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### **“Toward the Mid-21st Century Global Financial System”**

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Prompted by the conclusion of another calendar year and the imminent arrival of a new performance campaign for firms and investors, the peak of annual economic and market forecast season has arrived.

Although aspiring to peer at financial market developments in the day-to-day valleys below from atop the highest mountains, much of our collective thinking will remain short-term oriented.

Let's briefly pause from the digestion of year-end predictions as well as our collective infatuation with short-term “flow” economic, issuer, and market statistics-especially the monthly U.S. employment report, which does not explain all-and highlight some of the longer-term forces shaping the global financial system.

Appearing irregularly approximately once a decade, this happens to be another “Crossroads Interval” for the global financial system. At such intervals, the often-reliable prediction technique of presuming that the near-term future will highly resemble the near-term past may not consistently work, if at all.

The world geopolitical, economic, and market orders all stand at major crossroads in the late Teens.

And the bulk of the economic and market recovery from the Great Recession has concluded.

Business and capital market successes usually are portrayed as a series of superior short-term decisions. This perspective certainly has merit. Unfortunately, long-term prophecy vindication has not spared many a prognosticator from prematurely being carried off the field by impatient associates and clients. For example, the sustained dot.com bubble correction of 2000-2002 gored chronic equity bulls. And perennial bond bears have not fared too well since 2005.

The best decision-makers incorporate a blend of short-term and long-term considerations into their calculus. The real forecasting skill resides in determining the optimal blend between short-term and long-term factors.

This is especially an opportune time to peer beyond the typical year-ahead only proclamations by “Oracles of Conventional Consensus” such as: normalizing central banks; steady-to-slighter higher economic growth; stronger dollar and/or stronger euro; single-digit equity appreciation;



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upward rates drift; investment-grade corporate bonds hurrah; higher commodities; more EM diversification; and eventually rising volatility and inflation.

Exactly a decade has now passed since the U.S. slipped into the Great Recession of 2007-2009. Just as the Great War's conclusion in November 1918 will spark fresh Centennial interpretations of the root causes and aftermath over the coming year, the 10th anniversary of the Great Recession will inspire reflections on the causative instigators and analyses of the consequences.

An abundant literature already has thoroughly catalogued the most conspicuous catalysts for the Great Recession. As with most financial market upheavals, the combination of too much debt and a sudden swoon in animal spirits was found at the epicenter of the Great Recession. The magnitude of the economic and market shockwaves was amplified by inadequate regulatory oversight, compliant rating agencies, the introduction of new financial products like structured credit that were not universally understood, a diminution of prudent risk controls by too many financial institutions in their pursuit of swift profit growth, and the willingness of too many investors to prioritize yield maximization.

The application of standard and exceptional economic policy remedies ultimately arrested this severe recession and helped contribute to modest uplift. Major central banks dutifully lowered interest rates even into negative territory and embarked upon the novel accumulation of debt securities in a demonstration of "quantitative easing." After an initial jolt of fiscal stimulus, many governments, especially in Europe, pursued a less-productive policy of "fiscal austerity."

As the economic floodwaters very gradually receded during the Teens, monetary policymakers have moved into a policy normalization regime. In contrast, and acting as if the economic cyclical clock stood more at 2009-2010 than 2018, an apparent political majority in Washington endorses an unusual round of incremental fiscal stimulus arguably at the pinnacle of fundamental economic conditions.

Buoyed as well by a philosophical quest mainly in the U.S. to rollback regulations in industries like energy, environmental, and financial services, the global financial markets of the late Teens generally have expressed their appreciation with significant valuation uplifts.

After too many harrowing rides on the sentiment and financial asset valuation rollercoaster over time, not all capital market members are willing to endorse a Golden Goldilocks outlook enduring for perpetuity. Too many major uncertainties abound.

Indeed, after a healthy and prosperous 2017 for financial markets, the probability of an encore in 2018 dominates year-end market discussions.

Turning first to the geopolitical realm, the withdrawal of the U.S. from the Trans-Pacific Partnership, the Paris Climate Accord, and possibly Nafta underscore a repudiation of Wilsonian foreign policy and a retreat into a form of modern isolationism/modern mercantilism. This



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mammoth policy shift may lead to less global geopolitical stability and benefit key rising nations, especially China. Concurrently, a domestic political quasi-civil war grips the U.S. as the two major political parties diverge further and further.

The Middle East and terrorism remain high on the risk list. A possible military showdown between Saudi Arabia and Iran may loom. North Korean tensions frazzle. Polarized Washington policymakers puzzle over emigration, healthcare, and tax reforms. A disagreeable Brexit divorce process rumbles toward a contentious outcome. Catalonia's flirtation with Spanish succession and Scotland's quest for independence from the U.K. highlight possible nation-state fragmentation. As demonstrated by Russia's intervention in the U.S. election, the risk of cyber intrusion, particularly to the underlying infrastructure of the financial system, will not vacate institutional risk lists. Vigorous U.S. hurricane and western wildfire seasons in 2017 reinforce climate change concerns.

Major policy questions lurk in the global macroeconomic realm. Apprehensions have risen about the medium-term longevity of global economic expansion. The planned U.S. fiscal policy experiment of re-arranging the tax system may encourage corporate investments and hiring but also breed contractionary impulses (inflation escalation, social spending contraction, Blue State housing values decline) and larger-than-expected fiscal deficits. Brexit will restrain British economic growth. The velocity of Chinese economic growth and possible susceptibility to real estate and corporate debt corrections present possible challenges to systemic stability.

In the realm of financial markets, risky-asset valuations have arguably attained overvalued status, an opinion widely circulated. Crypto currencies have entered speculative bubble territory- or not according to nouveau users. Reminiscent of the exuberant big data enthusiasms of the early Teens, blockchain excitement resonates across markets and industries. Concerned by reduced issuer differentiation, some market watchers fret about the proliferation of indexing through conventional means and ETFs. The long-awaited arrival of more transparent electronic markets for many fixed income, currency, and commodity products has tempered market liquidity previously supplied by now less profitable broker-dealers. Mimicking the fractal analyses and genetic algorithm crazes of the early 1990s, the latest quest for the quantitative/technological asset management Holy Grail incorporates AI and machine learning to manufacture automated portfolios, guided by robo-advisors. Industry-after-industry confronts profound disruption from quickening technological change – perhaps none more so than financial services under the auspices of Fintech.

In this brief note, all of the key aspects of the dynamic global financial system cannot be addressed at this "Crossroads Interval." But we hope these comments stimulate long-term thinking and improve financial market decision-making even in the short and medium term. The Mid-21st Century Global Financial System is well under construction and will arrive sooner than generally expected.



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