# Thematic Report

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# The Crash of 2016

**In this issue:**



- **The improvement in economic performance during 2015 has lulled market concerns**
- **Continued QE has distorted many market indicators**
- **Many banks find themselves over-exposed and face 'bail-ins'**

## 1 The economic backdrop

One reason why the crash of 2016 was so devastating was that market concerns had been comfortably lulled by a marked improvement in economic performance in the course of 2015. Admittedly, this improvement was more apparent in developed market countries, especially the Eurozone, rather than emerging market countries. Indeed, a continuing slower rate of growth in Asia, notably in China, combined with the lifting of sanctions on Iran, extended the duration of low raw material prices, which improved the real incomes of consumers, especially in the energy-poor countries in both Asia and Europe. The recovery from previous sluggish, or absent, growth, was most apparent in Europe. There now appeared to be light at the end of the tunnel for the Eurozone, and both difficult relationships with Greece had been eventually handled effectively, while there was increasing confidence that the UK referendum on Brexit would result in a vote to stay in, as subsequently happened. Also, a long awaited recovery in wages growth started to occur in Japan.

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So, with Europe and Japan recovering, the continuing divergence of exchange rates between the dollar and the euro, despite occasional reversals, did not appear to be delaying a continuing process of tightening in labour markets in the US and the UK. In this context, by the time of the first move upwards of the Federal Funds Rate, to return to normalisation, that came to be seen as inevitable, and was treated as an, almost boring, foregone conclusion, with little market effect. Estimates of the NAIRU continued to be revised downwards, and the blue dots of the FOMC continued to suggest an extremely gradual rise in interest rates. Indeed, there was a general suffusion of enhanced confidence, at least in DM, by the autumn of 2015.

## 2 All change

*"Meanwhile, annual inflation began to rise quite sharply, back towards 2%, as base effects from the previous year's fall in oil prices fell out of the system."*

It all changed, however, in the first three months of 2016. The Philips curve sprang back to life, and suddenly wages in a number of countries, where unemployment had been declining for some time, rose significantly again, notably in the US, the UK and Japan. Furthermore, demographic changes were beginning to take effect in China, so despite the relatively slow growth there, wage increases were quite marked. Meanwhile, annual inflation began to rise quite sharply, back towards 2%, as base effects from the previous year's fall in oil prices fell out of the system. There began to be worries that the FOMC/MPC had fallen behind the curve. A combination of the upwards surprise in GDP growth in the Eurozone, and the recovery in HICP, led to pressure from the Bundesbank for QE in the Eurozone to be brought to an earlier end. Finally, there was beginning to be a growing realisation that demographic changes would start to make wage and inflation pressures greater over subsequent years. Against this background, the yield curve, having been remarkably flattened, began to shift upwards quite sharply.

## 3 QE distortion

QE had been effective in distorting both the level and the shape of the yield curve. On the back of QE, banks had been engaging in a massive carry trade, borrowing cheaply from their Central Bank, especially the ECB, for the purpose of investing in government bonds. This had been a hugely profitable enterprise over the past few years, and it enabled European banks in particular to offset the effect of their losses on their non-performing loans. Especially in so far as such sovereign debt was carried in their trading books, banks suddenly faced a reversal of the previous favourable situation, with losses arising from adverse interest rate movements. Moreover, these interest rate movements were not gradual, but occurred more sharply than anyone had previously foreseen.

Liquidity in bond markets had been greatly reduced as one of the unintended consequences of the regulatory tightening since the beginning of the Great Financial Crisis. So, when the bond market began to reverse from its distorted and exceptional high levels, it was not so much a gradual retreat, but a rout. Meanwhile life insurance companies and pension funds – who had been pressured to shift their portfolios into long-dated bonds, e.g. by the Solvency II regulation, at the worst possible moment – took a large hit from the rise in yields.

## 4 Pressure on the banks

Even though the banks primarily held shorter-dated debt, the extent of decline in bond prices, combined with the continuing losses on their loan book, put a number of European banks under great pressure. In effect, they became unable to meet their TLAC requirements, and the new resolution arrangements for creditor bail-in were triggered, in a couple of extreme cases. And the fragility of the longer-term savings institutions not only both worried and angered the general public, but also led to a sharp, even if temporary, rise in the savings ratio.

*"There were many demonstrations, in particular against central banks..."*

This experience of losses on bail-inable bonds and cocos, put a further sharp downwards screw on declining bond prices generally. The danger then shifted to concern about the solvency of pension funds and life insurance companies. With private sector companies responsible for topping up their own pension funds, this led to a huge diversion of cash resources from investment into support for the savings institutions. Concern about the viability of their savings inflamed the middle classes in particular. There were many demonstrations, in particular against central banks who were accused both of having initiated an unsustainable bubble in bond prices, and then had stood back while attempts of renormalisation had led to the subsequent collapse of such prices, which had further endangered the financial system.

## 5 Further QE

Against this background, the authorities in Europe had little choice but to retreat and engage in further, even augmented, QE. But with the US economy continuing, relatively unscathed, this led to a further and even more extreme divergence between exchange rates in the US and the Eurozone. With the euro then falling rapidly in value, the alternatives for monetary policy in the Eurozone then appeared to be quite stark, with potential much increased inflation on the one hand, or further financial disruption on the other. The great uncertainty about what was best to do, led to an even greater decline in confidence.

## 6 The next chapter

How did it all end? That will be revealed in the next chapter of the economic history of this century, which we hope to publish shortly.

**Professor Charles Goodhart**

## Biography

**Biography**
Charles Goodhart
*Central Bank Policy Adviser*

Professor Charles Goodhart, CBE, is ECU's Chief Economic & Central Bank Policy Adviser and a member of the Global Macro Team. Charles worked at the Bank of England for 17 years as a monetary adviser, becoming a Chief Adviser in 1980.

A former member of the Bank of England Monetary Policy Committee, Charles is Emeritus Professor of Banking & Finance at the London School of Economics and also a senior economic consultant for Morgan Stanley.

**For more information on our other strategies, please contact Bansi.Jashapara@ECUgroup.com**

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Neil MacKinnon, Kit Juckes


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Chaired by Andrew Rozanov, we provide a "Start the Week" client-driven Q & A discussion between Neil MacKinnon and Kit Juckes focussing on topical issues and driving forces influencing major asset classes.

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A "Start the Day" roundup, providing opinion and strategy, and highlighting key events, data releases and global market news.

### FX Strategy
Stephen L Jen

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Stephen Jen provides a detailed and rigorous study of a key topical investment theme or global market issue.

**Weekly:** My Thoughts on Currencies

Stephen delivers a strategic analysis of key global issues driving currency markets.

### Asset Allocation Roadmap
Robin Griffiths

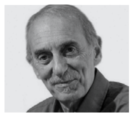
**Quarterly:** The Big Picture

Chief Technical Strategist Robin Griffiths takes a look at the longer term trends prevailing in global asset classes.

**Monthly:** Asset Allocation Roadmap

Robin uses ECU's proprietary models and qualitative analysis to give monthly strategic opinions and updates.

### Thematic Pieces
Professor Charles Goodhart, George Magnus

**Monthly:** Think Piece

Professor Charles Goodhart and George Magnus write topical and thought provoking pieces that explore longer term themes in the market and issues that affect the global economy.

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