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We may stave off this recession, but can we escape the next?

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Highlights

- **Global central banks have started easing interest rates to avert a sharp slowdown… but are we setting ourselves up for a harder landing in future?**
- **The world has shown its inability to withstand higher rates for long; meanwhile, the Eurozone and Japan has shown monetary policies are losing their effectiveness.**
- **Markets have not fully understood the impacts of increasing political disparity, widening income gaps and an overly-responsive Fed to bond markets.**

Almost every tool in the box has been used to engineer a soft landing in the current economic cycle downturn. Global central banks have not hesitated in rolling out monetary easing programmes. There are limits, however, to the effectiveness of constantly loosening monetary conditions. In fact, we may be setting up the global economy for a bumpier ride ahead.

An addiction that is losing effectiveness

In the past decade, the global economy has shown its inability in shaking off its addiction to loose monetary policy. Post GFC, the global economy may be likened to a patient who is recovering from a serious bout of illness. Multiple QE programmes and a record low US interest rate of 0.25% were needed to stem further deterioration in the health of the global economy. Fast forward to 2019, we now observe the same patient seemingly back on his feet, but reaches out for painkillers at the slightest hint of discomfort.

We now appear to have reached a point where rate cuts and QE programmes are losing their effectiveness. There is only a limited amount of stimulant left in the bottle, and increasingly it looks insufficient in covering the cracks of the economy. We may stave off this recession with rate cuts – but when the accumulation of stresses comes due in the next downturn, the lack of monetary policy space is likely to result in a harder landing for the global economy. One need only look to the Eurozone and Japan to observe the limitations of low (negative, even) interest rates on jumpstarting the economy.

Uncomfortable road bumps that could derail the global economy

A prolonged low-interest rate environment potentially raises three medium-term risks that markets have yet to fully understand:

1. **Increasing political disparity**

This is the biggest medium-term risk that the global economy faces, in our opinion. The strains of the GFC and the resulting zero-interest rate policy can still be felt today, as credit-fuelled growth slows and erodes the wealth of the middle class. A widening global income gap has started to borne more extreme political policies previously unthinkable. As the appeal of globalisation dims, we are witnessing more protectionist policies around the world – Brexit in the UK, trade wars from the US and the rise of far-right political groups in Europe.

In essence, what we have witnessed is the beginning of a clash between capitalists and socialists – a growing sense of discord between the haves and the have-nots. This could lead to a rollout of policies that seek to over-compensate the increasingly discontented middle class, such as increasing taxes on the ultra-rich and raising the level of welfare hand-outs. These populist policies are unsustainable in the long-run and are likely to add further stresses to an already strained economy.

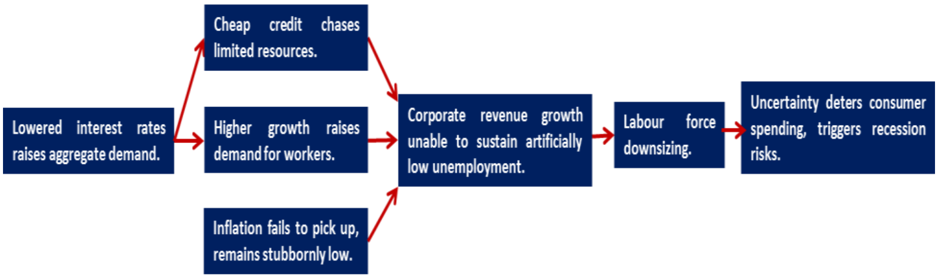
2. **Over-stimulating an economy arguably not in need of rate cuts**

The global economy has now shown it is unable to withstand higher interest rates, creating a new normal of lowered neutral rates. The Fed in July has started reducing its benchmark overnight rate, but how necessary is a rate cut needed at this stage of the US business cycle?

