Hard or Soft — How Do You Like Your Landing?

Summary: *With the end to the current tightening cycle seemingly around the corner, Beutel Goodman's fixed income team analyze the likelihood of a "soft landing" for the economy, which is uncommon but not unheard of when central banks hike interest rates.*

Source: Adobe Stock

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Looking back a year to June 2022, Canada's Consumer Price Index (CPI) recorded a year-over-year increase of 8.1%, while U.S. CPI was even higher at 9.1%. This brought easy comparison to the early 1980s, when spiralling prices led to a hawkish tightening cycle by central banks, and ultimately a deep recession. One year on, the lay of the land appears much more positive and the likelihood of a severe economic contraction has lessened. Instead of harkening back to the inflation problems of 40 years ago, the idea of a "soft landing" has resurfaced.

As we approach what appears to be the end of the central bank tightening cycle in Canada and the U.S., the focus is shifting to what comes next. Generally speaking, tightening cycles end with an economic recession or a credit crisis. The central banks' goal, however, is to achieve a soft landing, whereby the economy slows and then reaccelerates without dipping into a recession.

While somewhat elusive, there is precedence for a soft landing. The last time one occurred is generally considered to be 1994–1995,

during Alan Greenspan's time as Chair of the U.S. Federal Reserve (Fed). The conditions of that period have little correlation to the tightening cycle of 2022–2023, however. At that time, inflation was close to 3%, and the Fed decided to act proactively, increasing interest rates in the U.S. from 3% in February 1994 to 6% a year later. This meant that inflation quickly stabilized, but without a resulting rise in unemployment, and a recession was averted. In contrast, the Fed and its global peers were very much acting reactively at the beginning of this tightening cycle in March 2022.

Earlier in this tightening cycle, economists were calling for a recession in 2023. However, economic data have continued to be fairly robust to date, leading some market pundits to extend the predicted timeline for recession to 2024 — and in some cases reverse course altogether in favour of a soft landing outcome. Below, we outline the economic cases for both a soft and a hard landing.

The Case for a Soft Landing

The formal definition of a recession is two consecutive quarters of GDP contraction. In Canada, second-quarter GDP growth is tracking at an annualized pace of 1% (with April and May data reported). While preliminary estimates for June indicated that growth decelerated, this reading is slightly distorted by the public sector workers strike and suspended operations in the energy sector due to wildfires. According to Bloomberg News' July Canada Economic Forecast Survey, Canada's economy is expected to expand by 1.5% in 2023 and 0.6% in 2024, with a 35% chance of a recession over the next 12 months — a significant drop from the June survey that predicted a 50% chance of recession.

Economic Resilience

In the U.S., second-quarter GDP growth was 2.4% on an annualized basis, versus consensus expectations of 1.8%, with the strength attributable to an increase in business investment and inventory accumulation. The July Bloomberg Survey estimated that U.S. GDP would grow by 1.5% in 2023 and 0.6% in 2024, with a 60% chance of a recession over the next 12 months (this was unchanged from the June survey).

The resilience of the labour market in both the U.S. and Canada has been an important anomaly of this tightening cycle. The fact that we have experienced aggressive rate hikes but not seen job losses lends credence to those forecasting a soft landing for the economy. The Canadian economy has added 290,500 jobs year to date (to June 2023), and the unemployment rate of 5.4%, while above the cycle low of 4.9% reached in July 2022, is still below the pre-pandemic average of 5.7%. In the U.S., the unemployment rate of 3.6% (June 2023) is still below the non-accelerating inflation rate of unemployment (NAIRU) of 4.42% (source: U.S. Congressional Budget Office (CBO), The 2023 Long-Term Budget Outlook. June 2023).

