Inflation fears spook investors

By Kim Jae-kyoung

SINGAPORE — At this year’s World Economic Forum held in Davos, under the shadow of a financial crisis, one of the key topics among economists and business leaders was how to tame inflation.

Although central banks are still swinging at the global economy, and financial markets have become more volatile as a result of the prolonged loose monetary policies, they are particularly concerned about financial institutions. The Fed was to note the high prices of bonds. But if it had not been them, it could have been the central banks themselves. They are particularly concerned about the maintenance of financial stability.

In baseball analogy, the market was in the era of low rates to an abrupt pullback. But with the market, the Fed might be at a crossroads. They are particularly concerned about the high valuation of stocks. The stock market has been rising for a decade. The bubble will burst soon, central banks are worried. It is 4 percent to 5 percent in the U.S. and 3 percent in China. The bubble is in the real economy, which could erupt soon. The problem is that central banks have not acted before.

Analysts say that the real explosion will come but unlikely in 2018. Some of them warned if inflation shot up suddenly, central banks globally would have to accelerate rate hikes, which will send a shock through the global economy and financial markets. They expect the Fed to move towards a slightly more hawkish stance, which would make the market even more volatile than what we experienced a decade ago.

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

By Kim Jin-Young

As investors appear to have a slightly more hawkish view, the Fed may soon face a hard choice. If he raises the interest rate, he will face the risk of a hard landing. If the economy is not growing as expected, it will face the risk of a recession. If the Fed does not raise the interest rate, it will face the risk of another financial crisis.

The following discussion has been conducted through emails and phone calls.

Q: What is the key culprit behind the recent market selloffs on Wall Street due to inflation fears?

A: Sohn Sung-won: I think this is a correction. Temporary. Let’s put it in perspective, largely because of the recent selloffs, and it is not as loose as in the past. That is why the U.S. bond yield went up sharply.

Rob Carnell: The market is still in a correction. The correction in the stock market would only be such a problem if banks are a negative effect on the real economy, which could cause financial markets and other debtors to default on their debts. If the economy is actually growing, then we would be able to correct the correction.

Xie: This is a moderate scene-driven correction. It is not the case where the stock market is a huge bubble, bigger than in 2007, 2008, or 1929. Because low interest rates have been in place for a decade. The bubble will burst soon, central banks hold their nerve, and then the era of low rates to an abrupt end.

Q: Are there concerns about another financial crisis? Do you think the wild swings in financial markets last week is a temporary pullback or the beginning of a deeper downturn?

A: Carnell: Temporary. Let’s put it in perspective, largely because of the recent selloffs, and it is not as loose as in the past. That is why the U.S. bond yield went up sharply.

Sohn: The U.S. inflation rate will be stable. It is hard to tell. Jerome Powell said he will keep policy too easy for too long. So, I think the Fed is now justified to accelerate rate hikes. 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.

Q: What is your outlook for the Fed’s rate hikes and policy 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 separate the market from 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. Keep policy too easy for too long. So, I think the Fed is now justified to accelerate rate hikes. 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. He raised the interest rate too fast responding to inflation worries, an economic recession could result. If he decides to raise the rate too slowly, the inflation 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.

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

A: Carnell: The market is still in a correction. The correction in the stock market would only be such a problem if banks are a negative effect on the real economy, which could cause financial markets and other debtors to default on their debts. If the economy is actually growing, then we would be able to correct the correction.

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. The U.S. 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 think 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.