A quick look across data prints from the US scarcely shows a late-cycle economy in need of stimulus. Unnecessary stimulus to an economy could lead to marginal costs outweighing the benefits. With US unemployment averaging 3.7% this year - the lowest since 1969 – further stimulus creates an unsustainably low level of unemployment that does not commensurate with the low levels of inflation at present. In fact, there is a case to be made that this phenomenon is already happening in today's environment, with the 50-year low unemployment rate scarcely reflected in an inflation rate barely at 2%. If prices still do not exhibit inflationary pressures post rate cuts – which is highly likely, given the record in the past ten years – then one of the most direct ways to correct this imbalance (although not the only) is via a recession. As cheap credit continue to chase limited resources, "weeding the weak" forces inefficient businesses to shut down, driving the unemployment rate back up and balancing the soft inflation numbers.

In other words, the Fed may be setting itself up for a riskier environment up ahead if they should miscalculate the current stimulus cycle.

Impacts on employment and growth from an overstimulated economy.



3. An overly-responsive Fed to financial markets

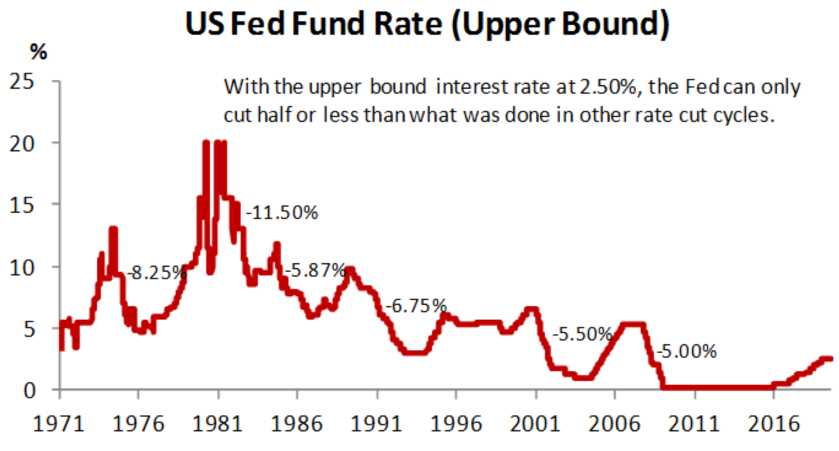
The Fed has increasingly looked very reluctant to upset financial markets due to a number of reasons. Firstly, as a result of a decade-long rally in US equities, they are faced with sharp market tantrums each time requests for easier monetary conditions are not satisfied. Secondly, the Fed faces a President that is more obsessive with stock price levels than any of his recent predecessors. These have resulted in a Fed that has appeared more hesitant in under-delivering rate movements that are already priced in by the bond market. This partial reversal in leading roles set up a precarious scenario, where the Fed may feel compelled to ease interest rates more than it desires, bringing us back to our point of over-stimulating the economy. This risk looks subdued for now, given the Fed's recent comments that the cuts in interest rates are not the start of an easing cycle, but rather a correction within the current rate-hiking phase.

Sacrificing tomorrow's monetary arsenal for today

The combination of these factors sets the global economy up for a bumpier ride ahead. The Fed's responsiveness this year likely means that a US recession is unlikely in 2019. The result by the end of this rate easing exercise, however, results in two outcomes:

- Firstly, the Fed will be at least one to two years behind their original intended rate cycle. If the stresses of the economy manifest themselves within the next 24-36 months, the Fed will find itself short of firepower in its rate policy space to combat a downturn.

- Secondly, the current has thoroughly proven that the world is still unable to handle higher interest rates. The Fed recognises this and has lowered its neutral rate in its June FOMC projections to 2.50% from 3.00% a year ago. This results in limited firepower for the Fed and puts them in dangerously uncharted waters. The Fed has always worked with the ability to slash rates of at least 500bp or more in the event of a severe downturn. With a neutral long-term rate of 2.50%, the Fed fund rate would hit the lower bound of 0% before the Fed can enact its full suite of rate reductions. This brings us to our next point: the US potentially entering a liquidity trap.

