Schroders

Economics

The headaches and the hope among top policymakers

IMF and World Bank meetings send a broadly optimistic message about the economic cycle.

27 October 2017

Huw van Steenis

Global Head of Strategy

There was a spring in the step of the officials and financiers in Washington at the annual meetings of the International Monetary Fund and World Bank.

The economic worries that have dominated recent meetings have faded as the mood reflected the strongest period of synchronous growth this decade. On new IMF forecasts, only 6 of the 192 countries aren't growing this year. The pick-up in world trade supporting emerging markets and corporate investment was particularly welcome.

Despite the positive outlook, there was a general unease about how to reel in easy money and the populist revolt against globalisation. But one question dominated: how late in the economic cycle - and bull market - are we? And what does this mean for policies and portfolios?

For many the starting point is the puzzle of why inflation has consistently undershot central bankers' fair-weather models. A meaningful pick-up in inflation would be very consequential for monetary policy and asset prices given market expectations. Amongst past and present central bankers at a seminar on Rethinking Macro Policy at the Peterson Institute one thing was sacrosanct: the strongly held view that there will be a sturdy trade-off between inflation and unemployment and that inflation will – eventually – pick up. As such, central bankers don't feel they need to adapt their Phillips curve theory to incorporate any deflationary impacts of technology or globalisation. So, the consensus was the Federal Reserve (Fed) is likely to be on "near autopilot" in gently raising rates over the coming years.

As a keen student of emerging market and Western banking crises, I also think it's helpful to focus not just on the length of the cycle - which looks extended on traditional yardsticks with some eight years of growth in the US – but also on how much of the excess capacity and risk averse behaviour created by the crisis has been repaired. Looked at this way, it could take another few years if growth remains slightly above potential to finish this process of repair.

Whether deregulation and fiscal policy could extend the cycle was also much discussed.

Take US financial reform. I was struck how much the US policymakers' thinking has moved since the first US Treasury report on banking was published in June. In part, because the report does not look to roll back swathes of financial regulation but rather to recalibrate rules modestly. Policymakers recognise they need a diverse financial ecosystem and intermediaries which are able to provide liquidity as the Fed exits part of its balance sheet. I came away with even higher conviction that much of the Treasury recommendations which don't require legislation are likely to come through.

The US Treasury reports are also likely to prove a blueprint for Basel and European financial regulation. European central banks will also need a financial system which supports exiting quantitative easing. But this may take several years. Speaking on an International Institute of Finance panel with European policymakers I was reminded how raw the experience of addressing Europe's weaker banks still is. Longer term this is positive for investors and banks.

The lack of volatility in markets is clearly troubling many. Is it a signal of complacency about the cycle? Interestingly it is the banks who are the most worried about this, although it may reflect in part the pain that low volatility is inflicting on their trading units.

The risks most-discussed were policy related. Will geopolitical tensions turn to conflict? Will policy mistakes in the White House hinder the outlook? Would a poorly resolved Brexit create shockwaves? Or would quant meltdowns and cyber risks play havoc on markets? But fat tails are hard for markets to price and asset prices will reflect them if they should come to pass.

No cycle or bull market lasts for ever. Investors will need to weigh risk and reward carefully. But the message from Washington last weekend was optimistic: the growing breadth of global growth, gradualist central bank policies and improving corporate investment are supportive of a longer cycle.

To the extent that you are in North America, this content is issued by Schroder Investment Management North America Inc., an indirect wholly owned subsidiary of Schroders plc and SEC registered adviser providing asset management products and services to clients in the US and Canada.

For all other users, this content is issued by Schroder Investment Management Limited, 31 Gresham Street, London, EC2V 7QA. Registered No. 1893220 England. Authorised and regulated by the Financial Conduct Authority.