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Monthly Economic Outlook for Private Equity

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Financial markets raise fears of potential recession

On August 5, global financial markets plunged, with the Nikkei dropping 12 percent, the Nasdaq plummeting 6 percent shortly after the opening bell, and volatility soaring[i]. Financial markets have recouped some of their losses since, but the severe market gyrations raised worries that a recession, particularly in the US, could be upon us. However, at least some of the market plunge was due to a sharp decline in technology company stocks as investors reassessed their lofty values[ii]. The market selloff was also exacerbated by the continuing unwinding of the Japanese carry trade after the Bank of Japan looked more hawkish and the Fed more dovish. This raised the value of the yen, making the carry trade less profitable and forcing a selloff of global financial assets[iii].

Although a stronger yen hurts the profitability of Japanese manufacturers, which rely heavily on exports, thereby lowering Japanese equity prices, it supports the domestic economy. Japan imports much of its energy and food, which are often priced in US dollars or foreign currency[iv]. The stronger yen will make these non-discretionary items cheaper for Japanese households, thereby giving consumers greater purchasing power that can be spent elsewhere in the economy. It also helps to ease inflationary pressure as the Bank of Japan intended when it tightened monetary policy.

Another part of financial market concern is that US economic data looked weaker than expected, which suggests the Fed could be behind the curve when it comes to cutting interest rates. Of particular concern is the labor market. Although employment growth slowed and the unemployment rate increased in July, the report was not catastrophic[v]. Plus, the Fed has been explicit that it wants to loosen the labor market to push services inflation down, Other US economic indicators, such as consumer spending and income growth, show the US economy is still growing albeit at a slower rate[vi]. Even if the Fed is behind the curve, it has room to cut rates sharply if it needs to. Indeed, investors have raised the number of rate cuts they expect this year, shifting the yield curve lower.

Although much of the focus has been on the US and Japan, it is Europe's economy that seems to be in the more precarious situation. The ECB is stuck balancing a relatively weak economic recovery and elevated inflation. Eurozone real GDP growth has been modest this year, with Germany's economy continuing to struggle with high energy costs and weak demand[vii]. Despite the relative weakness in the economy, Eurozone inflation appears to be stabilizing above the central bank's target. Most worrisome has been services inflation, which has showed few signs of slowing[viii]. Part of the challenge is that real wages are rising while productivity is falling. The persistence of inflation could also delay the ECB's next rate cut, which many believed would occur in September[ix].

While other large economies grapple with elevated inflation, China is struggling to prevent deflation, amid excess capacity and weak domestic demand. Core inflation in July was the lowest it has been since 2021[x]. Even so, the policy response has been relatively modest. The PBOC cut a key interest rate by just 10 basis points in mid-July. Later that week, it surprised markets when it cut another key interest rate by 20 basis points[xi]. The central bank's cautious approach is likely due to fears of creating too much downward pressure on the currency. Many economists believe China needs fiscal stimulus rather than monetary stimulus to put the economy on the right path[xii]. Such policies had seemed to be off limits, but key policymakers recently acknowledged the need for more fiscal support, and the government announced a plan to provide subsidies for households to purchase automobiles and consumer electronics.

Volatility in markets is likely to continue as central banks normalize policy. An election in the US, geopolitical tensions between the West and China, and ongoing conflict in the Middle East and Ukraine all add to the uncertainty in the global economy. However, there seem to be few signs of a looming recession even if global growth is slowing.

Endnotes

[i] https://www.bloomberg.com/news/articles/2024-08-06/japan-s-stock-meltdown-was-so-epic-it-s-rewritten-record-books?sref=TtzswLLC
[ii] https://www.forbes.com/sites/dereksaul/2024/08/05/big-tech-falters-magnificent-7-sheds-14-trillion-as-apple-nvidia-stocks-head-to-worst-days-since-2020/
[iii] https://www.bloomberg.com/news/articles/2024-08-05/global-carry-trade-unwind-extends-as-peso-sinks-yen-surges?sref=TtzswLLC
[iv] https://www.trade.gov/country-commercial-guides/japan-market-overview#:~:text=Japan%20is%20highly%20dependent%20upon,%2C%20franchising%2C%20and%20real%20estate.
[v] https://www.bls.gov/news.release/empsit.nr0.htm
[vi] https://www.bea.gov/news/2024/personal-income-and-outlays-june-2024
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[viii] https://ec.europa.eu/eurostat/web/products-euro-indicators/w/2-02072024-ap
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[x] https://www.reuters.com/markets/asia/chinas-july-consumer-prices-jump-faster-than-expected-producer-deflation-2024-08-09/#:~:text=Core%20inflation%2C%20excluding%20volatile%20food,of%20especially%20big%2Dticket%20items.
[xi] https://apnews.com/article/china-economy-interest-rates-pboc-68cdaa96d33cfb7f60b59f6c13dee132
[xii] https://www.bloomberg.com/news/articles/2024-04-16/china-reports-surprisingly-strong-growth-driven-by-industry?sref=TtzswLLC