Market resolutions for 2016

Economist Insights

Based on the experiences of 2015, we once again suggest some New Year's resolutions for the market. Among others:

- I must behave like an adult if I want central banks to treat me like an adult
- I must acknowledge that lower potential growth means earlier rate hikes
- I will start the year with more humble expectations of growth
- I will treat emerging markets as emerging (yet again)
- I will think of Greece as a holiday destination, rather than as destroyer of the Euro
- I will recognise that the global economy is diverging

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As we close our fourth year of Economist Insights it is time once again to look at the New Year's resolutions that we believe the market should follow. What lessons should the market take from 2015 to avoid repeating the same mistakes in 2016? Our suggestions follow, along with links to the Economist Insights issues that provide more detail.

I must behave like an adult if I want central banks to treat me like an adult.
Central banks need to think about risks, so it makes sense to talk about risks. But when the market scrutinises every word of every sentence, mentioning a new risk is likely to trigger an over-reaction from the market. So when the Fed mentioned risks from China back in September, the market suddenly decided that China was the pivotal factor in the Fed's decision. The Fed themselves likely thought it would have been odd not to have mentioned events in China, but only as a risk. Seeing the childish market reaction to that one line, they removed it in the next statement even though the risks persisted. The market is clearly not mature enough to handle a grown-up discussion of risks. See *Splendid Isolation*, 2 November 2015.

I must remember that rates can rise.
This may seem obvious to people in many countries, but in the major investment markets (US, Eurozone, Japan and UK) it has been more than eight years since we last saw a rate hike (if we ignore the ECB's policy error in 2011). Despite some doubts on the way, the Federal Reserve finally hiked rates in December. Central banks do not tend to hike once and forget it, so there should be more to come. The question is simply how fast and who else will follow. See *Half-Fed*, 21 December 2015 and *International Monetary Fears*, 7 September 2015.

I must acknowledge that lower potential growth means earlier rate hikes.
The market consensus is that potential growth is lower in most economies than previously thought. Since this is bad news, most people assume that this means monetary policy must be looser. But if rate hikes are predicated on narrowing the gap between actual growth and potential growth, the gap will then be smaller. Just look at how little growth is apparently needed to bring down the unemployment rate. So lower potential growth may mean an earlier start to rate hikes, although the terminal rate would then be lower. Unless, of course, interest rates are currently too high, as suggested by the idea of secular stagnation. See *Theory of relativity*, 1 June 2015, *Potentially misleading*, 13 April 2015 and *Going spare*, 16 November 2015.

I must change how I think about the effects of oil on economies.
After oil prices fell sharply in the latter part of 2014, pretty much everyone (ourselves included) thought that this would bring a big boost to the oil importers. In the event, the modest growth was a bit of a disappointment (unless the counterfactual was that growth would have been awful). The behaviour of OPEC has also been unusual, and has led to lower oil prices for longer than many expected. See *Side Effects*, 28 September 2015 and *Show and Cartel*, 14 December 2015.

I will start the year with more humble expectations of growth.
Each year the market has been over-optimistic on growth for the global economy. Early optimism in January gives way through the year to more and more pessimism (most of that in the first few months). There was one notable exception this year, which was the Eurozone, where the market started out pessimistic but was pleasantly surprised. Perhaps if the market finally starts out more pessimistic on global growth, Murphy's law will kick in and we will get upside surprises. See *Delphic*, 5 January 2015 and *Functional forecasts*, 12 January 2015.

I will treat emerging markets as emerging (yet again).
This is one of those resolutions that is a lot like giving up smoking, after failure it is repeated each year. Emerging markets are, by their nature, volatile which means they are risky. China was the prime example this year, as investors were reminded that when markets are imperfect (thanks to state control) prices can get out of kilter very quickly. See *The 'Greater Fools'* of China, 13 July 2015, *Catching cold*, 27 July 2015 and *Easy come, easy go*, 5 October 2015.

I will think of Greece as a holiday destination, rather than as destroyer of the Euro.
Once again a change in the political situation triggered a panic about Greece, and once again the economic (and political) realities won the day. The situation did become rather surreal when Syriza rejected a deal in order to hold a referendum which also rejected the deal, only to accept what was essentially the same deal the following week. But this just demonstrates that in the face of sharp economic realities the political grandstanding is just that. See *Will it all end in Drachma?*, 22 June 2015, *Burning Bridges*, 6 July 2015 and *Icarus*, 14 July 2015.

I will recognise that the global economy is diverging.
After many years of integration and globalisation, it really does look like economic outlooks and monetary policy are diverging. This is not just an emerging versus developed market split, there is a split within each of those groups as well. This also means greater currency divergence, even amongst those with a long history of being pegged to the USD. See *Globalessation*, 12 October 2015 and *Fixation*, 17 August 2015.

I will not overestimate the impact of the rest of the world on the US economy.
The stronger USD was widely predicted to cause big problems for US growth, but in the event the US has been fairly solid. And in any case, what matters for the global economy is US domestic demand (which includes imports), not US GDP. See *Import-ant*, 16 March 2015, *Easing off*, 26 October 2015 and *Fixation*, 17 August 2015.