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LEADING THOUGHTS

Grounghog or Canary?

The recent market gyrations look more like an entertaining sideshow, but it's worth asking when they might be a signal of something worse.

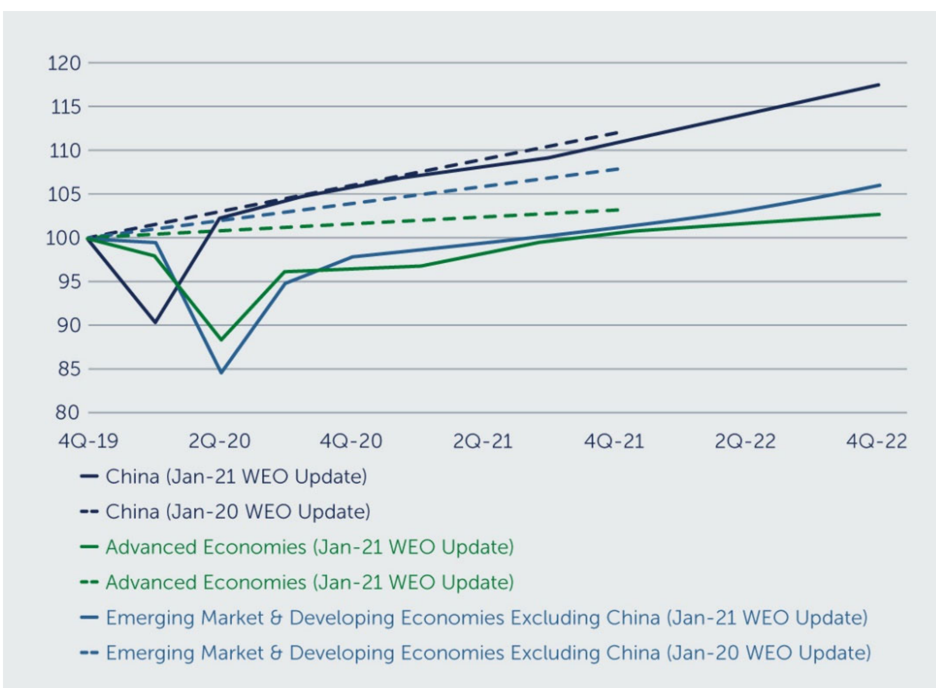
Rare is the moment for an investor when the next 12 months look more predictable than they do now. Vaccines are here, government support continues, and the recovery is in sight. It may be longer or shorter because of inoculation logistics or damaged labor markets, but the economic trajectory is improving.

Right?

But what of these nagging thoughts when you read about GameStop, its day traders and an angry chatroom that fuels wild gyrations in stock and options prices? Is it a distraction as significant for the global recovery as the Tuesday appearance of Punxsutawney Phil and the sighting of his shadow? Or is it a coal mine canary – a sign that something is seriously wrong in global markets that are awash with so much central bank liquidity and leverage that the plumbing is in danger?

Most evidence suggests we're still on solid ground. The outlook is surely improving if you look at the new numbers from the International Monetary Fund. Its economists now forecast growth at 5.5% this year, up 0.3% from last October due to the arrival of vaccines and higher government spending in the United States and Japan. Last year's global contraction was revised to -3.5%, nearly a full percent better than the previous projection.

DIVERGENT RECOVERIES: WEO FORECAST FOR ADVANCED ECONOMIES



Source: IMF. As of January 28, 2021.

Like the average temperature of hospital patients, however, these numbers hide a great deal of differentiation. Stunningly, the IMF now plots a Chinese trajectory for the next two years essentially as if there had been no pandemic at all, with 2020 GDP already 2.3% higher than the previous year. The United States and Japan may recover to 2019 output levels later this year, but Europe and the United Kingdom may not until 2022. There's a much broader divergence across Emerging Markets and a dire projection that as many as 90 million people are falling below the extreme poverty threshold due to the crisis.

Of course, amid the short-term risks from poor vaccine logistics and sagging employment data, financial markets have been soaring. Equities markets are trading at elevated valuations, and corporate debt spreads have largely recovered to levels before most investors could find Wuhan on a map. In a separate report on global financial stability, IMF economists note that the recent softening in economic data from winter lockdowns has barely dented investor enthusiasm.

To be sure, the report includes an obligatory list of potential risks: "rising corporate debt, fragilities in the nonbank financial institutions sector, increasing sovereign debt, market access concerns for some developing economies, and declining profitability in some banking systems." But the main worries center on governments pulling back on stimulus, vaccines not getting out fast enough and continued scarring in the global economy, especially with rising numbers of long-term unemployed.

U.S. EARNINGS REVISIONS AND RATE EXPECTATIONS

Source: IMF. As of January 28, 2021.

If financial markets look stretched, they may not be wildly out of line if inflation and rates remain low, as seems likely. Corporate profits are still edging higher and the current earnings season has brought few disappointments so far. Moreover, an elevated level of market volatility market volatility suggests that investor exuberance does have limits.

And yet history teaches that massive liquidity injections like those triggered by the pandemic often lead to strange things. Few would have predicted the line from subprime U.S. mortgage securities to Greek default. When the stock price of battered business models like an electronic gaming retailer surges so wildly that some clearing firms can't handle the volume, it may be nothing at all. But this story has gained momentum so fast, it looks likely to leave at least some damage.

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To be sure, a few minutes in one of the chatrooms that apparently drove much of the activity is a fresh reminder of just how much anger lurks in today's world. And the announcements of Congressional investigations into the current saga suggest there is more to uncover.

Financial bubbles and crisis triggers are usually only visible from the wreckage of the next crisis. From all appearances, the current recovery remains on track and the world's banking system is rock solid. There will surely be more corporate bankruptcies ahead, but corporate balance sheets generally look liquid enough to avoid a cascading series of defaults.

Still, last week's sagging markets suggest this is a sideshow well worth watching. We just want to confirm that what looks like a groundhog isn't really a canary.

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