Are we heading toward another crisis?

Analysts say 'real explosion will come but unlikely in 2018'

Inflation fears spook investors

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SINGAPORE — At this year's World Economic Forum held in Davos, Switzerland, in late January, a financial crisis was one of the key topics among economists and bankers.

Although chances are still slim, they said the global economy and financial markets have become more vulnerable as a result of prolonged loose monetary policies. They are particularly concerned financial authorities are unprepared to deal with the next crisis.

An excessive run-up in global stock markets coupled with growing uncertainty stemming from the huge volatility in trading of digital coins has sparked fears the global economy may be heading for another downturn.

Some of them warned if inflation shot up suddenly, central banks globally would have to accelerate rate hikes, which will send a shudder through the global economy and financial markets. They expect the next crisis will be much more violent than what we experienced a decade ago.

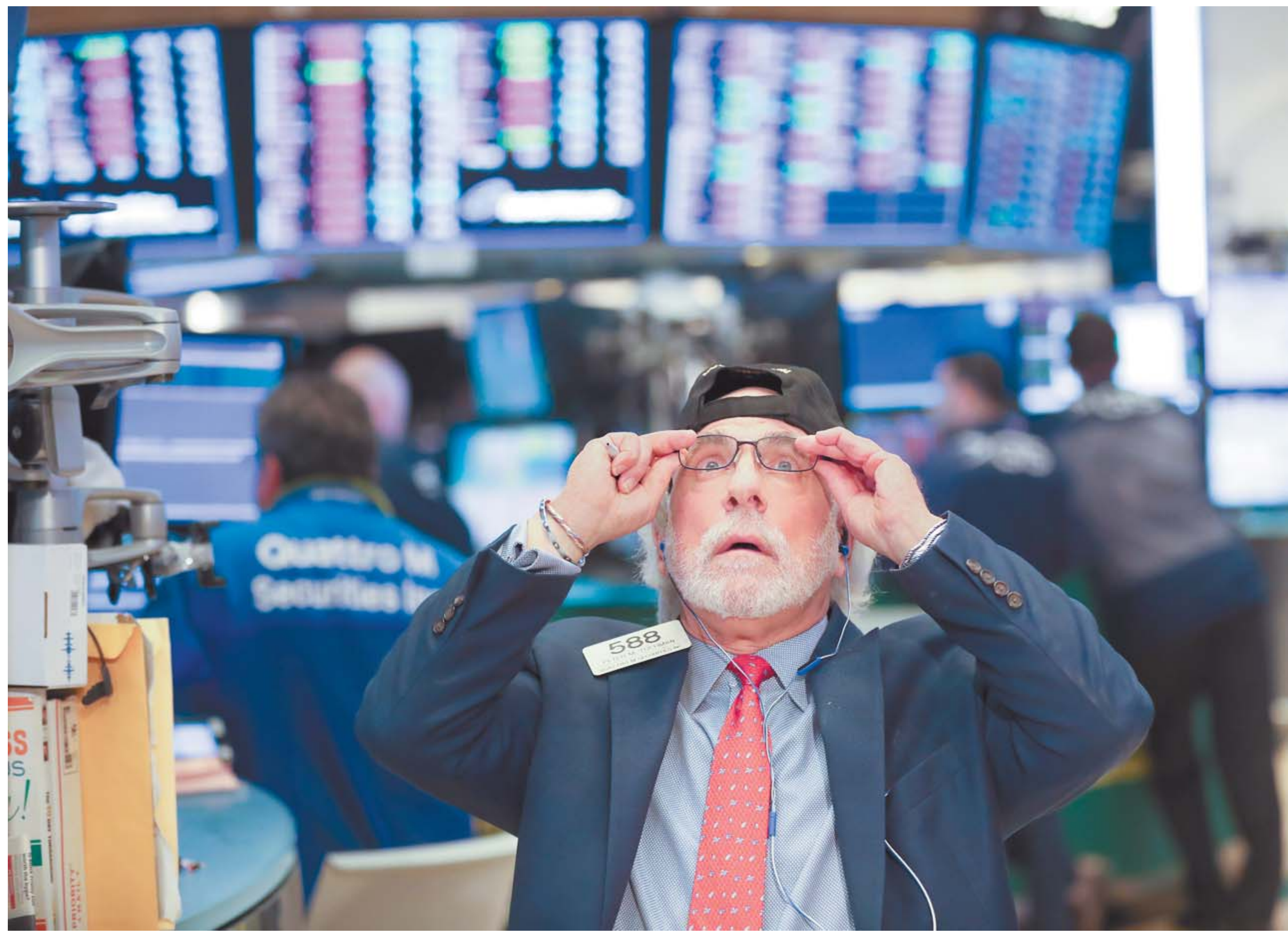
The massive selloffs on Wall Street over the past week further intensified fears of another financial crisis spreading gloom to most Asian markets, including South Korea.

