**Global equities**

# The synchronised economic expansion: How much further to run?

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**Key takeaways**

- The synchronized economic expansion has boosted global stock markets, benefited international trade and improved multi-national profits.
- The Federal Reserve, Bank of England, European Central Bank and Bank of Japan all face balance sheet unwinding in the years to come.
- It's unclear how global markets might react should interest rates rise and quantitative easing end faster than expected.

The global economy continues its synchronised recovery, as evidenced by robust data across regions. Indeed, all 45 countries tracked by the Organisation for Economic Co-operation are expected to post positive economic growth in 2017 for the first time in 10 years. Even more optimistically, 33 out of 45 countries are seeing accelerating growth. This has boosted international trade and commodity prices, and helped make the global expansion story gradually more self-sustaining. On this basis alone, the prospects for 2018 look positive, with broad-based improvements across the major developed economies and a number of emerging market economies expected to continue.

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The synchronised economic expansion that we've seen post the global financial crisis has helped stock markets rally and boosted the profits of many multi-nationals – creating what some might call a sweet spot for equities. The longer that global macro data continues to trend higher, the longer that the globally synchronised earnings upturn will remain compelling. Moreover, the benign global inflation environment has allowed central banks to keep monetary policy very loose – for now.

However, we will not remain at that sweet spot forever, and there is reason for caution. Are we in for a period of stronger, more decisive change in monetary policy? It's certainly possible. The US Federal Reserve (Fed) has said that it would stick with plans for further interest rate rises, and it has thrown its crisis-era stimulus programme into reverse. Meanwhile the Bank of England (BOE) raised UK interest rates in November, and the European Central Bank (ECB) announced that it was looking at how to reduce the amount of economic stimulus it is currently providing. Everyone has been so used to the accommodative stance of the past 10 years, and markets have become complacent.

But what if interest rates rise and central banks exit quantitative easing faster than expected? How would global financial markets react? This isn't a scenario that's priced in at the moment.

### The beginning of a new era?

The global financial crisis of 10 years ago was a watershed event for financial systems around the world. Systematic losses by banks and the ensuing losses in economic output spurred governments into action. Governments in advanced economies stepped in to provide support to banks and other financial institutions, as traditional sources of funding dried up. Central banks reacted to the downturn by cutting interest rates and expanding balance sheets simultaneously by buying securities funded via the creation of excess reserves.

We are now entering the phase of the "great unwind," with the Fed beginning to slowly sell the $4.5 trillion in assets it bought to stabilise the economy. It's a real milestone to reach. Could this be the beginning of a new era? The Fed has made lots of reassuring noises about the care it will take, but this is an unprecedented action. No one can be sure that policy mistakes won't be made, disrupting bond and equity markets around the world. Even if the Fed's reduction of its balance sheet is uneventful, the BOE, ECB and Bank of Japan all have to go through the same process at some stage.

Low interest rates and low bond yields created a massive hunt for yield, which pushed up prices for many assets (and saw the cost of capital reduced). The last 10 years have seen asset owners do well, encompassing property as well as equities, and thereby greatly increasing wealth inequality. But what of those who have been excluded? Government policy continues to lag in this area.

The employment picture remains strong. Unemployment levels have reached record lows of 4.3% in the UK for the three months ending August 2017, down from the post-crisis peak of 8.5% in 2011 and tying the lowest level since 1975.[1] In the US, the unemployment rate fell to 4.1% in October 2017, the lowest since December 2000.[2] However, real earnings continue to decline. There are many explanations as to why wages have not risen

1 Source: Office for National Statistics (ONS)
2 Source: Bureau of Labor Statistics

as unemployment declines, but the result is that central banks have been reluctant to raise interest rates. The risk in 2018 is that any upturn in wage growth could see central banks forced to raise interest rates more quickly than expected.

Just as no one had lived through anything like the scale of the 2007 global financial crisis, the recovery and post-recovery phases also see us in unchartered territory. The focus of the last 10 years might have been the wholesale rescue of the financial system, yet the policies which were aimed at growth creation mostly created asset price inflation in the end. The ultra-easy monetary policies — though undeniably necessary to prevent an even worse economic collapse in 2008 and 2009 — have arguably been carried on for far too long.

Economic growth prospects are as good as they have been since the global financial crisis, and there has been a real upswing in financial earnings. Equity valuations are trending at significant premiums to their long-term average and are arguably discounting a lot of the good news with low levels of volatility, showing that investors are optimistic about prospects. The risk to this scenario is that central banks have to change their monetary policy more quickly than financial markets are currently anticipating.

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