Why we think volatility is here to stay

Geopolitical fracturing, the rise of sophisticated technologies, demographics and climate change all pose threats and opportunities as the world moves beyond the post-financial crisis regime of heavy central bank intervention, according to Shamik Dhar, Chief Economist at BNY Mellon Investment Management.

In an analysis of the current economic and geopolitical climate, Dhar said he did not expect to see any dramatic shift in market fortunes over the next two years.

“We have been in an unusual economic situation for the past 10 years, ever since the end of the global financial crisis (GFC), which was probably the single most important economic event in 70 years.

“While we do expect to see normality reappear at some point, the big question is when that will happen and we do not think it is likely to happen soon. At a wider level, too often markets think we are back in the world of the 1980s when inflation was the main threat but I simply don’t believe that to be the case. What is likely to change is the extraordinary monetary stimulus that we saw from central banks. This year should be the first in a decade where central bank balance sheets are shrinking rather than expanding.”

According to Dhar, the expansion of central bank balance sheets in the decade since the GFC helped suppress market volatility. Thus its withdrawal may trigger its reappearance. “We could be entering a period where we see slightly more volatile markets but it is also a market where active management and buying opportunities could abound more often than they have done in the recent past,” he added.

Within this climate, Dhar believes there is significant lost output to recover. “From 1962 until 2008 we averaged growth of just over 2.5% per year. Since the GFC we haven’t got close to this. In the US, in GDP per head terms, we are now roughly 8% below where we would have been if the financial crisis hadn’t happened (see chart below).

US GDP per capita compared with what might have been…

Chart shows real GDP per capita in the US (grey line) with an exponential trend line – where we may have been if the global financial crisis had not happened (dotted blue line). The dotted blue line assumes growth continued at the average rate of 2.5% per year from 2008 onwards. Periods of recession are shaded grey on the chart. Source: BNY Mellon Global Investment Strategy team using data from US Bureau of Economic Analysis, as of December 31, 2018. A log scale, or logarithmic scale, is a non-linear scale based on orders of magnitude rather than a standard linear scale – so the value represented by each equidistant mark is the value of a previous mark multiplied by a constant. Chart contains hypothetical information and is for illustrative purposes only. Actual results will vary.
Dhar expects real interest rates to stay very low to negative over the next 24 months, with inflation expectations remaining anchored. He also believes bond-equity correlations will remain negative or low in the months ahead.

Commenting on the shape of the wider geopolitical landscape, Dhar added: “We are in a very different political environment than we were even five years ago. In some sense, against a backdrop of geopolitical fracturing, we are seeing the dismantling of the post-1945 economic and political settlement. How that will work out for the global economy and politics in the longer term remains unclear.”