Last Monday, the Dow Jones industrial average plunged 1,175 points. On Thursday, the Dow index sank more than 1,000 points again as inflation fear spooked investors. The Dow, together with the S&P 500, is now down 10 percent from their all-time highs, set Jan. 26.

Most analysts view the ongoing market turmoil as a temporary pullback, rather than the end of a bull market. They predict the global markets will go through a few ups and downs before facing a deeper downturn.

The Korea Times interviewed five leading global economists and market analysts to better grasp the future course of financial markets and the U.S. Fed's interest rate policies.

They are Rob Carnell, Asia-Pacific chief economist at ING Bank in Singapore; Andy Xie, independent economist in Shanghai; Sohn Sung-won, professor of economics at California State University-Channel Islands; Kumada Mikio, executive director of Global Strategist at LGT Capital Partners in Hong Kong and Mauro Guillen, director of the Lauder Institute at the University of Pennsylvania's Wharton School.

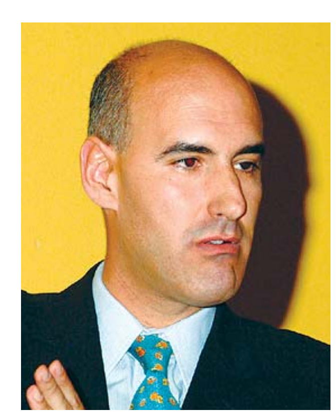


A trader watches stock prices on the floor of the New York Stock Exchange on Feb. 5 when The Dow Jones industrial average plunged 1,175 points on fears of higher inflation. It was the worst loss in six and a half years.
AP-Yonhap


Rob Carnell


Andy Xie


Kumada Mikio


Mauro Guillen


Sohn Sung-won

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> *"If the Fed does not signal a slightly more hawkish tone, the outlook could worsen as inflation expectations and interest rates will rise too much."*

> *"What is clear is that continued weakness in U.S. stocks would be contagious worldwide."*

> *"To begin with the market has been overvalued. In baseball analogy, the market was in the ninth inning."*

The following discussion has been reconstituted based on separate interviews conducted through emails and phone calls from Feb. 5 to 9 — ED.

Q What is the key culprit behind the recent market selloffs on Wall Street and wild fluctuations?

A **Sohn Sung-won:** To begin with the market has been overvalued. In baseball analogy, the market was in the ninth inning. Overvaluation increases the probability a correction will come. Overvaluation alone does not cause a correction. There is usually a catalyst. In this case, rising interest rates, especially bond yields, have shot up reflecting inflation concerns. This could lead to faster increases in the interest rate by the Federal Reserve.

Andy Xie: Yes. The driver of the selloff is rising bond yield. China is tightening and the Fed is tightening. Money supply is not as loose as in the past years. That is why the U.S. bond yield went up sharply.

Rob Carnell: With the benefit of hindsight, the U.S.' strong wages figures on the recent payrolls numbers look to be one of the most likely culprits. But if it had not been them, it would likely have been something else. Truth is, equity markets have looked overstretched for some time. Yellen's parting remarks as she left the Fed were to note the high prices of equities. In the end, these markets may simply have self-corrected. We tend to look for causes afterwards, when the movements may in fact have been autonomous.

Mauro Guillen: It seems investors are reading the good news on the U.S. and global economies as if they were negative. Stronger growth, declining unemployment and rising wages could be the harbingers of inflation, which in turn might prompt central banks to accelerate interest rate increase, and thus bring the era of low rates to an abrupt end.

Q There are concerns about another financial crisis. Do you think the wild swing in financial markets last week is a temporary pullback or the beginning of a deeper downturn?

A **Carnell:** Temporary. Let's put it into perspective, largely because the gains in January were so aggressive.

