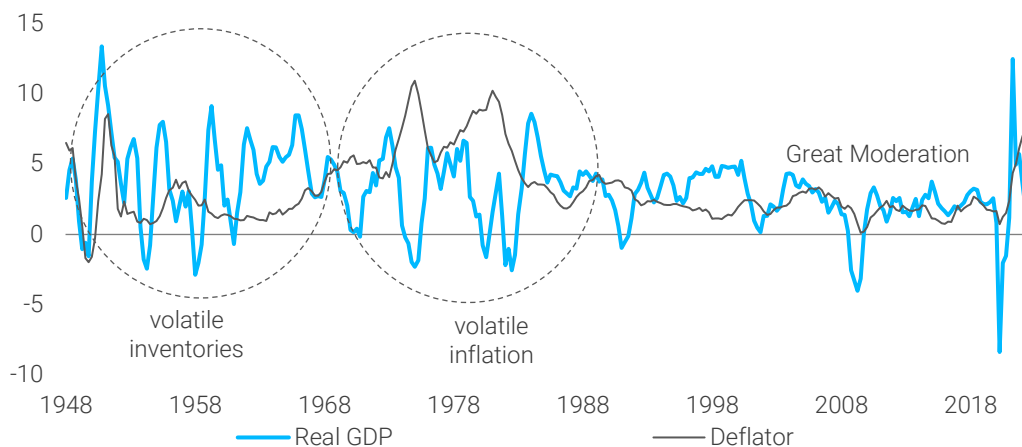


Macro Picture

NEW ERA OF MACRO VOLATILITY

Dario Perkins

The Great Moderation is giving way to an era of significant macro instability. Inflation will become more volatile and recessions more frequent. Risk premia in financial markets should rise, especially in bonds, which have been slow to adjust. But it is not all bad news – we could end up with shorter, less pronounced credit cycles and fewer systemic financial disasters.

Chart 1: The Great Moderation seems to be over


Source: BEA, BLS, TS Lombard

RIP GREAT MODERATION

Global policymakers are always quick to take credit for the Great Moderation, which started in the 1980s. Until recently, inflation has been consistently low and stable, while economic growth has been interrupted only briefly by global financial crises and pandemics. Yet it is clear the Great Moderation was never just about “good policy” – “good luck” also played a decisive role.

THE GREAT VOLATILITY

New technologies, super-efficient supply chains and a series of beneficial supply shocks have flattered the performance of global policymakers since the start of the Great Moderation. Now, unfortunately, their luck seems to be running out. The world is facing a series of negative supply shocks, which could make inflation significantly more volatile and recessions more frequent.

REVERSE MINKSY MOMENT

Besides raising questions about the competency of policymakers, a regime of macro instability could have important implications for financial markets. Risk premia should increase, especially in bonds, where the term premium remains historically low. But it is not all bad news – greater short-term volatility could mean less protracted credit cycles with fewer extreme systemic risks.

NEW ERA OF MACRO VOLATILITY

For more than three decades, there has been a relentless bull market in central-bank hubris. Even the subprime crash in 2008, the worst financial calamity since 1929, failed to dispel the notion – often perpetuated by central bankers themselves – that it was their superior management of the economy that had delivered the post-1980s “Great Moderation” in macroeconomic volatility. Forget the breakdown of communism in Europe, or the widespread deregulation of capital markets, or the rapid advancements in digital technologies that led to massive improvements in inventory management, or the huge increases in global energy efficiency, or even the entry of China into the WTO – these were all just “relative price shocks”. No, inflation was low and the economy more stable, simply because that was the way the authorities wanted things to be – it was their “monetary credibility” that must have been responsible. Yet while surprisingly few economists (or investors) questioned the official view about what had caused the Great Moderation, its empirical foundations were always a little shaky. The empirical debate about whether it was really the result of “good policy” or “good luck” was never actually settled. Now that central banks’ luck appears to be running out, we may get some more concrete answers.

