Not enough bad news is priced into the financial markets

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How much bad news is priced into the global markets?

The gap between the prevailing market prices – stocks, rates, credit and volatility — and forecasts of poor economic growth, political instability and social unrest would suggest that the answer is "not enough".

Global growth forecasts from the International Monetary Fund warn that the world economy may never return to the pace of expansion seen before the 2008 financial crisis . Meanwhile, recent analysis from McKinsey, the global consulting firm, posits that the rate of GDP growth is set to decline to just over 2 per cent a year — 40 per cent lower than its rate over the past 50 years. Their research claims per capita GDP growth would be 20 per cent lower than in the past half century.

Yet as major global stock markets continue to soar, clearing historic highs on the UK's FTSE and flirting with highs on the big US bourses, these growth forecasts have done little to change sentiment.

Similarly discounted have been proclamations such as that of the chairman of the US Joint Chiefs of Staff General Martin Dempsey, who in February 2013 told the US Senate Armed Service Committee: "I will personally attest to the fact that [the world is] more dangerous than it has ever been." More recently, in early 2014 James Clapper, the director of National Intelligence, testified that he had "not experienced a time when we've been beset by more crises and threats around the globe," and in July last year the senator John McCain said the world was "in greater turmoil than at any time in my lifetime". The Economist Intelligence Unit has worryingly projected that nearly half of the world's economies – 65 out of 150 – were at a "high" or "very high" risk of political and social unrest; the worst of the past decade.

Of course, perma-bears have long sounded the alarm in the aftermath of the financial crisis. However, their views have generally been dismissed as predictions of financial Armageddon on the back of historically low rates, unsustainable sovereign debt and collapsing equity markets propped up by unconventional monetary policy (such as quantitative easing) have scarcely materialised.

Yet, shifts in economic fundamentals and rising geopolitical risks that have long been appreciated by the think-tanks and policy makers should now be on firmly on the radar of the markets. With the passage of time, investors should have adjusted and the cognitive dissonance between macroeconomic trends and market positions should be declining.

In financial market parlance this "time decay" can be expressed by, for example, the difference between the price of an option that has 10-years to expiration and that of the same option with only two years left to expiry. The time decay of the 10-year option is negligible and the market can ignore it, whereas that of the same option as a two-year expiry starts to matter hugely for the performance of a portfolio.

If properly modelled, many of the trends highlighted by economic and market bears such as demographic shifts, technological disruption of jobs and the end of fiat money in the US are tail risks that can have a negative impact on global growth. And despite recent positive growth statistics, albeit weak, in the US, Europe and other major economies, these more entrenched risks have now come to the fore, placing multiple billions of dollars of positions at risk.

And although macroeconomic data of ageing populations and job erosion from automation continue to converge with the views of the long-term futurists — such as George Magnus and my fellow blogger Andrew McAfee — making their line of thinking much more relevant, many market participants seemingly remain unconvinced.

Money managers remain invested in the equity markets, even when those markets have moved from fundamentally cheap to perfectly priced; and driven by a climate of liquidity (with monetary inflation programmes in Japan and Europe and rate cuts in China) and few better options to park cash, they continue to pile into sovereign debt. The investment climate is further complicated by a lack of policy clarity; despite the fact that the US Federal Reserve continues to signal a path of rate hikes, Fed officials do not speak with an unambiguously unified voice.

No doubt many investors are too scared to sit on the sidelines or they subscribe to the "greater fool" theory and believe they'll never be the last one to the exit. But they should remember that although macroeconomic shifts are undoubtedly slow-moving impulses, these shifts can be hugely destabilising and incredibly costly when they break.

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