"This Age of Global Capital Market Wariness"

Jack Malvey

November 30, 2016

Annual economic and market forecast season is upon us. Most prognostications will address only the next year ahead and focus excessively on the policy maneuvers of major central banks. But many of the drivers of economic and financial market performance will flow from a multitude of unfolding multiyear trends, the centerpiece of our discussion on November 30.

Change permeates the air, especially in the aftermath of Brexit and the U.S. election. For about a decade now, advanced economies have registered only anemic growth. Productivity gains limp along, in spite of the quickening pace of technological change. Lofty financial leverage continues to pose a strategic threat to the stability of the global financial system. Financial assets generate paltry nominal, real, and risk-adjusted returns. Retirement resources may prove inadequate. Career risk climbs in many industries. Another new generation (the Millennials), with still-to-be -fully determined behavioral characteristics, will increasingly take society's leadership reins. Climate change seems to be accelerating, auguring the long-term potential for massive economic challenges.

Yet, the current mark-to-market looks sanguine. Equities soared to new heights in late November 2016. Signaling little immediate concern with recession risk, credit spreads tighten. The U.S. dollar firms, converging on parity to the euro. While still microscopic by historical standards, certain bond yields have become marginally more attractive. Oil and precious metals comfortably orbit mid-range equilibriums. Real estate valuations generally remain stable-to-slightly ascending. After a few recent upward spurts, volatility has calmed down.

On an asset valuation basis, the Middle Teens of the second decade of the 21st century will be recalled as fairly benevolent. For investors, this period compares very favorably to the portfolio-crushing losses incurred during the dot.com equity bubble purification of 2000 – 2002 and the Great Recession of 2007 – 2009.

The conclusion of the highly- contentious U.S. elections represents the prime catalyst for this late 2016 ascension of risky-asset valuations. The diminution of political uncertainty, accompanied by the prospects of stimulative fiscal policy in the form of tax cuts and the mitigation of regulatory oversight (especially for financial institutions), has brightened near-term consensus capital market expectations.

The advancing pace of technological progress further elevates the capital- market mood. Big data, nanotechnology, 3-D printing, drones, driverless transportation vehicles, medical advances, robots, FinTech, and artificial intelligence all promise to deliver positive-disruptive changes.

Despite this current constructive global financial system milieu, full amnesia has not obliterated the memories of past corrections. And after succumbing to general forecast complacency prior to the Great Recession, few Panglossian capital market prophets endure. Indeed, contemporary capital market discourse is dominated by contemplation of potential black swan events.

As in the decades immediately following the Great Depression, an underlying capital market wariness likely will persist for an extended stretch. As manifest in our discussion agenda, this wariness springs from multiple sources.

At the pinnacle of the macro risk mountain, concerns emanate from the triad of escalating geopolitical risk, business cycle longevity, and technological disruption.

The prevailing world geopolitical order, established in the wake of the Great War (particularly the Middle East sovereign maps) and World War II, is undergoing substantial renovation. Numerous frictions accompany the transition to a multipolar world. As uncertainties flourish, the chasm widens between political, economic, and cultural ideologies. Economic stagnation breeds populist inclinations, ranging from the instigation of sturdier sovereign borders to inhibit unwelcome immigration and to the questioning of the multi-century conviction of most economists in the benefits of unencumbered international trade and globalization.

The prevailing world economic order is also undergoing substantial renovation. The neoliberal Washington consensus appears to be dissipating. Ironically in the quest for less government involvement in business activities, substantial modifications of long-held existing policies, like the U.K.'s participation in the European Union, will spawn periods of pronounced adjustment and, almost certainly, unintended consequences. The limits of monetary policy accommodation have probably been reached and arguably breached. The eventual normalization of monetary policy may trigger turbulent economic and market reactions at first.

And the prevailing world capital market order is being resculpted. Often with lags, legislative and regulatory overseers, financial intermediaries, and individuals vie to adapt to changing industry circumstances. Some European financial institutions apparently have not completed their business and balance sheet rightsizing. As a result, the construction of appropriate strategic and tactical portfolio policies in response to fast-moving industry conditions can be daunting. Diminished confidence in future capital market outcomes reinforces the swelling embrace of passive portfolio strategies.

Absent an unanticipated shock, like an adverse geopolitical event, the Teens may be recalled as a fairly benign decade for global capital markets. But as this global economic expansion continues to age and in view of the pervasive systemic restructurings underway, the frequency of episodic market "bouts of doubt" likely will escalate. The protracted endurance of "This Age of Global Capital Market Wariness" may prove the most accurate forecast of all.