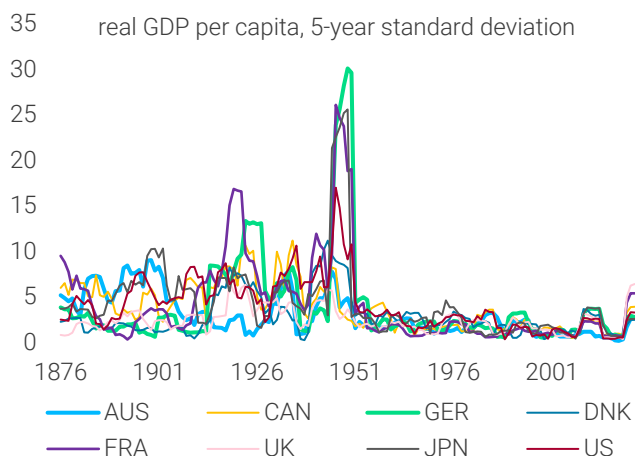
In contrast with the sequence of favourable supply shocks the world experienced during the Great Moderation, policymakers face a number of severe challenges in the 2020s. These include: (i) the immediate transition to higher interest rates, which looks difficult for a financial system built on the premise of perma-zero borrowing costs; (ii) volatility in food and energy prices as a result of climate change; (iii) the transition to a “low carbon” economy, which means more intermittent energy sources and large sectoral dislocations; (iv) new inefficiencies in global supply chains as a result of reshoring and deglobalization; (v) an increase in the share of manufacturing and durable goods production, which could make GDP and employment more cyclical; and (vi) greater uncertainty about macro policy, with politicians set to play a larger role relative to central banks. Far from the stability and “mean reversion” of the Great Moderation, there is even talk of a “polycrisis”, where several of these supply-side problems could interact and cascade, triggering a general systemic failure. While the polycrisis narrative seems unduly pessimistic, the next decade is sure to teach policymakers a degree of humility following their hubris of the last 30 years. At a minimum, we should expect a macroeconomic environment that is significantly more volatile.

What does this new era of macro volatility – the reversal of the Great Moderation – mean for financial markets? Naturally, risk premia are likely to be wider. Equity investors have already been on the wrong side of this dynamic, as the strike price for the “central-bank put” has plunged and the prevailing buy-the-dip mentality proved the wrong response. Although equity markets were not immune to large losses during the Great Moderation, the swift response from central banks always ensured that volatility returned quickly to historical lows. We might expect different dynamics to play out in the 2020s. The bigger implication, however, is for bond markets – especially as term premia have not yet responded to the more uncertain inflation outlook. (Bond investors were similarly slow to acknowledge previous regime shifts.) With more frequent supply shocks, inflation is likely to become significantly more volatile in the 2020s, which, in turn, will weaken the correlation between bonds and equities and make fixed-income markets a less attractive portfolio hedge. Yet the end of the Great Moderation isn’t entirely bad news. With higher frequency fluctuations in GDP and inflation, we are less likely to experience the accumulation of the large macro-financial imbalances (such as credit bubbles) that have characterized the past 30 years. Somewhat ironically, this could deliver a financial system that is ultimately more resilient.

