HYMANS ROBERTSON
INVESTMENT SERVICES

## Hymans Robertson Investment Services (HRIS)

# Recession – what's the potential impact on investors?

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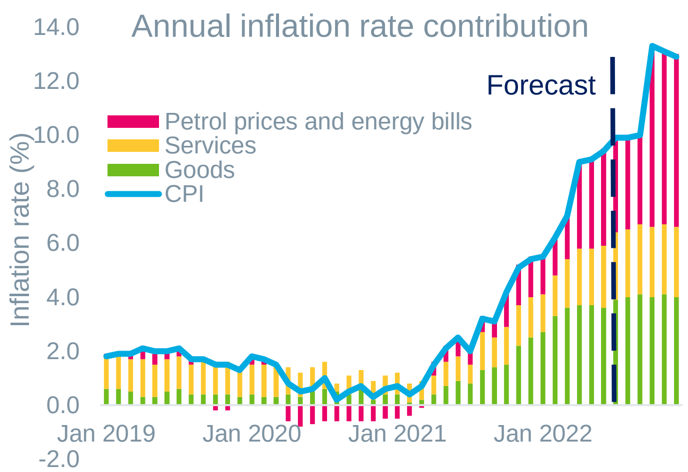
- In August, the Bank of England (BoE) provided a gloomy outlook for the UK economy. Forecast for peak inflation hit 13%, although the recent energy support package should help to avoid these levels
- A weak UK economy could boost the value of overseas assets if sterling remains weak
- Equity markets tend to fall in anticipation of a recession, but investment opportunities may arise once the recession eventually arrives

## What is a recession?

Although formal definitions vary by country, a recession generally means a sustained period of economic contraction which usually involves a fall in spending and a rise in unemployment. The UK and other countries define a recession as two successive quarters of negative GDP growth. However, in the US, a broader definition is used that takes into account a wider set of metrics such as unemployment, industrial production and real income.

## What is behind the BoE's forecasts?

The BoE has been alluding to a likely recession for a number of months now. In August, their forecast shifted from a mild recession to a protracted downturn, predominantly driven by the persistence in elevated energy prices, especially natural gas. Although the UK is not hugely dependent on Russian gas, the invasion of Ukraine has increased competition for non-Russian produced gas from other European countries such as Germany. The UK is more dependent on natural gas for central heating than other countries and has less storage capacity meaning it is acutely sensitive to swings in pricing on wholesale markets.



*Source: Bank of England*

Higher energy prices and inflation more broadly will directly impact businesses and consumers' ability to spend, increasing the likelihood of a recession. In addition, the BoE themselves will be increasing the risk of recession by tightening monetary conditions through interest rate hikes and the reversal of its QE programme, or "quantitative tightening". The BoE feel a slowdown in growth might be necessitated in order to get inflation back under control.

## How bad could the recession be?

Although the duration of the recession is forecast to be long, it is not expected to be as severe as the 2008 or pandemic induced recessions. The labour market is historically tight (latest figures indicate there are more unfilled jobs than unemployed people) given the decrease in the labour force since the pandemic, meaning unemployment is not expected to rise until halfway through next year. In addition, the forecast from the BoE only accounts for fiscal support already announced at the time. The recently announced energy support package for consumers and businesses will hopefully mean the full extent of the downturn may be avoided.

## The global picture

It's fair to say that the UK is far from being alone in facing slowing growth, as Western central banks tighten monetary conditions in a bid to tackle inflation, while other European countries face the same energy challenges as the UK. Whether the slowdown in growth is strong enough to cause a recession in economies like the US or even globally is more finely balanced although the likelihood has been increasing over the past few months. However, the International Monetary Fund's latest estimates place only Russia below the UK in terms of economic growth in 2023 indicating that, although other economies are slowing, the UK is an outlier.

## What's the impact to investors?

As most investors invest on a global basis the main impact on portfolios of a UK recession will be through the exchange rate mechanism. Any overseas assets in an unhedged foreign currency may appreciate in value as poor UK growth prospects should lead to a weaker pound. For UK assets the story is less clear. A recession is clearly bad news for the prospects of domestic focused businesses but most of the largest companies that make up the FTSE 100 generate a large proportion of their revenues in overseas markets which will be boosted by the weak pound.

For this reason, the real risk is a US or even global recession - the latter will almost certainly follow the former. It is widely assumed that recessionary periods are normally unfavourable for riskier assets such as equities. However, it is important to remember that equity market prices are based on expectations. Analysis shows that the worst period for the equity market tends to be prior to the economic contraction. By the time the recession occurs the market may already be bottoming out (see table 1). The S&P has already fallen 17.1% this year to the end of August as the threat of high inflation, rising interest rates and low growth has unsettled markets.

At this stage, the market is not pricing in a full global recession. The fall in markets thus far has predominantly been a reflection of higher interest rates, not necessarily a significant drop in earnings. Although there is a risk that earnings forecasts are rerated downwards in the coming months, investors should look to the long-term and, as far as possible, take comfort that ultimately markets look beyond shorter-term economic conditions.

| Table 1 | S&P performance | |
|---|---|---|
| **Period** | **During the recession (%)** | **12 months prior (%)** |
| 1948-49 | 9 | -2 |
| 1953-54 | 18 | -3 |
| 1957-58 | - 4 | -5 |
| 1960-61 | 17 | -6 |
| 1969-70 | - 5 | -11 |
| 1973-75 | - 13 | -18 |
| 1980 | 7 | 14 |
| 1981-82 | 6 | 8 |
| 1990-91 | 5 | 3 |
| 2001 | - 2 | -23 |
| 2008-09 | - 37 | 4 |
| 2020 | -4 | 28 |
| **Median** | **2** | **- 3** |

*Source: See It Market, HRIS, S&P returns in local currency*

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