THE RISK OF MONETARY POLICY MISTAKES

ABOUT THE AUTHOR

Gustaf Hagerud is the Managing Director of Ress Capital. He has worked in the financial industry since 40 years. Gustaf spent most of his time on global asset allocation and strategic portfolio construction. For seven years he served as the deputy CEO of the public pension fund AP3, responsible for all investments, including global equities, global bonds, hedge funds, private equity, real estate, forestry, infrastructure, and insurance-linked securities. Prior to that, he spent ten years working with global asset allocation at the pension funds Alecta and AP1. He began his career in the banking sector, as a trader at Nordea and Swedbank. Gustaf holds a PhD in Finance from Stockholm School of Economics. His research focuses on volatility forecasting, and he has co-authored a textbook on the Swedish financial markets.

EXECUTIVE SUMMARY

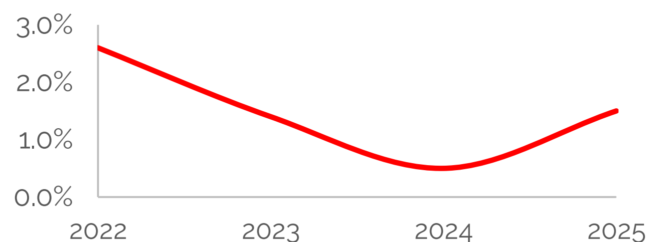
- In this Market Insight, Gustaf Hagerud, gives his views based on his experience from senior roles in asset allocation and portfolio construction.
- Inflation in the US and Europe is expected to move close to central bank targets in the summer of 2024, opening for policy rate cuts in Q2 2024, continuing into the middle of 2025.
- Developed economies as a group are expected to avoid recession in 2024, and GDP growth will increase in 2025.
- However, the risk is not negligible that central banks will make policy errors pushing developed economies into recession in 2024.
- This risk motivates a defensive asset allocation and an allocation to alternatives with low correlation to the global business cycle.

GROWTH AND INFLATION OUTLOOK

After the swift tightening of monetary policy by major central banks in 2022 and 2023, the outlook for global economic growth in 2024 is weak. GDP growth in developed countries is expected to be around 0.5%, compared to an estimated 1.5% in 2023. This slowdown in growth, in combination with moderating raw material prices, will most likely reduce inflationary pressure, thus increasing the possibility for lower policy rates from central banks during 2024 and into 2025.

Given the positive prediction on interest rates in developed countries in 2024 and 2025, increasing economic growth should occur in 2025. Both in North America and Europe, GDP growth will most likely be more than 1 per cent higher in 2025 than in 2024. Considering that it takes around 18 months for monetary policy changes to impact the real economy, the so-called *monetary response lag*, the improvement in GDP growth should further accelerate in 2026. Thus, if central banks are successful in their fight against inflation, the medium term forecast on growth is clearly positive, as can be seen in Figure 1.

Figure 1: GDP Growth in Advanced Economies in 2022 to 2025



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FINANCIAL MARKET EXPECTATIONS

As always, forecasts on growth and inflation differ among financial markets participants. However, the general prediction priced into financial markets is one where monetary easing will start in the middle of 2024, which can be observed in short-term interest rate expectations. Furthermore, given a generally positive tone on global equity markets, investors are pricing in a soft landing in global growth. Thus, a recessionary scenario is expected to be avoided.

