NATIXIS
INVESTMENT MANAGERS

ECONOMIST POINT OF VIEW

In search of the next economic narrative

In a 2018 article printed in the Washington Post, economist Jared Bernstein proclaimed “Expansions don’t die of old age: They’re murdered by bubbles, central bank mistakes or some unforeseen shock to the economy’s supply and/or demand side”. While the global economy is still in reasonable health and the US is enjoying its longest interrupted stretch of expansion for over 100 years, there are some potential threats on the horizon. For the second year in a row, Natixis Investment Managers, Ossiam and Barclays Investment Bank gathered two economic titans, one American and one European, to discuss the potential catalyst of the next downturn. This debate was moderated by Esty Dwek, Head of Global Market Strategy, Dynamic Solutions.

“The suggestion that an inversion of the yield curve is a leading indicator of recession could well be somewhat of a self-fulfilling prophecy.”

Robert Shiller
Professor of Economics at Yale University

“Central banks have been losing the fight against capital markets. Today they have become forced to act in line with capital market expectations.”

Patrick Artus
Chief economist and member of the executive committee of Natixis

On zero interest rates…

When interest rates are at zero this is usually a sign of secular stagnation, as illustrated by Japan’s lost decade in the 90s. We may be about to repeat history, with zero interest rates representing an act of desperation. And negative interest rates… well that’s even worse.

On persistently low inflation…

Japan’s history supports the Neo-Fisher Effect, but there are others that come and go. What strikes me is that people are no longer focussed on inflation. It used to be that people feared inflation as one of the biggest problems facing the world. Now they’re more worried about immigration than inflation.

On the true impact of trade tariffs…

In my recent book titled “Narrative Economics: How stories go viral and drive major economic events” I did some research on tariffs in the Great Depression which didn’t, in fact, make it into the book. I found reports suggesting the implementation of the Smoot-Hawley Tariff Act caused a trade war, that put further strain on the international economy during Great Depression.
In reality, international trade was so negligible at that time that it couldn’t have had a material impact, but nevertheless the narrative stuck.

On the predictive power of an inverted yield curve…

The suggestion that an inversion of the yield curve is a leading indicator of recession could well be somewhat of a self-fulfilling prophecy.

“It used to be that people feared inflation as one of the biggest problems facing the world. Now they’re more worried about immigration that inflation.”

On zero interest rates…

Central banks have been losing the fight against capital markets. Today they have become forced to act in line with capital market expectations. Neither Powell nor Draghi have told capital markets that they will not necessarily act in a way that is expected.

On persistently low inflation…

I have been looking into the Neo-Fisher Effect, which suggests that what drives inflation is in fact long run nominal rates. So low nominal rates over time cause low inflation. If you believe this theory to be credible, then the suggestion is that central banks are, in fact, causing low inflation and thus making the world more pessimistic. Though, of course, I don’t think the ECB would appreciate such a label.

The changing way that the labour markets operate are also a cause of low inflation. Year-on-year wage inflation today is around 1%, while core inflation is at 1.6%. This means that just 0.6% is coming from everything else, including the impact of trade tariffs. If you look back in history, at similar points in the cycle wage inflation is typically 4-5%. There has been a significant decline in the bargaining power of labour.

On the true impact of trade tariffs…

If people begin to believe that continued trade disputes will impact growth, they will. Recent academic studies have found that the current impact of trade tariffs is equivalent to 0.1% of global GDP, versus predictions of as much as 0.8% by some economists. If these predictions are true, the suggestion is that the difference between these two figures is due to the associated panic or worry.

The economy changes because people’s thinking changes. If you look back over a century ago, yield curve inversions were not considered to be a leading indicator and in most cases were barely reported. But people like apocryphal stories. So could the recent yield-curve inversion lead to a recession? Yes, I think it could.

On the catalyst for the next recession…

The Philadelphia Fed have done some research to show that economists are pretty good at making predictions over three to six months. But as you get beyond a year the accuracy of predictions rapidly deteriorates. It’s somewhat embarrassing as an economist to hear that we struggle to predict such critical events as a recessions significantly ahead of time but, then again, there is a deep psychological component to recessions and crashes.

If you look at the US is today, Trump is an astute studier of public opinion and has peddled the American Dream with the charisma of a motivational speaker. This narrative is 50 years old but has been so strong in driving the US economy. The next recession might well come when the next narrative takes hold.

If you look at the DotCom Bubble, or rather the “Millennium Bubble” as it was much more than just DotCom stocks, the Cyclically-Adjusted Price-Earnings (CAPE) Ratios don’t necessarily reflect bubble like behaviour today. Neither do house price ratios for that matter. In the previous recession, the new narrative was about ‘flipping’ houses. I would have taxi drivers give me advice on real estate markets, without knowing who I was in the back of the cab. I can’t yet identify the narrative today that will cause the next recession.

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> *“What we need to do is look for something that will make inflation re-appear and for that I have been looking closely at the political programs of the opposing candidates in the 2020 US presidential elections. Policies like the doubling of the minimum wage or the introduction of punitive taxes on US shale gas are the types of policies that could make the election a potential recession catalyst.”*

China is moving from a manufacturing economy to a service economy and growth in services typically requires much less investment than growth in manufacturing. The only component of Chinese GDP that is growing is services. This shift is likely to have a much bigger impact on Global GDP than trade tariffs.

On the predictive power of an inverted yield curve…

Often it’s the timing that’s important. There was a yield curve inversion in 2004 and a recession in 2007, but does this therefore make it a leading indicator of recession? The San Francisco Fed has done some work on this to show that when the yield curve is flat, the term premium disappears and as a result the yield curve is no longer a leading indicator of growth.

But can we go as far as saying a flat or inverted yield curve is bad for growth? In Europe, yes I believe we can. A flat yield curve often causes banks to move away from the traditional business of lending and into other peripheral activities such as asset management. The result of this often means less loan origination which potentially means less growth.

On the catalyst for the next recession…

Social mobility is an important concept. Or rather, the perception of it is. If people perceive social mobility to be high, they tend to be much more accepting of inequality. In the US the perception is that social mobility is high, yet in reality it’s actually relatively low. In France it is the reverse, which is somewhat ironic when you contrast the American Dream with the Gilets Jaunes.

There will at least be no debt driven recession with rates at zero. When interest rates are at zero, everyone is solvent. There could however be a global economic slowdown led by China, which is growing at 4% today versus 8% historically.

What we need to do is look for something that will make inflation re-appear and for that I have been looking closely at the political programs of the opposing candidates in the 2020 US presidential elections. Policies like the doubling of the minimum wage or the introduction of punitive taxes on US shale gas are the types of policies that could make the election a potential recession catalyst. Elsewhere, any political shock that specifically impacts the OECD labour market policy could equally lead to recession.

<ENDS>

This debate took place in Paris on 10th September 2019

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