Insights
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Why revisiting scenarios now is important for investors.

Global central banks are either at the end of their rate hike cycle, or near it. The US Federal Reserve, the European Central Bank, the Bank of England and the Reserve Bank of Australia are probably set to leave rates unchanged at restrictive levels for some time. Historically, the end of a rate hike cycle gave way to recession within 6-18 months. The consensus now expects this time to be different. A soft landing is expected, where recession is avoided. We prefer not to have to rely on the argument that this time is different. Instead, we have relied on our scenario analysis to ask how the global economy may unfold over the coming 18 months, to guide our investment decisions.

We have built three scenarios that are plausible.

Table 1 below shows three scenarios that we think are plausible. The recession scenario describes a typical recession that has historically followed the end of the rate hike cycle. We think it is the most likely outcome over the coming 18 months. The extended cycle is the soft-landing consensus. We are sceptical that this can be achieved, even though we hope central banks can side-step history and manage to avoid recession. The productivity boom scenario acknowledges the recent AI frenzy, and imagines a world where years of poor developed-world productivity is reversed as a function of the AI revolution.

Table 1: Three plausible scenarios for investors.

Scenario	Recession	Extended Cycle	Productivity Boom
GDP	Recession that lasts for most of 2024	The Fed achieves a soft landing as inflation slows back to trend in 2024	AI boosts productivity, allowing trend GDP growth to move higher
Inflation	Disinflationary pressures with a medium-term recovery	Disinflationary pressures give way to within target inflation over the medium term	Productivity boom allows wages to grow without a meaningful increase in inflation
Monetary Policy	Rates are cut abruptly by up to 5% and left at lower levels for up to 1 year	Rates remain elevated for most of 2024 then are cut back to neutral	Rates remain elevated for 2024 before being cut back to neutral
Medium-term market impact			
Equity Markets	Average annual returns are very low relative to history	Returns are in line with historical outcomes over the medium term	Average annual returns are higher relative to history as earnings growth is boosted by margin compression and sales
Sovereign debt	US Treasury yields fall sharply offering solid returns	US Treasury yields remain elevated compared to recent history before normalising in 2025	US Treasury yields remain elevated compared to recent history before normalising in 2025
Corporate Credit	Credit defaults spike in lower credit grades, before credit spreads narrow gradually	Credit spreads remain near tights as defaults are manageable and low	Credit spreads narrow to historic tights.

Use data to gauge the likelihood of each scenario.

We do not know with any confidence the probability of each scenario being the right scenario. And these scenarios may sit on the same or different probability distribution,

making quantitative modelling difficult. So rather than assign probabilities, we have focused on a series of data that can help gauge which scenario is relatively more likely.

We can Bayesian update these relative likelihoods to reflect that new information in real time. Table 2 captures the data we are focused on.

Table 2: Key economic indicators to gauge the likelihood of each scenario.

Data	What matters?	Assessment
US PMIs	Is the economy close to recession – i.e below 45	The PMI is below 50 but above 45 – this suggests below trend growth but no recession yet
US Jobless Claims	Is jobless claims rapidly increasing above 250k-300k	Jobless claims have been low at around 200k – indicating recession remains some time away.
US Treasury Yield Curve	Is the yield curve normalising back towards zero from deeply negative	The yield curve has normalised to -0.72% from -1.08%. This is concerning but not indicating recession yet.
Oil prices	Are production cuts pushing prices higher or is weaker demand limiting price increases	Oil prices have climbed steadily back to USD90/bbl as production has been cut. Demand is holding up.
Corporate defaults and downgrades	Are defaults and downgrades on the rise	Defaults and downgrades are trending higher, which is a worrying development.

Markets are priced for perfection, not for risk.

Equity markets have driven higher in recent months. But they are not discounting the risk of earnings or an economic recession. Multiples look stretched and vulnerable to re-rating in the case of a sudden economic slowdown. With PMI's trending lower and corporate defaults and downgrades ticking up, risks are to the downside and equity investors may be punished if earnings miss expectations.

Current credit spread levels do not compensate investors for the growing risk of credit rating downgrades and defaults. This is especially the case in the lower high yield credit universe. Investment grade may remain somewhat insulated. But credit quality in investment grade has also deteriorated over recent years and we think there is risk of spread widening. That leaves significant downside risk to total returns in the near- to medium-term.

Government bonds are priced for 4 rate cuts next year – which is in line with a soft landing. The yield curve has steepened in recent months. Historically, a normalization of the yield curve from inversion has coincided with a recession. That leaves government bonds vulnerable to a rapid repricing of rate cuts to a more typical recession. In a recession, central banks cut rates dramatically, with government bond yields typically falling at a similar rate.

How can we use scenarios to manage portfolio risk?

Given markets are already priced for the soft-landing consensus, the risks are that it is disappointed. We can use these scenarios to manage that risk.

Equity markets are priced for the soft-landing scenario. They are probably also priced for the productivity boom scenario, given the rapid run up in AI related equity prices.That suggests treating equity risk with caution, and adopting a bias to reduce risk into equity market rallies.

Credit risk is similarly priced for both the soft landing and productivity boom scenarios. We suggest taking short spread duration against the risk these expectations are confounded.

Government bond yields are elevated and offer good income. They are likely underpricing the likelihood that the Fed cuts rates next year – even in the soft landing scenario and productivity boom scenarios, inflation will slow allowing rate cuts. Government bonds look attractive in all three scenarios.

Monitor and act as more information is released.

The outlook is uncertain. We are potentially near the end of the cycle. Scenarios are a useful way to manage portfolios and to understand investment risk and market vulnerabilities. We suggest reviewing these scenarios or considering other scenarios as a sensible portfolio management tool in this environment.

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