Institutional Investors Symposium 2017

Closing Keynote Address

by Ravi Menon, Managing Director, Monetary Authority of Singapore

Financial markets are under-estimating the pace of monetary policy normalisation by central banks globally, particularly the US Federal Reserve, says Ravi Menon, managing director of the Monetary Authority of Singapore.

On Wednesday 14 June the US Federal Reserve, raised benchmark interest rates for a second time in 2017, despite inflation still being well below its target of two per cent. Speaking at the DBS Institutional Investor Symposium, in Singapore on 22 June, Menon warned that global markets appeared not to be fully pricing in potential further rate hikes.

“The Fed’s guidance suggests one more rate hike in 2017, and three each in 2018 and 2019, but markets are pricing in less than three total hikes for the rest of the year through 2019,” he said.

Speaking at a press conference following the latest US rate hike, Fed chair, Janet Yellen, said that despite lower than expected inflation rates the prospect of full employment meant that inflation was likely to soon hit its target rate, and Menon - partially - backed his fellow central banker.

While he conceded that lower oil prices and muted wage growth meant that there is a low risk of inflation suddenly rising, a tight labour market means this cannot be fully discounted, particularly as unemployment is around its natural rate in the US.

“Past experience suggests that the pass-through from labour market tightness to inflation, tends to accelerate as unemployment falls below the natural rate.”

In this scenario Menon warned, monetary policy normalisation could occur much faster than the market currently anticipates.

Menon said that if this happened it could produce some unpleasant surprises for investors. He contrasted the low levels of both investments in the real economy, and productivity growth in the post-crisis economic landscape with a “voracious”, appetite for risky financial assets by institutional investors.

He said that then continuing search for yield meant that investors were extrapolating the current low levels of both interest rates and realised volatility into the future, resulting in equity and bond valuations in developed markets that are rich in historical terms. As an example, Menon pointed to the cyclically adjusted, price-to-earnings ratio, of US equities as being in the 97th percentile.

“There has been some dampening of exuberance in recent months. Even so, the question remains: have markets over-priced the good news and under-priced the bad news?”

In addition to the possibility of monetary policy normalisation occurring at a much faster rate than market expectations, the current state of persistently low levels of realised volatility is potentially at odds with the heightened political uncertainty, he said.

Menon posited that low expectations over economic growth could be drawing market attention away from policy risk - a trend he characterised as a conundrum between volatility and uncertainty.

“But surely political uncertainty is at elevated levels? And when politics is uncertain, can economies remain unaffected?”

Menon pointed to the potential for a disorderly Brexit process to drive a spike in market turmoil and trigger sharp asset price corrections, and also the emergence of trade protectionism as key potential issues.

He said that while the risk of the latter had reduced of late, increased global trade barriers remained a significant tail risk for growth expectations, particularly if the wrong policy decisions were taken by governments.

“Against that backdrop, a rising tide of populist backlash against globalisation is a wild card for the medium term. [But] these risks are not pre-destined...Where we go from here hinges strongly on domestic policy responses in each of the major economies and the trade-offs they make today between the short and the long-term.”

While global growth prospects have an air of uncertainty to them, Menon was much more positive over the medium-term outlook for Asia. He pointed out that emerging markets in general, and Asia in particular, have not experienced the push-back against globalisation seen in more developed markets.

“Asia remains committed to openness, is positioned for sustained growth, and offers much promise to investors. Led by China and India, Asia will remain the fastest growing region in the world.”

To support his view Menon quoted the International Monetary Funds projection that emerging and developing Asia will grow by an average of 6.3 per cent a year until 2022. Breaking this down onto its constituent parts the IMF says, the Asean Five countries of Indonesia, Malaysia, Thailand, Vietnam and the Philippines are expected to register annual growth rates of five per cent, China (six per cent) and India (seven to eight per cent).

The driver of this growth will be the continuing expansion of the region’s middle class and rapid urbanisation. Menon quoted an Asia Development Bank report which predicted that one billion people from Asean, China and India would be in the middle income bracket by 2030.

“That is more than a threefold increase from today and presents significant potential for growth in private consumption.”

Menon said that this growth has been underpinned by sustained investments in physical and human capital. He pointed to the massive investment in education by Vietnam as a prime example of this trend. Education spending in the communist country currently sits at around 20 per cent of total public expenditure - an approach which has already seen payback in terms of its global ranking in Pisa - the Programme for International Student Assessments

Menon said that Vietnam was part of a new source of untapped growth for the region, what he termed the CLMV countries: Cambodia, Laos, Myanmar, and Vietnam.

“These are increasingly plugged into the global economy and regional supply chains, participating as downstream manufacturers in regional production networks.”

Again he cited Vietnam, pointing out that manufacturing now made up a third of the economy, with Samsung producing 40 per cent of its phones there.

“To be sure, Asian economies will continue to be subject to the political, economic and social uncertainties that characterise emerging economies, but the region’s fundamentals are sound. Growth inherently enlarges the size of the asset pool and and markets in Asia make a compelling case for global investors.”