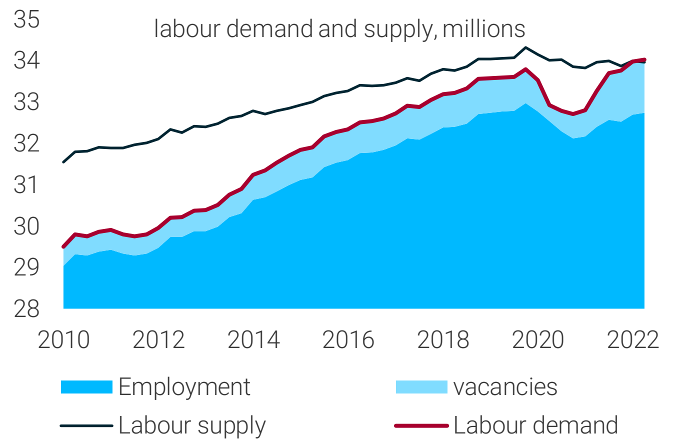
their spending power. Or rather, they have continued to increase their spending in nominal terms, but their real spending has shrunk, which has undermined output and employment. The good news is that this squeeze should fade in 2023. Not only is inflation likely to come down, but nominal wages have steadily accelerated, even in the euro area and Japan. This would be consistent with recent IMF analysis, which shows that big declines in real wages are usually followed by periods in which workers claw back some of their lost spending power; and they do so without necessarily triggering a dangerous wage-price spiral – indeed, inflation still declines.

Chart 28: Imbalance in US labour market



Source: BLS, TS Lombard

Chart 29: UK labour market is especially tight



Source: ONS, TS Lombard

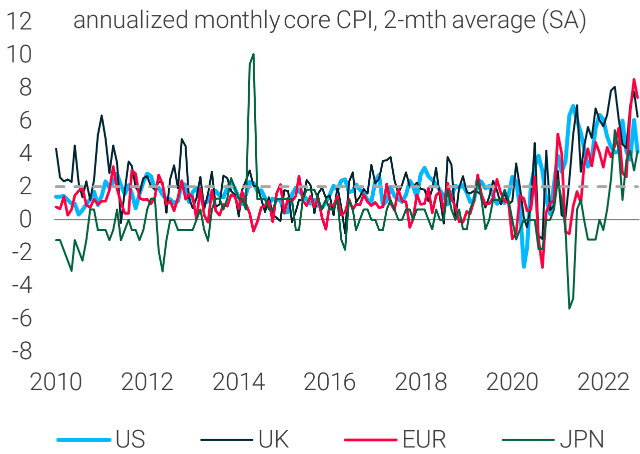
A soft landing?

The combination of lower inflation and a stronger economy sounds like the return of the pre-COVID Goldilocks era. But, in reality, it would be simply the reversal of the extreme stagflationary impulse of 2022. The fact that few economists can currently imagine such a benign environment is not surprising after they failed to imagine the stagflation of the past 12 months. That is not to say that Goldilocks will remain with us for long. As we have explained elsewhere, we see a much more challenging environment for investors over the next decade. But, restricting our focus to 2023, there is every possibility we could end up with a more benign environment, which would at least provide some respite for financial markets – after the battering they have taken in 2022. The only problem with the "no landing" scenario is that it would leave a fundamental imbalance in labour markets. Eventually, central banks would want to resume their policy tightening.

The monetary authorities have made it clear that lower inflation is not the only condition they need for a "soft landing". They have also identified a more fundamental problem, namely, the shortfall in the supply of workers relative to demand. These imbalances are particularly pronounced in the US and the UK. While central banks accept that interest rates are not a solution to the things that are currently keeping inflation high, they clearly believe they need to address the longer-term threat posed by "overheating" in the jobs market. Since they cannot increase the supply of workers – which shrunk during the pandemic – they need to restrain demand. While it is unclear whether our "no landing" scenario would achieve this, there are two reasons for optimism. First, because job vacancies everywhere are high relative to the number of people out of work, it should be possible to destroy labour demand without causing a rise in unemployment. Second, it is likely that a large part of current wage growth is due to a "levels" effect associated

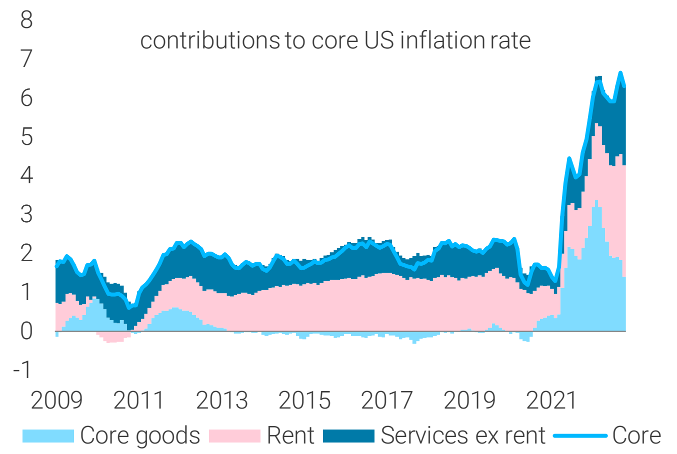
with specific sectors of the economy. If so, wage growth could slow to a more reasonable pace even if the authorities are not successful in actively curbing demand.

Chart 30: Inflation remains sequentially too high



Source: National sources, TS Lombard

Chart 31: Wages could support services inflation



Source: BLS, TS Lombard

As long as central banks are raising interest rates rapidly, the world is on course for a recession. The only question is timing. While our “no landing” scenario does not eliminate the need to raise interest rates, continued disinflation from the unwinding of supply distortions would at least remove the sense of urgency among policymakers. A good way to think about this is that while a tight labour market warrants a higher terminal rate, CPI data set the pace of rate hikes. Sharply lower inflation and a short-term recession scare would buy at least some time; and at this point, that would be extremely helpful in avoiding a hard landing. But what we definitely cannot afford is any further deterioration in inflation – be it from a jump in commodity prices related to China’s COVID reopening or from an escalation in the global energy crisis, among other factors.

Bottom line

Given the massive uncertainties in global macro, it would have been only natural to expect a material dispersion in consensus forecasts. But our analysis shows this is not the case – most “year ahead” outlooks are just somewhat different variations on the same theme. The major economies are likely to stagnate or experience mild recessions (the difference is mainly in the marketing), progress on inflation will be incomplete (staying above central banks’ targets) and monetary policy will remain tighter for longer, with a pause but no “pivot” – despite the deep inversion in bond markets. This is an environment that demands a “defensive” asset allocation, at least according to the advice of most sellside strategists. This, of course, is sensible guidance and probably the most likely scenario for 2023. Still, bearing in mind the woeful performance of economists’ predictions in 2022, it is worth considering the risks to the current consensus. One possibility is that we are underestimating the severity of any 2023 downturn. Because of the reflexivity that kicks in as economies contract, we have seen this pattern many times before. Perhaps something will break in financial markets or – more likely – the weakness in property markets will prove systemic. For their part, central banks are ignoring the “long and variable lags” in monetary policy. But perhaps the most under-priced risk is to the upside – that the global economy proves more resilient than everyone expects. In fact, given the large distortions in the economy, we would not rule out the unscheduled return of Goldilocks. She is not going to stick around for long, but perhaps long enough to provide some welcome respite for investors.