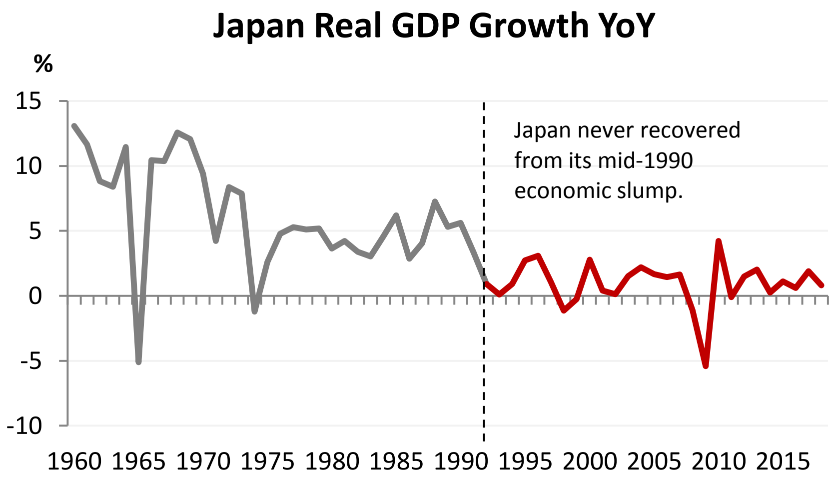


Source: Bloomberg, OCBC Bank

Growing fears that major economies are entering liquidity traps

Japan has largely led the way in demonstrating to the world how sticky a liquidity trap may be. One lost decade has grown into two, with seemingly no light at the end of the tunnel despite zero interest rates. The same may be said about the Eurozone since 2012, where zero and even negative interest rates have failed to spark any form of growth recovery or inflationary pressures.

The US economy now looks increasingly close in following Japan and the Eurozone into a messy liquidity trap. The key difference is the US has not displayed the same kind of economic malaise that both Japan and the Eurozone have exhibited pre monetary easing. However, if the Fed chooses to ease more than it should, the reduced rate policy space blunts the effectiveness of its monetary policy tools – increasing the risk that the world's largest economy will follow the footsteps of the other two major economies.



Source: IMF, CEIC, OCBC Bar

Fiscal stimulus to grow in importance

With monetary policies looking as though they may fade in importance in the long-run, the importance of fiscal stimulus globally becomes more important than ever to prop up respective economies under severe distress. This is particularly evident in the Eurozone and Japan, where negative interest rates have neither lifted inflation levels nor economic growth. This revelation has also partially been the reason for Modern Monetary Theory (MMT) to have started gaining traction recently. It becomes more important than ever that capable and talented leaders are helming economic roles in countries – especially the US – rather than populist politicians. Inward-looking and protectionist fiscal policies, in the face of limited monetary firepower, will likely drag the global economy further into secular stagnation.

Implications on asset classes

Interest rates are expected to remain subdued as easy monetary policies suppress yields. This also partially results in a Treasury yield curve that is relatively easier to invert, given the low term premiums. A low-yielding fixed income environment increases the appeal of gold – it is our view that unless the benchmark 10-year Treasury yields return to historical levels of 3.50% or more, it is unlikely the price of gold will fall below $1,000/oz. Equities may receive a short term boost from looser monetary policy but at some stage will have to revert to earnings fundamentals. If the global economy unfolds as what we have detailed above, equities around the world may come in under heavy selling pressure in the medium-term.

Conclusion: the next downturn likely to be bumpier

It is unlikely that the US will enter a recession in 2019. By most measures, the US economy scarcely looks like it is in its late-cycle growth. The traditional drivers of recessions in the past – overheating due to high inflation and unsustainable asset bubbles – have barely shown up in today's macro environment. Despite so, the Fed is still proceeding with interest rate cuts this year. They now run the risk of over-stimulating the economy and ironically, set the US economy up for a harder landing in the next downturn.

Additionally, not enough attention has been given to growing political risks around the world, where a growing income gap has given rise to populist policies that seek to over-compensate a discontented middle class. There appears to be a growing risk that the US may enter a liquidity trap together with the Eurozone and Japan. As monetary policies lose their potency, the importance of fiscal stimulus will increasingly helm the limelight.

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