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2018: Tighter monetary policies, higher volatility

We are approaching the end of what has been a blockbuster year for equity markets. Looking ahead, 2018 promises to be a year of significant shifts in monetary policies by major central banks around the world – something that is likely to result in sharply increased volatility in financial markets. After an unprecedented eight-year bull market, global equity markets will increasingly become two-way streets again.

The departures of Janet Yellen, Stanley Fisher, William Dudley and Daniel Tarullo, mean the Federal Reserve (Fed) will have lost more than four decades of collective experience. With a new incoming Chairman (Jerome Powell) and five vacancies out of a total seven to be filled, the composition of the Board of Governors of the Federal Reserve will undergo drastic changes in 2018. It is fair to say that this will be the least experienced Fed board in decades. The challenges will be numerous as the new Fed's resolve will be tested by pro-cyclical fiscal stimulus at a time of a 4% unemployment rate and heightened concerns over wage pressures and weak price inflation.

A major concern is the push for massive fiscal stimulus this late in the cycle. The tax reform bill was hastily written as the GOP was desperate to pass a bill (any bill) before the end of 2017. This legislation will blow a hole through the budget and over the next ten years will add $1.5 trillion to the national debt, which at $20 trillion is already in the stratosphere. A tax cut of this magnitude helped the economy back in the 1980s when debt-to-GDP stood at 30%. At the current excessive debt-to-GDP ratio of 105%, the impact on economic activity will be limited at best, and counterproductive at worst.

The argument that the tax cut will pay for itself is highly questionable, as the underlying assumption is for 2.9% of annual real GDP growth for the next 10 years. The last time this kind of growth was achieved was before 2007 amid a massive credit and housing bubble.

Against this backdrop, the Fed will have little choice but to lean against the wind by collecting conventional policy bullets to fight the next downturn. This means the Fed will keep on tightening until credit spreads widen, the stock market becomes less overheated, the bubbles in tech stocks, Bitcoin and art deflate, all of which are products of excess liquidity.

In Europe the European Central Bank has started to scale back its asset purchase program and it is likely that a new President will be announced in the coming months as Mario Draghi's term ends in October 2019. There is a good chance that his successor will be from Germany which indicates that monetary policy will be more in line with Bundesbank philosophy, i.e. a lot less accommodative.

Furthermore, the People's Bank of China increasingly has a tightening bias as it attempts to address the problem of excessive leverage in the economy, and many at the Bank of England (BOE) are pushing for the normalization of interest rates. Even the Bank of Japan (BOJ) of late has been floating trial balloons over a policy shift at some point to move away from its 0% target for the 10-year Japanese Government bond.

The bottom line is that the coming shift in central bank liquidity will emerge as a very significant story in 2018. This is likely to knock the complacency out of the markets and mark a return to a 'more normal' investment landscape - the subdued volatility seen in 2017 was not characteristic of normal market conditions. Despite the expected increase volatility that 2018 could bring, we still expect that equity markets will outperform overall, though the tide may be more choppy at times.

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