Blog

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Five years on - where do we stand?

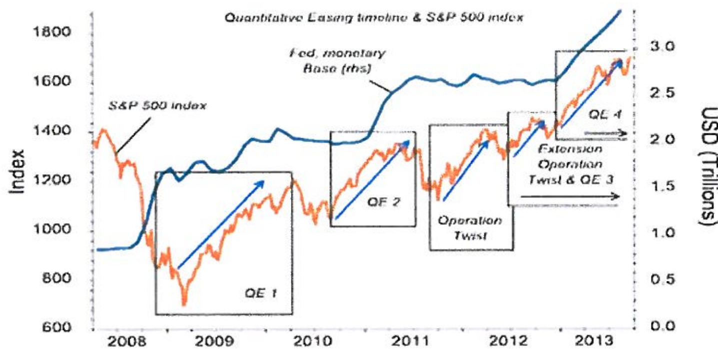
Great Recession, sub prime, financial crisis, debt problems, developed countries, bullish nature, equities, graph

In the aftermath of the "Great Recession" triggered by the sub-prime financial crisis, markets have generally been bullish since early 2009, with the equity market bullish for five years now. Over this period, the financial market landscape has been punctuated by the debt problems of many major developed countries. Indeed, debt is the one common factor colouring this landscape, whether it be over-indebtedness of the private sector or the increasing debt load taken on by governments to reflate economies and avoid a major economic disaster. "Inflate or die," as one market sage has put it.

The proliferation of debt or credit has been instrumental in the spurt of economic growth experienced over the last number of decades, a fact that is unprecedented in history. However, global interconnectedness and interdependence meant that the unsustainable debt or credit growth of the modern economy had to eventually collapse when confronted with defaults. The growing network of global credit markets on the back of increasing globalisation implied that any disequilibrium or instability in these markets risked a domino effect across the credit spectrum. Events since 2008 bear testimony to this fact.

To avert an intractable economic crisis, or potentially a deflationary recession as a result of the debt crises, monetary policy across the globe turned exceptionally easy or loose to try and stem the fallout. To a large extent this has been helpful, and it has certainly helped to drive the bullish nature of the equities market over the past five years, as the graph below illustrates.

Monetary policy has been a main driver of stock market performance since 2009



Source: Thomson Reuters Datastream / ECR

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However, the cost and ultimate implications of this unprecedented monetary and fiscal stimulus are still unknown. Addressing problems in one area, especially through unconventional policy means and interventions, does not mean that the world can circumvent or suspend the imbalances that are being created in other areas of the economy as a result. Central banks, and the US Federal Reserve in particular, are caught in an unprecedented attempt to micro-manage and fine-tune the economy in order to minimise natural economic and market functions and outcomes, especially negative ones. The result is that volatility and normal price determination or discovery are being artificially suppressed ("financial repression"). The suppression of these normal economic forces renders the system more vulnerable to large dislocations in the future as it allows pressures to build beneath the surface.

The impact and consequences of the global financial debt crisis have affected all countries to some extent, and will determine the shape of our collective economic future. It may therefore be useful to assess where we are and what trends or themes are in force or likely over the foreseeable future.

- Data suggests that world demand is picking up and the worst of the downturn in the global economy may be over, albeit still too fragile to be sustained in the absence of stimulus measures.
- The inherent fragility of over-indebted developed markets explains why there has been no strong recovery. That fragility implies that developed market countries are not yet able to weather normalised interest rates or monetary policy and remain vulnerable to shocks.
- For countries like the US, the post crisis/recession economic growth has been the weakest in living memory as nominal GDP growth has averaged just 2.3% in the past five years (the lowest since 1935). This attests to the fact that economic conditions are atypical to that of the normal business cycle experienced over the last three decades.
- Unprecedented and unconventional monetary policy remains a key feature of the current and foreseeable economic landscape. Given the structural issues that would continue to hold back growth, unorthodox monetary policy may actually need to persist or even increase in the years ahead.
- Expanding the prevailing quantitative easing (QE) might not be the answer. The debate could shift to policies that directly target nominal GDP and not just financial asset prices. This would imply a deeper partnership between governments and central banks.
- Despite massive liquidity injections by central banks (notably the US, UK, China, Japan), inflation has remained subdued. The global deflationary or disinflationary backdrop is expected to keep central banks watchful and loose on monetary policy.
- US inflation expectations have been rising somewhat but remain broadly at the lowest level in a quarter of a century.
- Deleveraging (that is the process of debt reduction) is expected to remain a key theme in the face of over-indebtedness.
- The prospect of the Fed tapering its asset purchases has made markets nervous. Now that the Fed has indeed started to taper, markets continue to display uncertainty as they oscillate between "risk-on" and "risk-off" moods.
- Bonds markets turned bearish during 2013. A continued rise in bond yields poses a risk to the sustainability of the improving economic backdrop. Central banks would be concerned if developments on the interest rate front

prematurely jeopardise growth nurtured through massive QE efforts. Furthermore, it remains unknown how the unwinding of QE may ultimately impact economies and markets. If they wobble nevertheless, this will raise some serious questions about the effectiveness of QE in nurturing self-sustaining economic growth in the face of major deleveraging pressure.

- Optimism on global growth has been rising over the last year, especially as leading economic indicators and other signals turned positive. It is worth noting that the market rally has occurred despite all the negative news, fears and uncertainty that prevailed. A key question is whether or not the market has already discounted the best ahead and thus risks turning down despite improving economic conditions.
- While the equity market bull run may continue, it is at a mature stage given historical experience. The median bull market has historically lasted 50 months and on average 67 months (Bull Markets Since 1871: Duration and Magnitude by Tobias Carlisle, greenbackd.com).
- It may be instructive to note that other markets (e.g. bonds and commodities) have not been registering new highs as evidenced in the equities market. Furthermore, developing market equities have generally underperformed relative to developed markets. This is a departure from the case in the preceding cyclical bull market and as such confirms that the drivers of markets are different.

Given these trends and themes, where do we stand five years on? Investors have become increasingly bullish in their outlook on the back of good equity market returns and improving economies. Financial assets, especially stock markets, have been supported by QE. Looking ahead, a virtuous and self-sustaining economic growth cycle has to take root and with it commensurate earnings growth to justify increasing valuations. If these do not materialise, markets risk capitulating in the face of less global liquidity (tapering) and persistent deleverage. In light of the above and the fact that the general outlook tends to become quite bullish towards the end of a market rally, caution is warranted.

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Topics: GREAT RECESSION, SUB PRIME, FINANCIAL CRISIS, MARKETS, LANDSCAPE, FACTOR COLOURING

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