Will we see a rerun of a market meltdown, just like in 2016?

Many observers believe global recession risks are high this year

WireRunner yesterday

Jay Powell, Fed chairman, has compared the current economic situation to that in early 2016 © Bloomberg

The sharp recovery in risk assets in January has followed significant policy changes by the US Federal Reserve, the Trump administration and the Chinese authorities. These actions have reduced the markets' perception of recession risks, even as economic data have continued to weaken.

No lesser figure than the chairman of the Federal Reserve, Jay Powell, himself has compared the current situation to that in early 2016, when a pause in US monetary tightening, and a Chinese stimulus, unleashed a major extension of the equity bull market.

Global equities rose by almost 50 per cent in 2016 and 2017 combined. Could anything comparable happen again?

> ***No one knows whether this year will be like 2016. But we will be prepared to adjust policy quickly and flexibly and to use all of our tools to support the economy should that be appropriate to keep the expansion on track***
>
> ***Fed Chairman Powell, 4 January 2019***

There are certainly similarities between today's global economic situation and that in early 2016. Then, markets were in meltdown because activity data in the US and China were both weakening markedly, deflation risks were intensifying, and the policy response from the Fed and the Chinese authorities was delayed and apparently inadequate. Some important economic forecasters were predicting a world recession within 12 months.

The latest activity data from the US have not yet reached the low points seen in 2016, but China has returned to the lows. Nowcasts for both economies are still falling (see below) and the Eurozone is also plumbing new depths. At Davos last week, the IMF downgraded projections for global growth and warned quite loudly about contractionary forces taking hold.

Deflation concerns are, admittedly, less threatening than in 2016. US inflation expectations have fallen less than they did then. Even in economies where interest rates are stuck near zero, including the eurozone and Japan, the tail risk of deflation has not shown any ominous rise, according to the

inflation swaps markets. Furthermore, China seems much less likely to impart a deflationary shock to world goods prices by suddenly devaluing its exchange rate.

Still, the overall picture for economic growth seems broadly similar to three years ago. Many astute observers, including Lawrence Summers, believe that global recession risks are high, because aggregate demand will ebb away as the forces of secular stagnation reassert themselves.

As in 2016, the outcome is likely to be determined by the response of macroeconomic policy in the US and China, including trade policy, to the weakening in the global economy. To what extent will policy be able to offset the contractionary forces that have taken hold in recent months? The answer depends on developments in three key areas:

1. ***US macroeconomic policy.*** There is little scope for an easing in fiscal policy, since the capacity for stimulus has been more than fully absorbed by the Trump tax package last year. On monetary policy, the picture is more mixed. The positive news is that US interest rates have now returned almost to equilibrium, permitting a decline of almost 250 basis points if needed during a severe economic downturn. Less reassuring is the fact that the labour market is far tighter than it was in 2016, and wage increases are more robust. This will make the Federal Open Market Committee considerably more cautious about extending their pause on rate hikes than they were three years ago. Their hands could be tied if wage inflation continues to climb.
2. ***Chinese macroeconomic policy.*** Successive policy stimulations in China have saved the economy from recession on several occasions since 2008, including in 2016. This time, the fiscal and monetary authorities have acted less decisively to arrest the downturn in activity, because they are giving priority to debt deleveraging and improving the quality, not the quantity, of economic growth. This self-imposed restraint on the size and nature of the recent stimulus has resulted in the latest Chinese

nowcast dropping to below 5 per cent, well below the 6.0-6.5 per cent region targeted for growth this calendar year. In extremis, the authorities could probably boost the growth rate fairly quickly, but this would involve a return to "old China" policies. Their self-denying ordinance in this respect is a meaningful constraint on stimulus at present.

3. ***Trade policy.*** This risk to growth was entirely absent in 2016. Although a further postponement of tariff escalation by the US seems likely at the end of February, more destructive action could emerge at any time from the Trump administration.

Overall, macroeconomic policy therefore seems less well positioned to combat an economic downturn than it was in 2016.