Kumada Mikio: I think this is a correction, temporary. The markets had risen too quickly, too sharply, driving valuations too high. For example, thanks to rising interest rates and normalizing inflation, the two-year treasury bond yield rose quickly above the dividend yield level of the S&P 500. That means that suddenly, you can earn the same return but without risk if you buy treasuries. This correction will help bring things into balance. We are at delicate stage now, given that interest rates are rising.

Sohn: A financial crisis usually reflects some fundamental imbalances in the economy such as too much debt or a poorly capitalized banking system. Fortunately, there are no serious structural imbalances in the economy. I do not see a major economic crisis on the horizon.

Guillen: The correction in the stock market would only be a sign of problems at banks if it has a negative effect on the real economy, which could cause families and other debtors to default on their debts. But so far the economy is actually growing and doing better than expected.

Xie: This is a moderate scare-driven selloff, not the crash. The stock market is a huge bubble, bigger than in 2007, 2000, or 1929, because super loose monetary policy had been in place for a decade. The bubble will really pop when interest rates catch up with nominal GDP growth rate. It is 4 percent to 5 percent in the U.S. The real explosion will come, but not likely in 2018.

Q What is your outlook for the future course of U.S. monetary policy? How fast do you think the Fed will raise interest rates?

A **Carnell:** Three rate hikes this year — in line with the Fed's own dot diagram. Whether the Fed can hike in March depends on how quickly markets recover their composure after recent selloffs, and it might inhibit a March hike. Then again, there are strong arguments for new Fed chairman Jerome Powell to stamp his authority on markets with a hike at his first press conference meeting.

Kumada: The rather fast rise in U.S. interest rates is related to concerns the Fed will fall behind the curve, i.e. keep policy too easy for too long. So, I think the Fed is now justified to accelerate rate hikes a little. Related to this "falling behind the curve" view is the surprisingly pronounced weakness of the U.S. dollar since December. That drop has also changed the inflation outlook for the U.S. a bit, allowing the Fed to tighten more.

Sohn: It is hard to tell. Jerome Powell is caught between a rock and a hard place. If he raises the interest rate too fast responding to inflation worries, an economic recession could result. If he decides to raise the rate too slowly, the inflationary pressure could build eventually leading to even higher interest rate. I assume he will take the middle road raising the interest rate slowly and gradually.

Guillen: The Fed has established a calendar for rate increases. They may raise rate by a bit more than initially planned if there is inflation. But if inflation remains relatively subdued, then there is little reason for the Fed to change course. Now, there is a new chairman in place now. It will be important to listen carefully to any statements he makes.

Kumada: If the Fed does not signal a slightly more hawkish tone, the outlook could worsen as inflation expectations and interest rates will rise too much. Like the balance between risk-free rates and dividend yields, the policy balance is now also delicate. I expect the Fed to reassure markets that the economy can take a few more rate cuts that planned this year. That should slow the rise in interest rates and restore a balance in markets.

Q What would be key variables that will determine the course of U.S. stock and global financial markets?

A **Carnell:** In the end, it boils down to growth and inflation, and how central banks respond. And in the end, I think growth will be okay, and inflation only a little higher than it is right now. And if central banks hold their nerve, and don't overcompensate one way or the other, this should enable some single digit gains in stock prices this year.

Mauro: Definitely interest rates.

Kumada: I think all the U.S. data already support the case for a "bullish tightening." If the Fed acts as I expect, I don't think there will be lasting negative consequences for Korea and Asia. This is about policy finding the right mix after the Trump tax cuts and the weakening of the U.S. dollar.

Sohn: The U.S. inflation rate will be the key variable to watch. Based on the rate, the Fed will act to raise the interest rate.

Q How do you think volatile U.S. markets will affect emerging Asian markets, including South Korea? Do you think it may lead to a capital outflow?

A **Sohn:** During times of uncertainty investors look for safe havens such as the U.S., Japan and Switzerland. At the moment it is too early to worry about capital outflows.

Guillen: It is hard to predict. Normally emerging markets are more volatile. But right now U.S. and European markets and also Japan are very volatile. IT is no longer like 20 or 30 years ago. What is clear is that continued weakness in U.S. stocks would be contagious worldwide.

Carnell: I don't really think so. In fact, I would say that as Asia tends to be a high Beta region with respect to global financial risk appetite, it will begin to look a good buying opportunity when confidence starts to return.