BNY MELLON

The Aerial View

Morning Briefing

Bubbles and a Catch-22

- **Bubble fears articulated by officials can hardly have been assuaged**
- **Stock markets have either recovered from a brief hiatus or powered on**
- **Mitigating the risks of deflation has compounded risks posed by leverage**

Last autumn, a number of officials aired fears about mispriced risk across global asset markets and we revisit the subject today because those fears can hardly have been assuaged by what we have witnessed in the interim.

BOJ Governor Haruhiko Kuroda got the ball rolling in October when he told the G30 that “market players [may be] complacent and not properly pricing risks”.

Shortly afterward, outgoing German Finance Minister Wolfgang Schäuble told the *FT*: “Economists all over the world are concerned about the increased risks arising from the accumulation of more and more liquidity”.

Then, on October 19, PBOC Governor Zhou Xiaochuan spoke to the Communist Party Congress about "Minsky Moments".

> ***Will stock market performance in 2018 come to***

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Email >

Newswatch

1.
Japanese services activity dipped in November >

2.
Small business confidence is ebbing in UK says lobby group >

3.

be defined by correction or continuity?

Since these views were aired, stock markets have either recovered from a brief hiatus in their pronounced uptrends or simply powered on, uninterrupted, to fresh new heights.

For example, the Dow Jones stands 6.3% higher than at the end of October while the Hang Seng has risen 11% to a decade high; the Straits Times has risen 3.7%; the Bovespa 4.9%; Turkey's Borsa Istanbul 100 is up 6.2%; the Jakarta Composite 4.7% and so on. In fact, the average 2017 increase for this selection of indices comes in at a staggering 30.2%.

Will stock market performance in 2018 come to be defined by correction or continuity? Such questions tend to polarize opinion (seemingly in proportion with market performance itself); but the answer is surely linked inextricably to the prevalence of low, longer-term US Treasury yields. Offering 2.46%, the 10-year UST is already applying pressure to stock prices (the dividend yield on the S&P 500 comes in at 1.78%), but then, yield curve dynamics clearly warrant caution for would-be bears in both markets.

Ultimately, this comes down to the very same problem the Fed has wrestled with since normalization began in 2013: low inflation, which has served to elongate the global credit cycle and complicate the Fed's mandate. In early 2015, James Bullard warned about the "disconnect between markets and the Fed" that would be "reconciled at some point"; but one year later – having famously metamorphosed from hawk to dove – he conceded that it would be "unwise to continue a normalization strategy in an environment of declining market-based inflation expectations."

This has been the basis for the Fed's dilatory approach to policy normalization

This has been the basis for the Fed's dilatory approach to policy normalization; but while mitigating the risks of deflation, it has also served to compound market risks by providing investors with a window of opportunity to increase leverage with which to pursue escalating asset prices. And it has been fear for the latter's stability that has reinforced such a measured

German retail sales surge in November >

On the Radar

January 05, 2018

• EZ Dec inflation (1000 GMT)

• US Dec non-farm payrolls (1330 GMT)

• CA Dec unemployment (1330 GMT)

Featured Article

Living with the New Normal

Many central banks will be up against it in 2018 if the USD goes south >

approach to tightening - something of a Catch 22 situation if there ever was one.

Highlighting the nature of the predicament facing the Fed and other central banks is relatively straightforward; identifying a solution to these problems is another matter entirely, however, and this rather suggests that questions of stability will remain unrequited before the fact.

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