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Insights: Three scenarios for 2023
November 2022

Three plausible scenarios – and what that means for your assets in 2023.

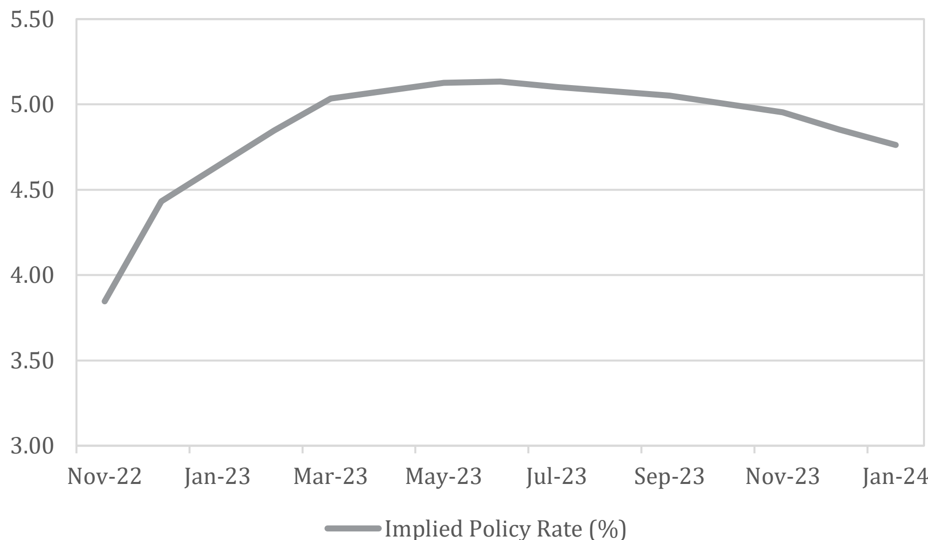
The US Federal Reserve hiked by another 0.75% at its November meeting. There has been a remarkable amount of tightening in a short period of time. Equities and rates markets are now pricing a short, shallow US recession place next year. In this Insights piece, I show why this is not inevitable – and what a range of plausible scenarios means for diversified portfolios.

Three plausible scenarios

The Fed wants restrictive for an extended period. The message is clear. But the range of plausible economic and market outcomes is wide. Here are three plausible scenarios:

Short shallow recession: In this scenario, the Fed hikes too far, too quickly, and is forced to cut rates almost immediately after reaching the terminal rate. Right now, that is priced to be above 5.00%, with around 0.50% of rate cuts over the following six months.

Chart 1: Rates markets expect a recession early in 2023.



Source: Bloomberg LP, Oreana

Painful, non-linear recession: Recessions tend to be non-linear. Economic contraction and collapsing sentiment reveal unexpected economic vulnerabilities. In this scenario, poor credit quality and rising rates gives way to a credit crunch, with a deeper, more painful recession.

Extended pause: The Fed has historically paused for a long period of time after reaching its terminal rate. This tends to extend the economic cycle. In this scenario, growth slows but remains positive, while core inflation falls below the Fed Funds rate.

Table 1 below shows the impact on economic and market variables over the next 12 months.

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Table 1: Three scenarios for the next 12 months.

	GDP	Inflation	Fed Funds rate	Equities returns	Treasuries returns
Short shallow recession	⇩	⇩	⇩	⇔	⇧
Painful, non-linear recession	⇩⇩	⇩⇩	⇩⇩	⇩	⇧⇧
Extended pause	⇩	⇩	⇧	⇧	⇧

Source: Oreana

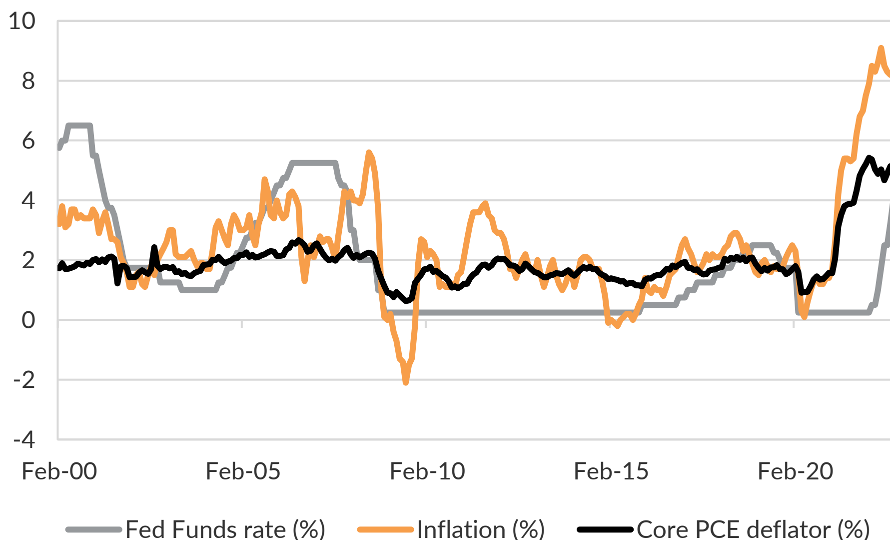
Is a recession inevitable?