1. RIP GREAT MODERATION

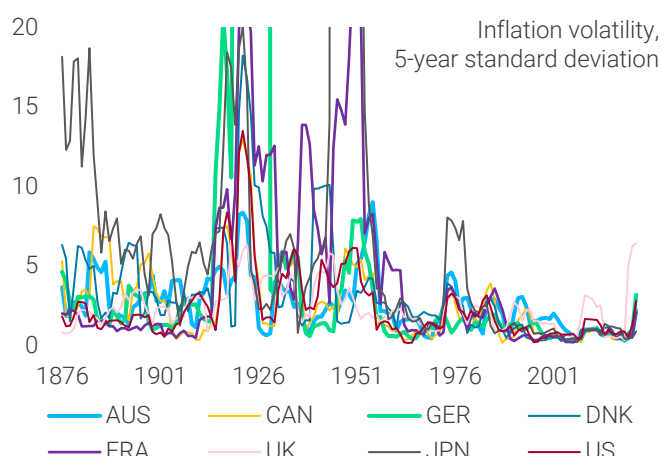
Back in the early 2000s – specifically around 2004-06 – there was a lively debate in macro economics about the so-called Great Moderation. Most developed economies had become significantly more stable, with fewer recessions, lower (and less volatile) inflation and long periods of uninterrupted GDP growth. Of course, when the global financial crisis erupted in 2008, the whole debate suddenly seemed rather silly, even ironic. In 2008-09, the world economy suffered its worst banking crisis in more than 70 years and global GDP contracted at its fastest pace since the Great Depression. Yet the basic tendency of the economy to converge on a “low-volatility regime” was ultimately confirmed. In the decade that followed, the Great Moderation not only returned, but the world economy recorded its longest expansion in history – interrupted only by the COVID-19 pandemic in 2020. This raises important questions for investors. Once the massive distortions associated with the pandemic and the war in Ukraine eventually fade, can we expect the global economy to return to its previous low-vol regime? And, if it does not, what are the implications for financial markets? Will risk premia need to widen?

Chart 2: Is the era of steady GDP growth over?



Source: MacroHistory, TS Lombard

Chart 3: The return of price instability



Source: MacroHistory, TS Lombard

Good luck or good policy?

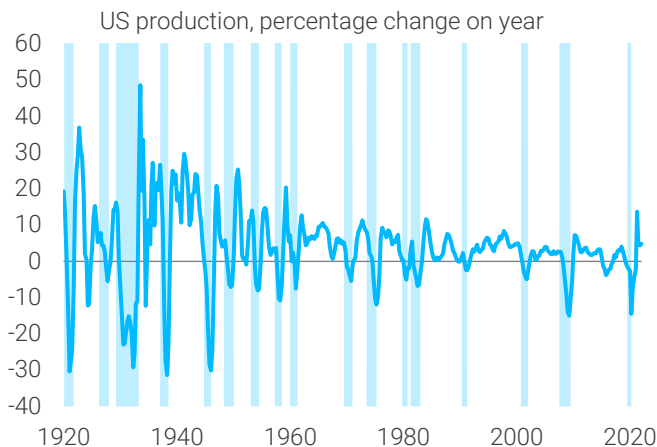
The debate about the Great Moderation ultimately boils down to a question of whether good policy or good luck – or a combination of both – has been responsible. There is no doubt which side of the argument central bankers prefer. Over the past 25 years, the authorities have given countless speeches and published hundreds of pieces of research to make the case that it is their supreme competence and “credibility” that has delivered price stability, which, in turn, has allowed the economy to thrive. Ben Bernanke was perhaps the most famous advocate of this view, delivering a [detailed analysis of the Great Moderation in 2004](#) – just as US house prices were really starting to boom. Yet, at the risk of heresy, it is worth considering a broader set of explanations, including the possibility that central bankers were not fully in control. A more complete analysis, [from the BoE’s former Chief Economist Charles Bean](#), who was clearly in a more humble and sombre mood in August 2009, outlined the three main possibilities:

- (i) **A series of positive supply shocks:** it is possible that the Great Moderation was just a happy accident, a period characterized by an unusually benign sequence of shocks. Certainly, there are plenty of candidates – including rapid improvements in new digital technologies, reduced trade barriers, the fall of communism in Europe and the entry of

China into the global trading system. It is no exaggeration to say that thanks to relentless globalization, new technologies and a massive increase in the effective supply of labour internationally, the post-1995 period was an era of cheap energy, cheap workers and a collapse in the price of manufactured goods. Even the most incompetent of policymakers stood to benefit from these shifts. Influential [analysis from Stock and Watson \(2003\)](#) argued that the Great Moderation was more than explained by the nature of the shocks hitting the global economy – rather than the behaviour of central banks.