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This tightening cycle has been focused on taming inflation at all costs, an approach that has largely had the desired effect. June CPI data brought further welcome news — the year-over-year headline CPI in Canada stood at 2.8% in June and 3.0% in the U.S. Having peaked in June of last year, headline inflation now appears to be approaching the central banks' 2% target. On the inflation front, core Personal Consumption Expenditures (PCE) inflation — the Fed's preferred gauge of underlying price pressures —softened in June and on an annualized basis is below the Fed's 2% target and softer than the Fed's 2023 median forecast of 3.9%.

Other economic factors in both the U.S. and Canada that point to a soft landing, include robust retail sales and no significant rise in bankruptcies and delinquencies, as well as buoyant consumer confidence. In the U.S., the housing market is in good shape, helped by limited supply, especially in existing homes. Housing prices are increasing, and demand remains strong as reflected in housing starts, housing permits and the confidence expressed in the homebuilders' second-quarter earnings conference calls. Demand has proven strong across the different buyer cohorts, from active adult to the more rate-sensitive, first-time buyer.

The Case for a Hard Landing

It has been a long time (a lifetime for a portfolio manager) since the tightening/easing cycle has been reflective of an economic cycle and not a credit cycle. In 2008/2009, the economic crisis was credit-driven, attributable primarily to the collapse of the subprime mortgage market and its knock-on effects in the financial industry. The 2020 crisis was not reflective of a traditional economic cycle in the sense that the pandemic shutdowns caused an abrupt halt to economic activity and liquidity which resulted in a brief credit crisis.

Currently, we are in an economic cycle and longtime industry experts may recall that economies often pass through a soft landing on the way to a hard landing. We may currently be experiencing the calm before the storm. In fact, several leading economic indicators are pointing to late cycle vulnerabilities. As illustrated in the table below it can take a significant amount of time between when an indicator hits the recessionary trigger point and when the recession actually occurs.

Table 1. Economic Indicators and Time to Recession Levels

This table outlines the average lead time of various economic and market indicators from trigger point to recessionary outcome for prior U.S. recessions (as defined by the National Bureau of Economic Research from 1979 onwards: July 1980 (1980/Q3), November 1982 (1982/Q4), March 1991 (1991/Q1), November 2001 (2001/Q4), June 2009 (2009/Q2) and April 2020 (2020/Q2)) (source: U.S. Business Cycle Expansions and Contractions).

Category	Datapoint	Trigger	Lead Time to Recession
Labour Market	JOLTS Job Openings	Peak	12 months
Housing Market	Residential Fixed Investment	<-10% YoY change	6-12 months
Business Outlook	Philadelphia Fed Manufacturing Business Outlook Survey New Orders	12m MA below 15	9-12 months
Composite Leading Indicators	Conference Board Leading Indicator Index	2 Negative YoY % Prints	12 months
Financial Liquidity	Senior Loan Officer Opinion Survey (SLOOS) on Bank Lending Practices	Lending Conditions Tightening	9-12 months
Monetary Policy	Central Bank Policy Rate	Pause in rate hikes	6 months
Corporate Earnings	National Income and Product Account (NIPA) Profits	Peak	12-24 months
Stock Market	Valuations (S&P 500 Returns)	Peak	6 months
Corporate Bonds	Credit Spreads	Begin to widen	12-15 months
Interest Rates	Curve (2y minus 10y yield)	Inversion	13-22 months
Interest Rates	Curve (2y minus 10y yield)	Steepening	1-2 months

Source: Beutel Goodman, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Federal Reserve Bank of Philadelphia, The Conference Board, U.S. Federal Reserve, S&P Global, Bloomberg L.P.,

Late Cycle Vulnerabilities

The hard-landing camp is pointing to indicators such as the yield curve inversion, tightening lending conditions, declining savings rate, manufacturing indices in recession territory and eroding business confidence as evidence of an impending recession. There is substantial precedent for this.

