GLOBAL riskupdate
The quarterly independent risk review for banks and financial institutions worldwide

Viewpoint 2018

by Dennis Cox, CEO, Risk Reward

Our Global Risk Expert Looks Ahead at Politics, Regulation, Technology, Jobs, Interest Rates, Consumer Spending, the Stock Market, Commodities & Property

It's nearly time to ring in the New Year and ring out the old one.

As each new year commences I always conduct my annual analysis to try to gain some insight into what is likely to happen. This year is no different, and yet it is so very different. Last year we identified that the likely direction of interest rates was upwards and then considered what the impact of this would be on the global market place, but 2018?

2018 is likely to be a year of uncertainty and of volatility. I expect interest rates to continue to rise and some of the consequences of this will be seen in what follows. Interest rate rises are based on politicians' mistaken views about the strength of the economy and the impact of increasing rates. In my opinion much of this is misguided but what caused the problems of the 1970s was embedded in what are really errors made in the 1960s in terms of managing the economy and these errors will recur with significant adverse consequences for the global economy.

To put things into perspective: we are now perhaps following the trend of the 1960s albeit rather faster than was previously the case. Consider the financial sector in let's say San Francisco today but look at what else was happening there during the '60s : drugs, crime, civil unrest and students revolting. It was not an optimistic time and that of course is what created the movement epitomised by San Francisco and its excesses. There were troubled waters ahead, and it all ended up with anarchy in the UK in 1977 followed by the peak of interest rates in 1982. Not a happy picture.

But before you decide that this is just another statement of a downward spiral, I would point out that out of adversity there are always winners. Many firms will still do really well and there is money to be made. And yet we are not entering this 2018 economic cycle with the global economy in the best of shape, another idea I will explore further.

The Political Situation

The political risks within 2018 will remain heightened increasing market volatility.

There are so many political uncertainties at present, critical matters relating to North Korea's threats of nuclear attack as well as governments globally changing their leadership 'rightwards' with uncertain outcomes. France, Germany and Austria have all had recent elections where the outcomes are hard to read in terms of their long-term implications. In Europe we are awaiting the end of Brexit and as I previously suggested the outcome will look a lot like where we started from. I remain fairly convinced that this will be seen to be little more than an expensive diversion.

In a negative economic environment, governments go under stress and to protect themselves tend to either strike out or become protectionist. Neither of these attributes are particularly attractive yet such activity is expected from some of the largest economies. We have learned that those who choose protectionism inevitably lead to failure of the protector and a contribute to the decline in global activity.

Technology and the Changing Workplace

There is a major change going on at present which I had expected to have occurred before now. It will have a profound effect on the political classes and the directions of economies globally. This is the true impact of changing technology on the workforce. I would argue that the changes that are to take place over 2018 and beyond are as gargantuan as the industrial revolution and some of the lessons of that exciting and scary time will need to be learnt. Increasingly tasks which are repetitive by nature are being eliminated. We have already seen the rise of robotics replacing manual labour but there had been a growth in what might be referred to as repetitive administration roles. That is coming to an end.

Throughout 2018 expect to see significant staff reductions in many head office and service organisations. Functions such as finance will be reduced in their headcount as straight-through processing belatedly impacts this area. Reconciliation teams will be reduced as auto reconciliation software moves into the mainstream. IT functions will shrink as systems power is increasingly delegated to the user. Call centres will be replaced by computers and with regret you will know the outcome. (Press one to wait for 20 minutes, press two to lose the will to live, etc) Bank branches will continue to slowly close consolidating into a small number of corporate banking centres. The use of cash will be reduced, and cheques will slowly disappear.

The High Street (retail banking, shopping) is clearly in difficulty as are out of town shopping centres continuing an existing trend. Currently customers visit the stores to look at items which they then purchase on line. In the near future the only stores that will be left are those supplying what might be considered as perishable or immediate purchases. This consumer spending model will not support the existing town planning and retail infrastructure and as sales move on line 30% of global Main Street retail business volume will be lost. But consumer spending will still increase aligned to greater efficiencies in the delivery and logistics sector. It's the 'how' and 'where' we shop that is in for a further shake-up and continues to impact property sector and employment and the related tax base.

I foresee a loss of a lot of entry and administrative roles in financial services. I also see a loss in some technical roles. Treasury operations are changing, for example. Now many dealing rooms are reducing their staff as modelling becomes increasing chartist and models-based. As models dominate there is no need to have staff other than the ones that check the models. Of course, there still has to be someone there to make sure that the machines are working but with straight-through processing actually now delivering on its promises both back and middle office teams will reduce in size.

I remember the massive loss of City jobs - more than 80,000 in one year alone - and it's devastating

effect on businesses and families. With hundreds of thousands of data entry, admin and technical jobs going where will these people find work? Will the leisure industry be able to pick up the strain - again - and so soon after the recent Crisis?
If more jobs are lost will the have and have-nots gap widen further and faster this time? Surely as history shows this is likely to stoke the fires of unrest. I would argue that this is likely to be the greatest challenge to society over the next ten years and this will become a major issue during 2018.