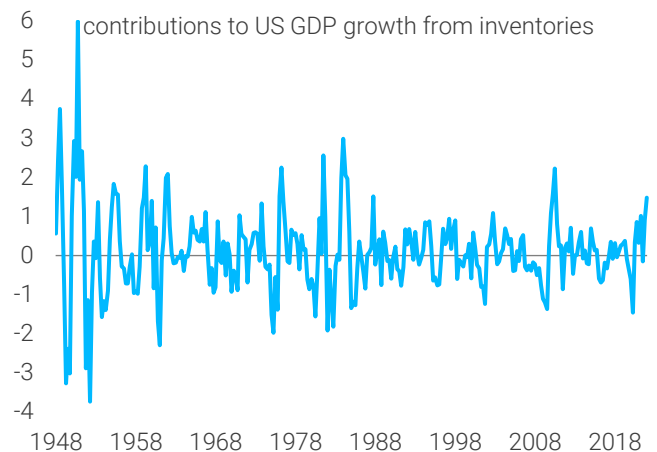
- (ii) **Changes in the structure of the economy:** Over time, most OECD economies changed in ways that should have made them intrinsically more stable. These big structural changes included the rotation from manufacturing to services, reduced dependence on agriculture, big improvements in inventory management (the result of new technologies such as computers and better communication), widespread de-regulation, increased competition in product and labour markets and massive innovations in financial markets that facilitated the efficient spreading of risk and the enhanced ability to smooth spending in the face of shocks to income and wealth. Sectors such as manufacturing, housing and durable goods production are typically much more cyclical than services activity, which means the volatility of GDP should naturally have declined over time. In part, of course, the developed economies were outsourcing these more volatile activities to the developing world, as they relocated their industrial supply chains overseas.

Chart 4: Production was volatile until WW2



Source: Datastream, TS Lombard

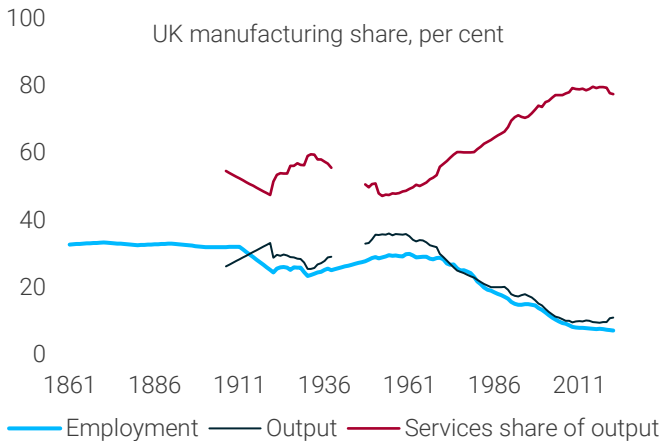
Chart 5: Inventory techniques eventually improve