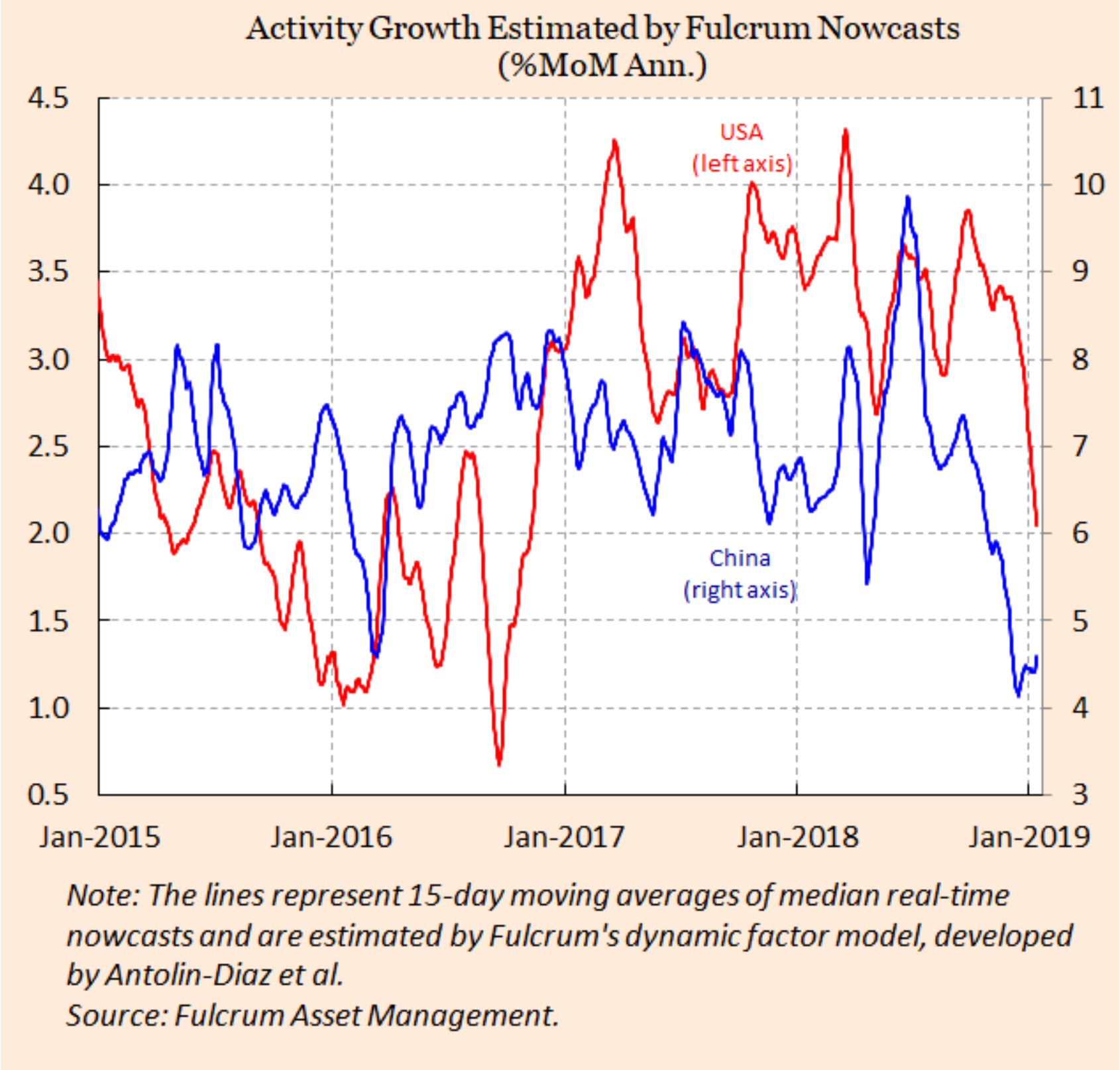
A final reason for believing that a further leg of the great bull market is less likely this time is that market valuations are much more stretched now than they were in early 2016. At that time, the Fulcrum model for US asset prices, which is one way of assessing market "valuation", predicted that three-year forward returns on US equities would be abnormally high at 8 per cent per annum in real terms. This forecast turned out to be in the correct ballpark, over the period taken as a whole.

Now, the equivalent three-year ahead forecast for real equity returns has dropped to only about 3 per cent, reflecting a much higher price/earnings ratio on the S&P 500, and also a rise in the bond yield. Expensive equity markets have less scope for major upside than three years ago.

All these factors will probably prevent a return of the golden period that followed 2016, although a global recession and major bear market are still not the base case .