Financial Sector Regulation and its Impact

The regulators have not understood that we have a changed economic environment. They are still stuck in the mindset of developing ever more complex rules for the largest banks which inhibit their ability to undertake the role that in this environment society needs them to do. Some of the revisions to the Basel 3 Accord which have just been finalised clearly fall into that category. I would highlight the ill-conceived large bank operational risk penalty which is actually completely counterintuitive since the larger banks tend to have better operational systems and staff. The existing rules already scaled the capital in accordance with size whereas the new rules bizarrely essentially square them. They are designed for an interest declining market, not an interest rising market.

Regulators are not learning the lessons from history and this really concerns me. The next financial crisis is normally seeded in the mistaken responses to the last crisis and this will show itself during 2018 leading to predictably another crisis in 2019. This will not be a 'too big to fail crisis', rather it will be 'too small to succeed'. It will be the 1979 crisis all over again but this time the regulations are all pointing in the wrong direction.

It is hard to judge exactly what the impact on global GDP will be of having optimised regulations in the wrong environment, but a conservative estimate of 1.5% of global GDP certainly appears sensible.

Capital has to be used, not put on a shelf in a jar and only taken down when absolutely and urgently needed.
You cannot have every bank in the world holding sufficient liquidity and capital to ensure that it meets soundness standards without global economic impacts. In an interest rate rising environment it is important to reduce capital requirements on banks to enable them to support the economy and growing companies. We need to bring back the lender of last resort so that the losses of the few can be picked up by the many and ensure that we do not force entire economic segments into decline with the resulting societal impacts.

Basel regulations have always been about buffers. Perhaps we should change some of them.

The Impact of Rising Interest Rates

I foresee the USA will raise interest rates by between 75bp and 125bp during 2018. That is my central expectation based upon a relatively benign economic scenario. The real question is when will the market decide that the game is up for long dated fixed income securities? There will be a point at which investors will realise that a fixed income security is better value tomorrow than it is today and then to some extent the game will be up.

Indebted countries are currently refinancing their debts through issuance of ever increasing amounts of fixed income debt. At the point when the market starts to slide based on lack of purchase volume it will become increasingly difficult for the - dare I call it - Ponzi style debt refinancing of governments to continue. The recognition of this means that interest rates will continue to lag inflation meaning that deposit accounts will become increasingly unattractive.

In such a market there needs to be a move to floating rate instruments but again the regulations have essentially disabled much of the risk mitigation market by requiring cash collateral in cases where it is not required. I also expect a sell off at the long dated end of the yield curve with bond portfolios increasingly being anchored by what might be referred to as optimistic redemption values. You cannot fund most government debt in 12-month and 15-month bonds. It is just not possible with consequent issues. Accordingly, I expect bond maturities to be extended rather than allowing them to formally default, what might be termed a technical default.

The Stock Markets

If I am right that there will be a sell off at the long end of bonds then defensive stocks should be the natural home for such funds, but there is a problem. Corporate valuations of Fintech are extended and clearly are not sustainable long term whereas those of defensive stocks are not so demanding. I am concerned that there could easily be a sell off of Fintech stocks reducing valuations to more sensible multiples. This could result in a 40% fall in some of the higher growth markets. Notice I am not saying that these firms will all fail, indeed they could continue to grow. What I am suggesting is that the rate of growth will decline wiping off billions in investment values.
I expect defensive stocks to actually be relatively static in 2018 but do anticipate the FinTech sell off which will look a lot like the 2000 crisis.

Commodities

So will funds move into commodities? I suspect not. The reduction in global activity will be negative for oil and metals and I anticipate declines in these assets. The commodity which will be picking up the investment will be cash assets and currencies which will not really assist anyone. I expect sterling to strengthen against both the Euro and Dollar in the year.

The Housing Market

So will money move into property? Again the analysis suggests that this will not be the case. The property market is not uniform and some parts will perform well where local factors make a difference, but on balance 2018 will be fairly neutral on property. As interest rates rise people are less likely to move property. That is because the banks are able to increase their marginal income as interest rates rise. This essentially means that as you acquire a new property you will have a higher priced revised facility and that will apply to both floating and fixed rate facilities; although the long dated fixed rated facilities for housing operational in some markets must stop during 2018. In the interest rising environment you have declining property values, increasing unemployment and also increasing unfilled vacancies.

Conclusion

So is 2018 a 365 day long 'Duvet Day' when you should try to move away from the economic indicators? Please don't. Be prepared because If you think things cannot get worse than what I foresee for 2018, 2019 will likely be worse. Much worse.

Dennis William Cox

18.12.2017

RISK REWARD
GLOBAL BANKING & FINANCIAL SERVICES EXPERTS

Risk Reward Limited
47 Skylines Village, 2nd Floor
London, E14 9TS
United Kingdom

Tel: +44 (0) 20 7638 5558
Fax: +44 (0) 20 7638 5571

Web: www.riskrewardlimited.com