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## Europe: Recession versus Stagnation

In recent weeks, the market's focus has started to shift away from high inflation in developed market economies, to the possibility of a broad-based recession. Risk assets remain under pressure as the rationale to hold long risk positions continues to deteriorate. Looking back on recent years, the market tends to think that a recession is imminent to justify poor risk asset performance. The most notable examples of this were 4Q15-1Q16 and the 4Q18 period. Worth pointing out that the only time the world went into a recession post-GFC, was in fact at a time when no one was concerned about such a scenario (i.e., before Covid).

When we think about the market going forward, there are two distinct scenarios under which we can perhaps witness a recession:

1. **Extreme central bank hawkishness:** If developed market central banks prioritise bringing inflation down over prioritising growth, by changing interest rates, it is possible to imagine a scenario where central banks tilt the world into a deep recession in an unsuccessful attempt to manage inflation. The main reason for this is because a lot of high inflation prints exist due to high energy and commodity prices (particularly in Europe), which interest rate changes cannot resolve.
2. **Russia cuts off gas to Europe:** If Russia decides to pre-emptively cut gas supply to Europe, the region will go into a recession. Germany, as one of the biggest importers of Russian gas, could see its GDP decline anywhere from 2% to 5% in such a scenario. Further, if Germany is in recession, it is certain that all other European Union countries would be too. However, it's worth pointing out that in this scenario, what we would see is a regional as opposed to a global recession, as it seems unlikely that the US or China would be materially affected.

In terms of central bank reaction function, we think that despite their hawkish rhetoric so far, when faced with a decision to choose between inflation or growth, central banks will eventually choose growth. Forcing an economy into a deep recession will go against any central bank's medium-term objective of controlling inflation. If the ECB, for example, forces Europe into a recession by raising interest rates too high, the region would consequentially require a significant fiscal and monetary response. As for the US, we think the Fed is likely to try and get the Fed Fund rate to around 2.5% as quickly as it can, and there is no reason to think that the US won't be able to handle such a hike.

As for the possibility of a European recession due to Russian gas cut off, important to keep in mind that a Russian gas cut off is one of the few scenarios from which we would see a sizeable fiscal response across Europe. In such a scenario, it is likely that individual countries would use the Covid playbook and try and use their government balance sheet as a way to protect the consumer and corporate balance sheet. The response on the individual state level has the potential to be very swift. We also think that there would be a Europe-wide response, not dissimilar to 'Next Generation EU' response to the Covid crisis, however this might take a few more months to finalise.

Absent the above two scenarios, we struggle to think that world economy in its current "steady state" is veering towards a meaningful recession. Our view from the start of the year has been that with the fiscal impulse fading across the DM world, growth is likely to be anaemic in Europe and even in the US and thus the environment we are facing is one of stagnation rather than a deep recession.

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