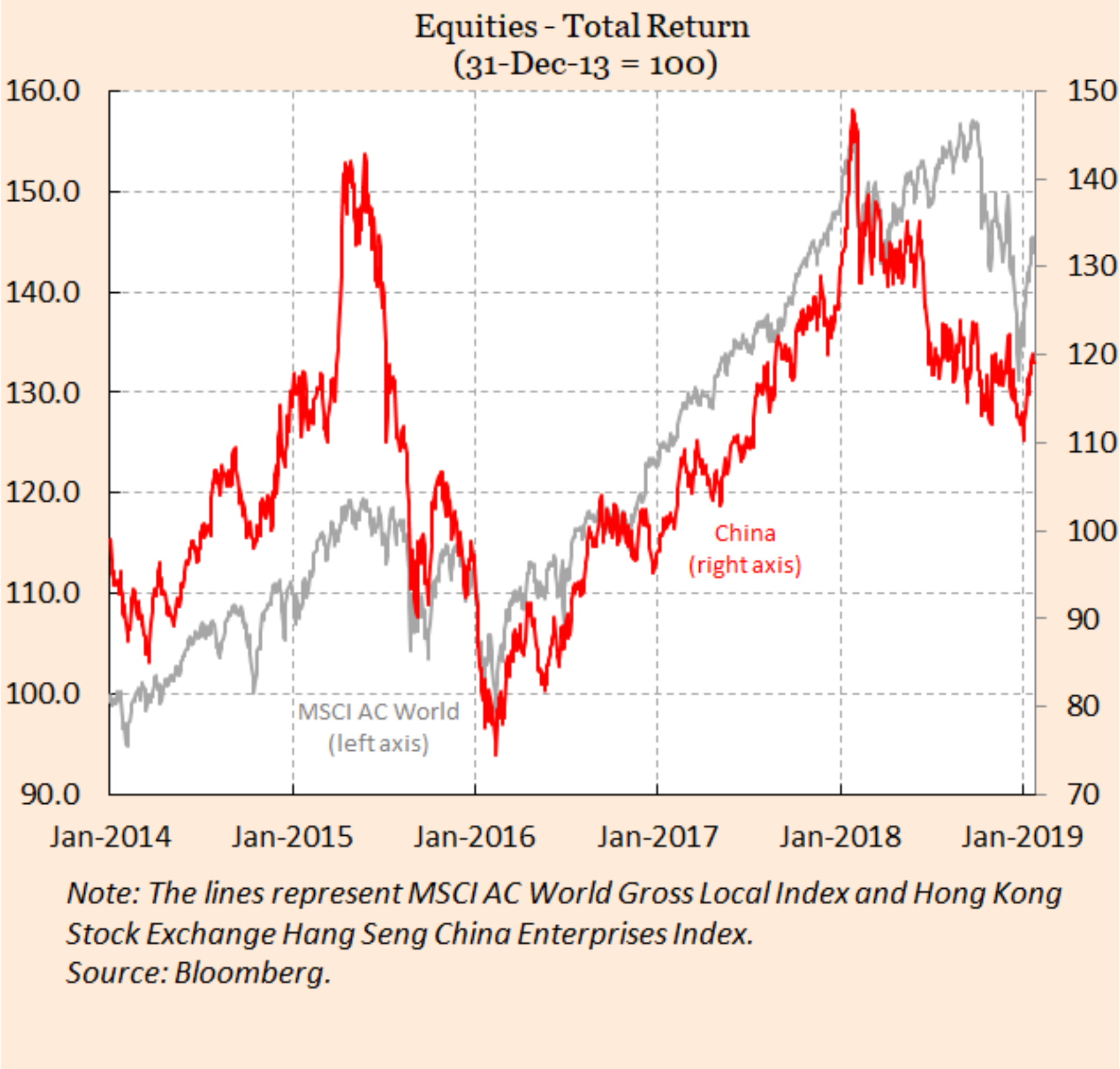
Comparisons between 2016 and 2019

Economic activity in the US has not yet weakened as much as in 2016, but it is still dropping and China is very weak...