If we have a recession next year, it will be the most anticipated recession in living history. US rates markets have certainly priced a recession. US equity markets have priced a recession. But while the Fed is talking tough, their historic reaction function suggests a recession early next year is avoidable.

We do not think so.

The Fed historically has hiked rates above core inflation. Right now, core PCE inflation is still above the Fed Funds rate. But by December it is likely the Fed Funds rate will be above core inflation. And by end-January, we expect core inflation will certainly be below the Fed Funds rate.

Chart 2: Core PCE inflation is above rates, but not for long



Source: Bloomberg LP, Oreana

And so, the Fed will pause. And that pause will last for at least six months. Possibly 12 months. Interestingly, Fed Funds futures 12 months from now are well above market pricing for inflation in 12 months from now. The

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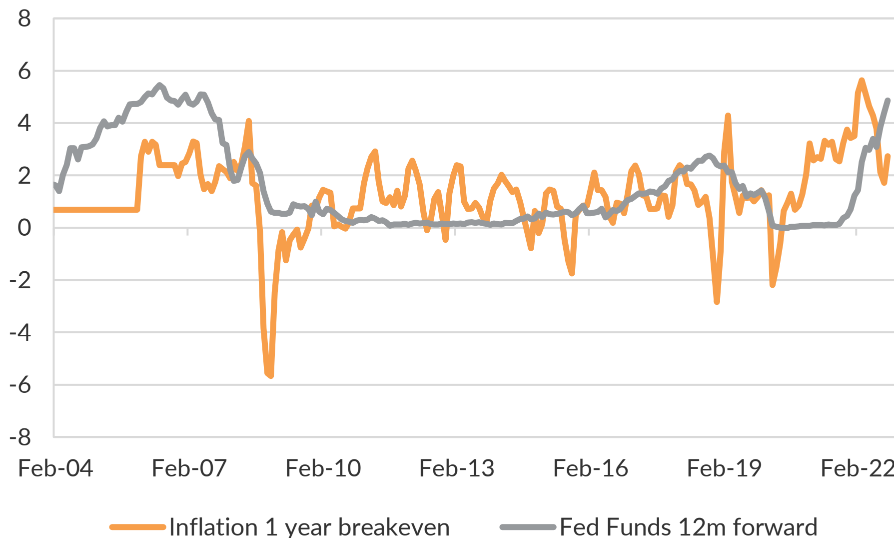
market is screaming that the Fed does not need to hike to 5.00% - the Fed is already in very restrictive territory.

Chart 3: The market is screaming we are in restrictive territory



Source: Bloomberg LP, Oreana

What does this mean for economics?

US growth is going to slow. US inflation is going to slow. We think disinflation or outright deflation is a bigger concern over the next 12 months. The different scenarios painted above differ only to the extent of that slowdown.

The interesting differences come through the Fed Funds rate. In the extended pause scenario, the Fed Funds rate is higher in 12 months than it is now. But if the Fed hikes too far, too quickly, we expect the Fed Funds rate will be either below its current level (a short shallow recession), or a long way below its current level (a painful, non-linear recession). Both of these scenarios destroy the Fed's credibility. We think that adds weight to the extended pause scenario.

What does this mean for assets?

All of the plausible scenarios are positive for Treasuries returns. In the recessionary scenarios, government bonds will provide critical downside protection for investors. We recently moved our rating for US (and Australian) government bonds to Moderately Attractive. That rating was at Highly Unattractive at the start of the year.

The outcome for equities is more nuanced.

A short, shallow recession could result in 10-15% falls from current levels. But 12 months from now, we think the recession would be over, rates would be lower and equities would be rallying – and potentially be higher than current levels.

A painful, non-linear recession could result in 10-20% declines from current levels. And the recession could last longer than markets currently have priced. In that case, we expect equities would be below current prices.

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An extended pause is not priced in equity or rates markets. Slower growth next year will slow earnings, but we expect earnings would outperform current low expectations. And that leaves upside from current valuations.

What can I do in my portfolio?

The Fed's most recent meeting bolstered the consensus view that we are marching into recession early next year. We do not think so. Even so, scenarios are a useful tool for investors, and actions will depend on your starting point.

Oreana Portfolio Advisory Service has been working with investors to build investment solutions that deliver through the cycle -whether they are implemented via model, SMA or MDA. We have a range of managed account solutions available – and can help build bespoke solutions – get in touch with us for more information.