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For instance, every recession in the U.S. from January 1955 to February 2018 was preceded by a yield curve inversion (source: Bauer, Michael D. and Mertens, Thomas M. "Economic Forecast with Yield Curve" Federal Reserve Bank of San Francisco, March 5, 2018). The length of time from inversion to recession varies significantly but has usually been about two years. With respect to business confidence, the S&P Global Purchasing Mangers' Index (PMI) US Manufacturing Output Index for June 2023 highlights that business for the year-ahead is now at its lowest level for the year. In addition, the latest GDP print in the U.S. indicates that the pace of consumption slowed. The consumer could finally be running out of pent-up discretionary spending following the COVID-19 lockdowns, which has blunted the impact of higher interest rates. Given the speed of this tightening cycle, though, the impact of higher interest rates on mortgages and consumer loans have yet to be fully felt. Recall too that student loans in the U.S. will need to start being paid back in late August and in Canada the payment forgiveness on the Canada Emergency Business Account (CEBA) loans expires at the end of 2023.

From the corporate side, earnings growth is contracting. For the S&P 500 Index, earnings on aggregate declined by 2.8% in Q1/2023 and are down a further 1.9% in Q2/2023 (with 333 of 418 companies reporting as of month end). In Canada, earnings for companies in the S&P/TSX Composite Index declined by 15.0% in Q1/2023 and 39.9% so far in Q2/2023 (with 67 of 228 companies reporting as of month end), according to Bloomberg.

In Canada, the housing market is exposed to interest rate risk and has the potential to limit economic growth across the board. The country experienced a boom in home sales during the early years of the pandemic, a time when interest rates were historically low. Many of those homebuyers will need to refinance their mortgages in 2025/2026, and with higher interest rates, monthly payments are expected to jump significantly. This could swell the ranks of the "house poor," which would have implications for consumer sectors.

Lingering effects of the pandemic may also be pushing out the timeline for a recession to occur. Excess savings has prolonged consumer spending power. Business under-investment and supply-chain disruptions have delayed the impact on supply responses. Companies that were scrambling to add workers following the pandemic may now be labour hoarding, thus delaying the impact on the unemployment rate.

Market Implications

It may be too early to tell if the outcome of this tightening cycle will be a hard or a soft landing, but the outcome has significant implications for markets. Equity and credit markets appear to be pricing in the soft-landing scenario. Stock markets continue to be strong, with the S&P 500 Index (USD), Dow Jones Industrial Average (USD) and S&P/TSX Composite Index (CAD) up 20.7%, 8.6%, and 8.4%, respectively, in the year to date (as at July 31).

In Canada, credit spreads have tightened by 19 bps, while U.S. investment grade and high yield

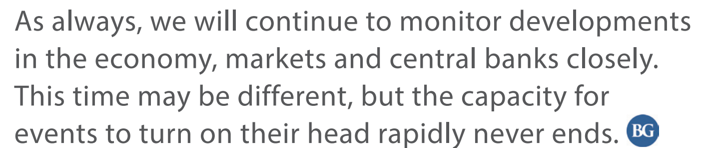
credit spreads have tightened by 18 and 125 bps, respectively over the same year-to-date period. Conversely, the rates markets in Canada and U.S. are both signalling rate cuts by the central banks starting in 2024, implying that the economy will need less restrictive monetary policy.

Outlook and Portfolio Positioning

Part of our risk-management process is to exercise caution, constantly questioning our assumptions. In our view, it is always best to plan for a host of potential outcomes and temper our positions. Our current base investment case therefore assumes that the soft landing is elusive, and the economies in Canada and the U.S. will experience mild recessions.

Given this outlook, we are maintaining a long duration position in anticipation of yields declining to neutral levels over the next six to nine months. Although the economic picture has improved somewhat, we remain defensive on credit, favouring liquid safe-haven assets in the Utilities and Infrastructure sectors, as well as Canadian banks. Focusing on liquidity should help us to take advantage of relative value opportunities in credit as they arise.

As always, we will continue to monitor developments in the economy, markets and central banks closely. This time may be different, but the capacity for events to turn on their head rapidly never ends.



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