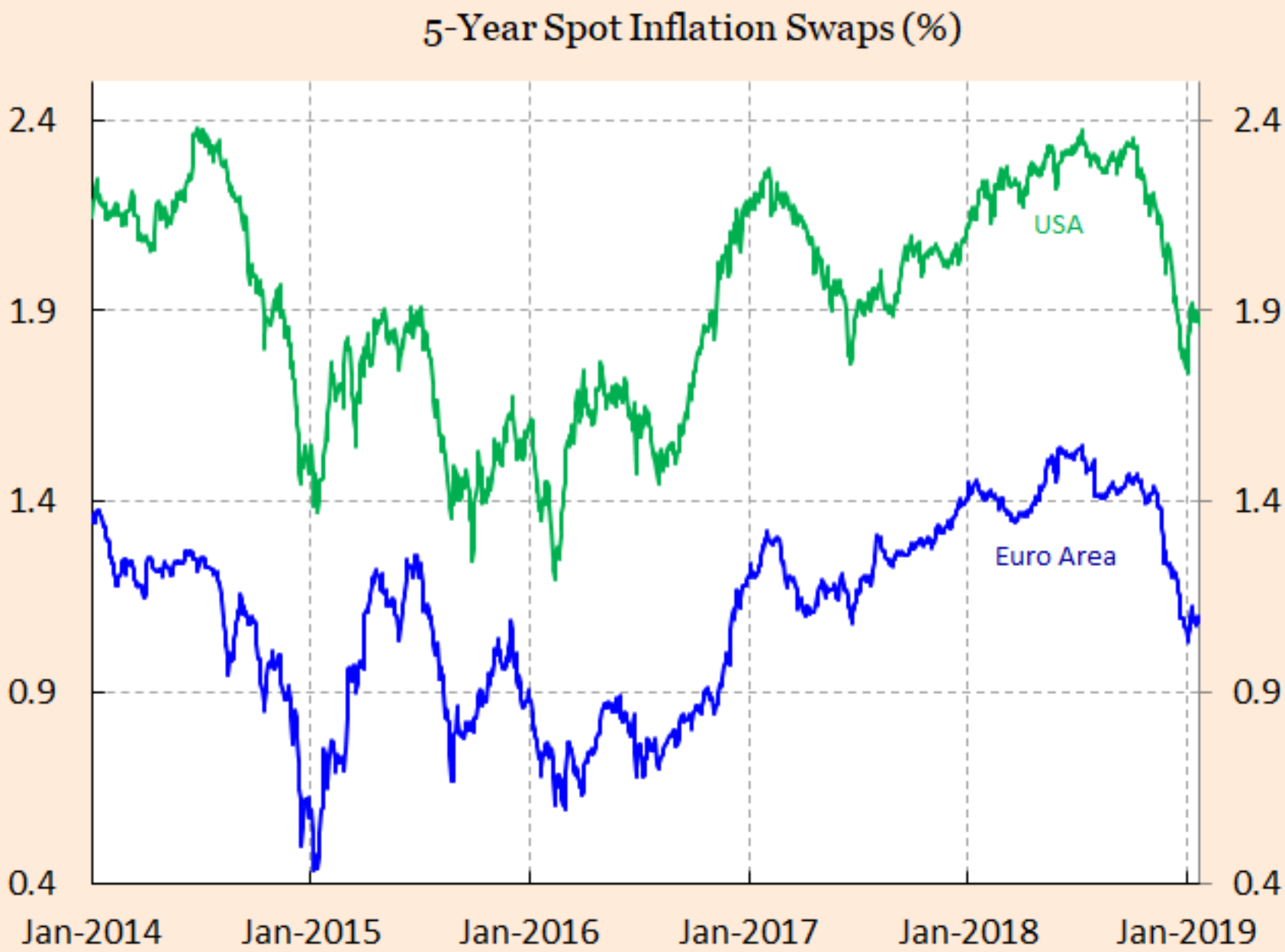
Note: The lines represent 15-day moving averages of median real-time nowcasts and are estimated by Fulcrum's dynamic factor model, developed by Antolin-Diaz et al.
Source: Fulcrum Asset Management.

When policy changed in 2016, the subsequent rise in global equities was very large. However, equity valuations were less stretched then than they are now…



Note: The lines represent MSCI AC World Gross Local Index and Hong Kong Stock Exchange Hang Seng China Enterprises Index.
Source: Bloomberg.

Fears of deflation are not as pronounced as they were in 2016…



The lines represent medium-term inflation expectations.
Source: Bloomberg.