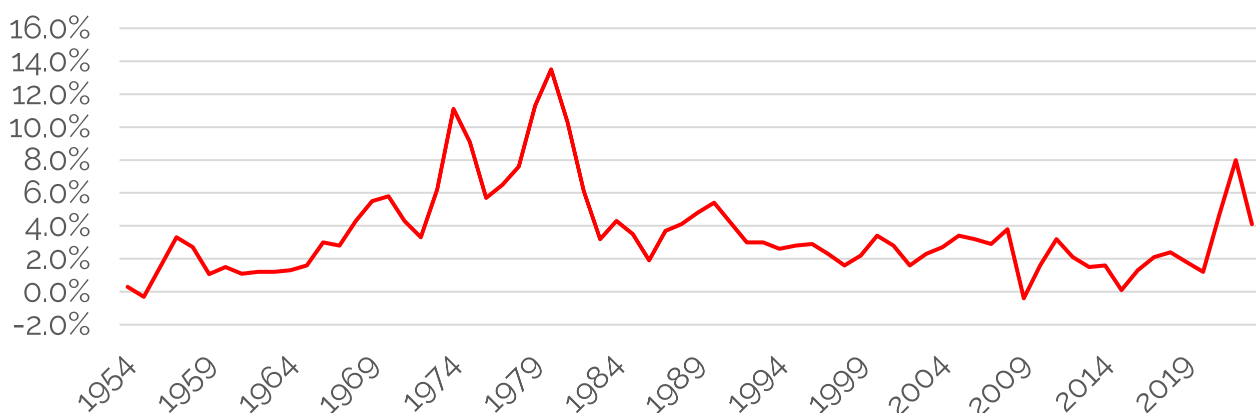
It should be noted that the market is still particularly nervous about unexpectedly high inflation numbers, since this is likely to delay monetary policy easing. This strong reaction by financial markets is something that Ress Capital mentioned in the Market Insight from April 2023. In that report, we noted that the correlation between the equity and bond markets returns had turned positive, after having been negative for many years, and we discussed the implications for portfolio returns. This can be explained by the fact that high inflation numbers will hurt both equity and bond returns. Conversely, lower inflation numbers, will have a positive effect on both equity and bond markets. We will return to this dilemma for asset allocators, in the section below, where we discuss the allocation to alternatives in the current economic environment.

THE RISK OF POLICY MISTAKES

Figure 2 below shows the consumer price index (CPI) for the US in the last 70 years. As can be seen in the graph, the Federal Reserve had not faced the high headline CPI-figures in 2022 since several decades. Figure 3, which is taken from the Federal Reserve's research database, shows how the Federal Reserve has reacted to changes in inflationary pressure during the same period. The solid line represents the *Effective Fed funds rate*. The shaded areas in the figure 3, represent periods of recessions in the US. From the graph, one can draw the conclusion that sharp increases in policy rates in many cases have led to recessions. In my view, financial markets participants have underestimated the risk that central banks might unintentionally push major economies into recession, which could have severe consequences for equities and bonds issued by companies which are exposed to the general business cycle.

An important factor to consider with regards to the risk of a monetary policy error, is the lack of statistical evidence on how monetary policy tightening feeds through the economy in the current highly integrated global financial system. Thus, even though macro-economic research has developed in the last 40 years, with more solid theoretical understanding of monetary policy, central banks have no recent experience on how to fight inflation above 10%. Therefore, there could be a tendency that central banks are requiring clear evidence that their policies have been successful, with both low inflation and weaker labour markets. Until they have such evidence, central banks may tend to overcompensate with tight monetary policy, creating a period of negative growth in advanced economies.

FIGURE 2: CONSUMER PRICE INDEX IN USA 1954 TO 2023, YEARLY OBSERVATIONS



Source: U.S. Bureau of Labor Statistics

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FIGURE 3: EFFECTIVE FED FUNDS RATE 1954-2023, SHADED AREAS INDICATE RECESSIONS

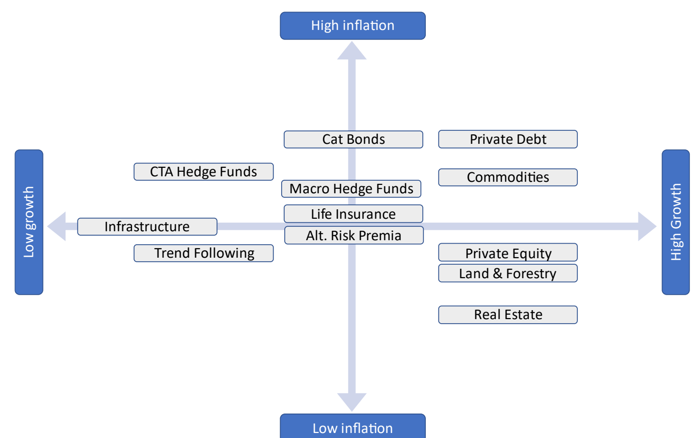
ASSET ALLOCATION RECOMMENDATIONS

My main scenario for global growth is that advanced economies as a group avoid a recession in 2024, and that GDP growth in 2025 is in the region 1.5-2.0 per cent. Inflation in the US and Europe is expected to move close to central bank targets in the summer of 2024. This will open for lower policy rates starting in Q2 2024 and continuing into 2025. The easier monetary policy is a major explanation of the pick-up in growth in late 2024 and in 2025.

