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WEALTH MANAGEMENT

Prepare For Landing Or Brace For Impact?

Newsletter, October 2022

"Let's have no illusions. We are in rough seas."
Antonio Guterres (1949 -), current Secretary-General of the United Nations

It was 1985, and I was on a Swissair flight to visit some friends in Chicago. We were making our final approach to O'Hare International Airport on a clear summer afternoon and just as we were about to touchdown, the engines suddenly went full thrust, causing an intense rumbling sound and vibrations that sent our Boeing 747 behemoth right back into the sky. A few minutes later, as we started gaining altitude, the captain made an announcement apologizing for the commotion and went on to explain the cause. The plane that had landed before us had not cleared the runway, which meant that our captain had to make a split-second decision to abort the landing in order to avert a potentially catastrophic accident.

The pilot was clearly more than experienced and fully trained to handle such situations and the maneuver itself was well within the plane's performance and tolerance specs, but how much of a risk we were exposed to at that moment in time is impossible to say. It is impressive to note the rarity of catastrophic incidents, considering the roughly 15,000 planes in the air at any given time[1], a figure that has constantly been growing over the years, as more planes come into service than are retired. This is a true testament to the immense technological progress and the effects of imposing more rigorous standards and regulations on the aviation industry.

Economic cycles are also like the various phases of a plane's journey. The "expansionary" phase of an economy is like a plane that is taking off and gaining altitude until it reaches cruising level. In an economic cycle the first phase of expansion is in an accelerating manner, before it reaches its peak and continues expanding in a decelerating manner. At some point the expansion itself ends, which is akin to the plane touching down. In a "soft landing" scenario, the economy skips recession altogether. Through a careful maneuvering of the central bank, the economy avoids overheating, continues expanding, but at a decelerating pace, until it reaches a point where it begins to accelerate again. This is also like the "no landing" scenario I described earlier, where the plane aborts the landing.

In a "hard landing", the economy has been overheating sufficiently that the only way to reverse course will require aggressively slamming on the brakes. Because economies tend to react to actions with great lags, the central banks are left guessing on when to pull the foot off the brakes, which is why hard landings more often than not lead to recessions, which are defined as periods of contraction, where the economy is literally shrinking. The "hard landing" is exactly what all central banks try to avoid or, at the least, diminish its impact. In other words, there are different degrees of "hard

[1] https://www.travelandleisure.com/airlines-airports/number-of-planes-in-air

landings". These range from the relatively mundane ones that cause mild recessions and the more serious ones that lead to deep, "great depression" type contractions.

Hard landings are like crash landings in aviation parlance, where the plane sustains some form of structural damage. If we translate all this in terms of the present economic circumstances, the current phase we are in is one of economic deceleration. Some pundits have argued that we are already in a recession[2], although it is impossible to know for sure, if only because of the huge lag between the "event" and the measures that confirm its occurrence. What makes the present cycle so particular is that the current phase began with the pandemic-driven sudden spike in inflation. Central banks were caught off guard, because they treated the supply shock as a one-off event with a very short life span.

What they certainly didn't see coming was a second phase, driven by an unrelated event, causing price pressures to rise further and well beyond the expected time frame. In other words, the economy began overheating and by the time central banks became aware of this, they had no choice but to apply the brakes. Even if we should be bracing for a crash landing, we don't really know for sure how things will unfold, mainly because the forces driving this cycle are unlike anything we've seen in the past, which means that there isn't a lot we can draw lessons from. Still, there is always a possible, if improbable chance that the recession ends up being a mild one.

At the end of the day, it is sentiment that determines the ultimate trajectory of both the markets and the economy. Until recently sentiment was firmly anchored on expectations that the turbulent conditions were a temporary matter that would subside, as supply chain problems resolved themselves and consumption demand became less skewed than during the peak of the pandemic. The resilience of price pressures and a Fed that has been taking on an increasingly hawkish stance has clearly changed all that. As the plane approaches its runway, the sudden appearance of dark clouds promises to make the remaining leg of this journey anything but smooth, and even if a crash landing can still be averted, the markets seem to be preparing the terrain for one.

Where Do We Go From Here?

Volatility has risen substantially, reflecting a marked shift in sentiment from tepid optimism to a growing sense of pessimism on the outlook, as the risks of a protracted period of higher prices begin to sink into the mind of investors. The stunning reversal in the direction of bond yields over the last couple of months and its seemingly relentless momentum is also causing a lot of turbulence for the markets, as increasingly attractive yields from bonds is sucking the oxygen of almost everything else out there. The strengthening dollar is also adding further fuel to the bonfire with shockwave effects on emerging markets with high dollar borrowings and the more advanced economies that are being squeezed by higher import prices and rising borrowing costs.

The sudden, sharp rise in interest rates caught investors by surprise, causing a marked increase in correlations between asset classes, leading to losses for even the more properly diversified investment portfolios out there. Bond markets also suffered sharp corrections and continue to do so as yields keep rising, sending their prices tumbling down. Stocks sustained sharp corrections across the board as dividend yields became less attractive than those of bond, and as input costs continued to soar whilst the global slowdown weakened demand further, squeezing profit margins to a point where the higher-than-average valuations began to stick out like a sore thumb.

The rising interest rates also caused a drag on other asset classes such as gold, that tends to perform well in times of acute uncertainties, but that has lately lost part of its luster as it competes with income generating bonds and the effects of a strengthening dollar. Its negative economic impact also became more pronounced, creating headwinds, for example

[2] https://www.forbes.com/advisor/investing/are-we-in-a-recession/

through diminishing demand for housing and curbing capital expenditures, as borrowing costs continue to rise. An increasingly volatile proxy war between Russia and the west, major energy supply uncertainties as winter approaches, rising food insecurities in a growing number of emerging market countries with fragile economies and the troubling emergence of a more hard-core brand of populism spreading across the European continent is pushing the world towards the brink of the next major crisis.

As inflation becomes "stickier", the window of opportunity for a "soft landing" diminishes, which also means that the risk of global recession rises. Years of inflation-free economic expansion appears to have blunted the vigilance of policymakers, making them sufficiently complacent that they are now having to play catch up. It has become a race against time, a challenging situation of having to engineer a "safe" landing with far fewer tools at our disposal. The clock is ticking, the ball is rolling, it is going to be a fine line between averting additional overheating which risks causing greater economic damage down the road, and engineering a recession that is sufficiently shallow to limit the damage.

This is clearly not the first time that we face such formidable challenges. Indeed, history is replete with examples of potentially major catastrophes being averted at the eleventh hour and it is more probable than not that we come out of this one relatively unscathed. Still, just as can be seen in any gaussian probability distribution curve, you always have the tails to contemplate with, even in those cases where they aren't pronounced[3]. The fact remains that these improbable "black swan" events are there and have the potential of causing a lot of harm. Think of a plane with its oxygen masks and inflatable vests tucked under the seats. Even if it is unlikely that either will ever be used over the entire service life of the plane, it is always better to be prepared for such eventuality than to be sorry.

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[3] https://en.wikipedia.org/wiki/Fat-tailed_distribution