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The global recovery is here - but may yet be derailed

Will Jackson | PortfolioConstruction Forum | 27 May 2016

Almost a decade since the start of the Global Financial Crisis (GFC), few economists expect an imminent return to the benign conditions of the early-to-mid 2000s. Indeed, much of the contemporary economic debate is underpinned by downbeat assumptions of long-term stagnation and continued unconventional monetary policy, as discussion shifts from the effectiveness of negative rates to the pros and cons of "helicopter money".

As a consequence, financial historian Professor Niall Ferguson explained at PortfolioConstruction Forum Symposium 2016, economists and investors risk being blindsided by a global upswing - a recovery he claims is already underway, but which could be choked off by a series of emerging geopolitical threats.

DEFLATIONARY FORCES "FADING"

Ferguson, a Harvard University professor and Stanford University senior fellow, challenged the growing acceptance of the "secular stagnation" thesis first proposed by economist Alvin Hansen in the 1930s, and revived recently by former US treasury secretary, Larry Summers. While Hansen's theory was undermined by the massive US economic expansion of the post-Second World War period, repeated over-bullish consensus growth forecasts since the GFC had given new life to his ideas, Ferguson noted.

"Larry has been winning this debate because all the official projections for growth turn out, year after year, to be too optimistic," said Ferguson. "[But] it is a characteristic feature of a view on the global economy, that when it becomes the consensus view, it is almost certainly about to be proved wrong. Once people at the World Economic Forum in Davos start talking about secular stagnation, you should start positioning yourself for global recovery. The greatest skill of any investor is to spot an inflection point as it is happening. I am telling you that this is the inflection point. Those forces which we can trace back to 2008 - which administered a massive deflationary shock to the global economy, comparable in scale to the shock of 1929-1931 - are finally fading."

ECONOMY AT AN "INFLECTION POINT"

As evidence of the global upturn, Ferguson cited the strong rebound in commodity and emerging market equity prices in the first quarter of 2016, and focused on real-time data analysis by British economist and commentator, Gavyn Davies, which suggests that underlying activity began to move higher in February across many developed and developing economies.

"The only place that didn't bounce was Japan," Ferguson said. "So Japan seems to be the place that has secular stagnation. And I want to suggest that this is how we should think about the secular stagnation hypothesis. It's absolutely right. But not about the US. And not about China. And not about the world economy. It is only true of Japan, and maybe a few European countries such as Italy."

To bolster his case, Ferguson highlighted historical research by academics Carmen Reinhart and Kenneth Rogoff. In their acclaimed 2009 book, This Time Is Different: Eight Centuries of Financial Folly, Reinhart and Rogoff revealed that financial crises have profound economic consequences, and that the after-effects of such episodes typically last five to 10 years. "If financial history has any relevance, we should expect the hangover from 2008 to be coming to an end about now," Ferguson added. "That seems to me to be a good basis for suspecting that the inflection point is now."

Ferguson proposed that a sustained recovery would be supported by three key factors:

- higher oil prices, owing to the likelihood of supply disruption in the Middle East and continued robust demand;
- tightening US and Chinese labour markets; and,
- the willingness of the US Federal Reserve to let US inflation run above its long-run 2% target, for the sake of global stability.

"The Fed has an international mandate - it has had for some time," Ferguson argued. "It acts as a global monetary stabiliser. If the Fed had carried on with the rate hikes that it had planned at the end of last year, it would have blown up the emerging world. I think [the decision to slow the pace of rate hikes] in February is probably the single most important reason that the inflection is here."

TRUMP (AND OTHER GEOPOLITICAL RISKS)

As a counterpoint to his upbeat outlook, Ferguson outlined five key risks which could derail the nascent recovery:

- a failure by the Chinese government to enact structural economic reforms;
- the appointment of Donald Trump as US president;
- the rise of populism in Europe, and the threat of a British exit from the European Union;
- Russian destabilisation of eastern Europe and the Middle East; and,
- an expansion of the Islamic State network into south Asia, Europe and beyond.

Ferguson estimated the likelihood of a Trump presidency at 50% – far higher than consensus expectations – and warned that the consequences could be significant. "If [Trump] wins the presidency, fasten your seatbelts," Ferguson said. "Donald Trump sees the World Trade Organisation as an opportunity for spectacular litigation, of the sort he excels in. Donald Trump doesn't mind talking about defaulting on the federal debt, debasing the dollar, building a wall across the Mexican border – there's nothing the man won't say, if he feels in his gut that it's going to go over well with his voters. And he will have to execute on some of that stuff if he wins. Donald Trump will not have a second term as US president if he fails to deliver on his anti-globalisation agenda."

NINETEENTH CENTURY PARALLELS

In his concluding remarks, Ferguson likened the GFC to the global financial crisis of 1873. While the initial equity market sell-off was less pronounced than those witnessed in either the Great Depression or the most recent crisis, the deflationary effects lasted almost 20 years.

"One of the things that interests me is that, in that period, populism really flourished," Ferguson explained. "And, there were backlashes on both sides of the Atlantic – against immigration, against free trade, and against monetary orthodoxy. I think we're in a similar place today. We may find ourselves in a situation in which recovery gets choked off by daft populist policies. Controls on immigration could be ramped up massively by a Trump administration. Tariffs could be imposed across the board on Chinese goods. All kinds of unorthodox things could be done – the Fed could lose its independence.

"Similar things happened in the late-nineteenth century. The Chinese were completely banned from immigrating into the US after 1882 – there's nothing unprecedented in what Trump proposes to do in banning Muslims from immigrating.

"So we face a dilemma, as investors. I think we see an inflection point in the data. I think it's real, in terms of commodity prices, in terms of labour markets, in terms of monetary policy. If everything else could just be held equal, I think we would be coming out of the hangover of the Global Financial Crisis. But, the inflection point could be choked off if the populists win. And that's why, between now and the end of this year, you should probably pay as much attention to the political pages, as to the financial pages, in your newspaper."

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