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Economic Newsletter

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Potential Disruptors of the Goldilocks Scenario

In economic theory, a Goldilocks scenario is a term used to describe a market environment in which economic growth is strong but not excessive, and inflation is moderate but not too high. This delicate balance creates a situation that is neither too hot nor too cold, but rather "just right". Such an environment can be very attractive to investors, as it provides a favourable backdrop for corporate profits and asset prices.

The Goldilocks scenario is often associated with a low-volatility environment in financial markets, as investors are confident that economic conditions will remain stable and supportive of asset prices. However, it's worth noting that the Goldilocks scenario is not always sustainable, and economic conditions can change rapidly. If the economy grows too quickly or inflation rises too rapidly, central banks may respond by raising interest rates to cool the economy, which can weigh on asset prices. On the other hand, if economic growth slows too much, it can lead to lower profits and weaker asset prices.

Current Market Conditions

The existing market conditions exhibit some characteristics of a Goldilocks-like scenario, however, there exist potential risks and challenges that investors should be aware of.

Positively, many countries are experiencing robust growth and falling unemployment rates. Corporate profits have been strong, and stock markets have rebounded strongly from their pandemic lows. Our own local equity market reached an all-time high towards the end of January, delivering welcome returns to South African investors.
Conversely, several potential risks and challenges may pose a threat to the Goldilocks scenario. High inflation, supply chain disruptions, and labour shortages have led to cost pressures and higher prices for goods and services. Central banks have responded by adjusting monetary policies, leading to higher interest rates and a more challenging environment for investors.

In a recent Stanlib Roadshow, Chief Economist Kevin Lings outlined three market scenarios which need to take place in order to engender a Goldilocks-like market environment, that is, an environment that is not excessively hot or cold:

1. US Inflation falls
2. Interest Rates are cut in this year
3. The Global Economy avoids recession and experiences a soft landing

Should all three of the abovementioned scenarios marterialise, the Goldilocks scenario will play out and investors should increase their risk exposure and buy the market.

1. Falling US Inflation

The only scenario currently unfolding in markets that is required for the Goldilocks economy is decreasing inflation in the US. US inflation rates have peaked and are on a downward trajectory, currently at a level of 6.4%, down from a high of over 8% in mid-2022.
Despite the success of the US Federal Reserve in directing inflation towards the desired trajectory, the current inflation level still far-exceeds the preferred target of 2%. The current decrease in inflation rates can be attributed, to a significant extent, to the base effects stemming from the

elevated inflation levels observed during the latter half of 2022. Economists have expressed doubts, however, that this alone will be sufficient to bring inflation down to target. If inflation persists above the 2% threshold, the Federal Reserve will be compelled to continue increasing interest rates, or at the very least pause its interest rate-hiking cycle in an effort to tame the inflation reading.

2. Interest Rates are cut in this year

The prospect of this scenario occurring in 2023 appears to be diminishing, owing to various factors. The most significant of these, as noted above, is the persistent issue of elevated inflation rates in the United States. If the Federal Reserve were to lower interest rates prematurely, it would run the risk of doing so before the inflation situation is fully contained. Such an action could trigger a resurgence of inflation, thereby necessitating a second round of aggressive interest rate hikes by the Fed. This outcome would have serious repercussions for the global economy and would likely lead to a deep recession.

A more likely outcome, at least for the 2023 fiscal year, is that the Federal Reserve continues to hike interest rates, but at a slower pace (increases of 0.25% as opposed to 0.50%). In the third or fourth quarter of the year, we may then see the Fed pause its interest rate hiking cycle, in order to allow time for the rate hikes to take effect. If inflation remains high the Fed may engage in further rate hikes before pivoting and beginning a rate-cutting cycle.

3. A Soft Landing

A soft landing in markets refers to a scenario where an economy or a particular market experiences a gradual and controlled slowing down of its growth rate, rather than a sudden and sharp decline. A soft landing is generally considered desirable because it helps to avoid the negative consequences associated with a hard landing, such as a sudden and sharp decline in asset prices, higher levels of unemployment, and a prolonged economic recession. A soft landing provides a smoother transition to a sustainable growth rate, giving market participants time to adjust their strategies and avoid excessive risk-taking.

A Fed pause this year would certainly aid in facilitating a soft landing for markets, particularly in the US. Jay Powell, the Federal Reserve Chair, has said that there remains a path to a soft landing but it is a path that gets more narrow the more stubborn inflation proves to be, and the higher the Fed has to push up borrowing costs to quell it. Uncertainty in this regard is common amongst economists. In a further statement, Powell admitted “I don’t think anyone knows whether we’re going to have a recession or not and, if we do, whether it’s going to be a deep one or not”.

Among the three scenarios outlined by Kevin Lings, the first one is presently in progress, while the feasibility of the second seems relatively low, and the last is enigmatic at present. Given these circumstances, it seems likely that markets will continue to exhibit instability and unpredictability throughout 2023. It is worth noting, however, that the Goldilocks scenario (or lack thereof) is not a fixed state, but rather a dynamic equilibrium that can shift over time. As a result, investors should remain vigilant and monitor economic and market conditions to identify potential risks and opportunities. A diversified portfolio that can withstand a variety of market scenarios can help investors navigate changing market conditions and avoid the pitfalls of relying too heavily on a single scenario or asset class.