The most important risk to this positive main scenario is higher than expected inflation numbers during 2024. This will most likely lead to a very slow reduction in policy rates, increasing the likelihood of policy mistakes by central banks. The mistakes, as mentioned in the previous section, would be that monetary policy is unnecessary tight, pushing advanced economies into a period with negative growth. This will eventually end, when central banks start to lower policy rates sharply, but the adaptation period could be painful for global financial markets with high volatility in stock and bond markets.

Investors should be cautious in their asset allocation about exposure to sectors of the equity market sensitive to economic growth. When it comes to fixed income allocations, they should be towards higher credit quality since a prolonged period of higher interest rates increases the risk of bankruptcies among financially weak companies. To further decrease the exposure to business cycle risk, I recommend increased allocation to alternatives at the expense of liquid equity and fixed income instruments. This view is partly based on the observation that the correlation between equity and bond markets might become positive in periods when inflation is surprising investors on the upside. Thus, the risk-reducing element of an allocation to bonds disappears and the market value of equities and bonds fall at the same time.

FIGURE 4: SWEET SPOTS FOR ECONOMIC GROWTH AND INFLATION FOR DIFFERENT ALTERNATIVES



In this current macro-economic climate, I would like to highlight the illustration in Figure 4, which is taken from Ress Capital's Markets Insight on asset allocation from October 2023.. In this figure, different alternatives are classified according to their dependence on the strength of the business cycle and their exposure to the inflation rate relative to central bank targets. The position of different asset classes indicates under which regimes they are expected to perform well, and thus deliver high risk-adjusted returns. Given that investors are seeking an alternative portfolio that will perform well in the above risk scenario, I would recommend allocations to CTA Hedge Funds, Cat Bonds, Macro Hedge Funds, Trend following Strategies and Life Insurance policies.

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CONCLUSION

In the last three years, the world has witnessed a sharp increase in inflation to levels not seen since the 1980's. The increase in inflation is primarily the result of supply side shortages after the pandemic and increases in food and raw material prices after Russia's invasion of Ukraine. Since the peak in 2022, inflation levels in advanced economies have come down significantly. However, in my view, there is a risk that inflation will not move down quickly enough to policy targets, motivating central banks to delay interest rate cuts. If this happens, there is a clear risk that central banks will push major economies into a recession, which would be a policy error.

The risk that central banks make policy errors is amplified by the fact that they do not have reliable statistical data on how economic activity reacts to a sharp contraction of monetary policy. The last time central bankers had to fight inflation levels of the magnitudes seen in 2021-2023, were over 40 years ago, when global financial markets were far less integrated.

My main scenario for inflation and growth in the advanced economies is a positive one, where inflation will fall further in 2024 and the business cycle turns positive at the end of 2024. However, since the risk for monetary policy errors is relatively high, I recommend a defensive asset allocation, with more exposure to segments of the equity and bond markets that are less affected by lower economic growth. Furthermore, a high allocation to alternatives that have low correlation to global growth is prudent.

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ABOUT RESS CAPITAL

Ress Capital is an alternative investment fund manager (AIFM) regulated by Finansinspektionen, the Swedish Financial Services Authority. The company employs ten people at its office in Stockholm. We have since 2011 purchased life insurance policies on behalf of Ress Life Investments, which is listed at NASDAQ Copenhagen.

The management team has extensive experience and complimentary backgrounds in financial markets, life insurance and international experience from having worked at major banks and hedge funds.

Proprietary portfolio management systems and pricing models have been developed internally which gives us a competitive advantage when selecting policies. Ress Capital also collaborates with external medical underwriters, specializing in senior mortality in order to provide more accurate assessments.

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