Source: BEA, TS Lombard

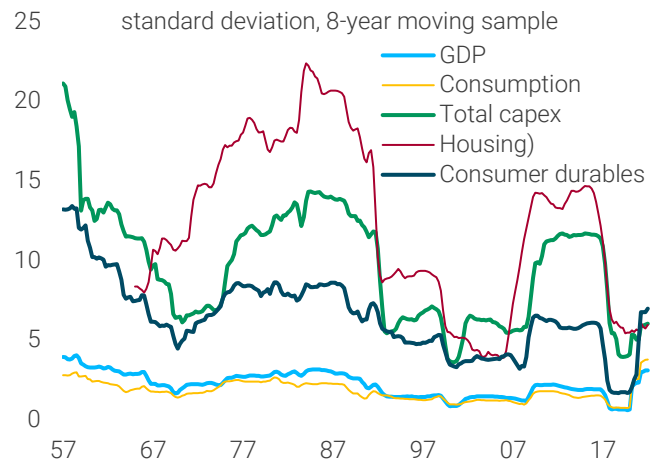
- (iii) **Good policy:** By allowing inflation expectations to become “unanchored”, economists blamed the instability of the 1970s on poor policymaking and a series of disastrous errors. Conversely, it is reasonable to think improved policy frameworks – including the enhanced independence of central banks that set credible inflation targets – contributed to the Great Moderation. Ben Bernanke spoke about [monetary policy moving closer to the “efficient Taylor frontier”](#), which meant the authorities had managed to find the best combination of low volatility in output and prices. While this is no doubt an exaggeration – not least because it ignored a series of asset bubbles and credit booms – it is clear that even when the economy did face large shocks, such as spikes in energy prices or a collapse in demand, central banks were a stabilizing force. And investors certainly had a great deal of confidence in the authorities, sometimes too much even.

Chart 6: Big sectoral rotations helped stability



Source: Bank of England, TS Lombard

Chart 7: The most volatile GDP components

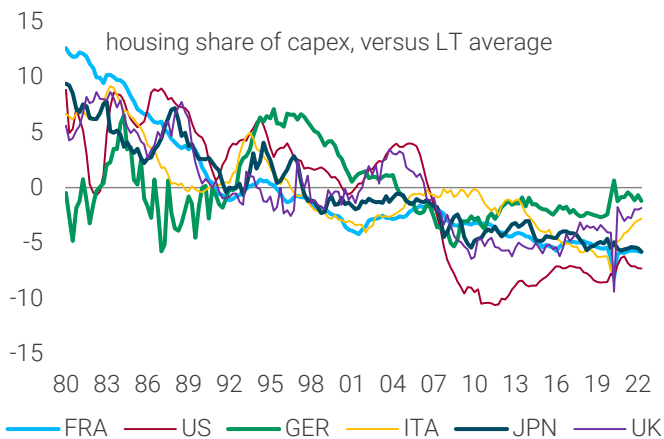


Source: BEA, TS Lombard

The evidence

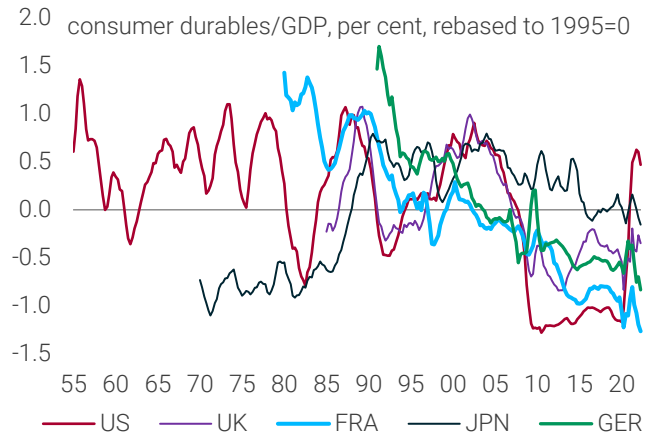
Figuring out the relative contributions of these three factors is clearly important as we look to the future. If the Great Moderation was down simply to “good luck” or a series of favourable shocks, there is no reason to think these benign conditions will continue. But if it was down to structural changes or better policy, there is more chance they will prove permanent. Unfortunately, the evidence from the academic literature has failed to provide conclusive answers. While it was clear most economies faced fewer nasty shocks – which supported the “good luck” hypothesis – it was also the case that the propagation of those shocks (their “autocorrelation”) had weakened, which supported the claim of central banks. Even when there were historically large increases in commodity prices, such as in 2008, inflation expectations did not become unanchored, nor were there any obvious wage-price spirals. But again, this could have been due to structural changes – such as reduced energy intensity and the absence of worker power – rather than the mythical credibility of central banks. Indeed, controversial (but hilarious) analysis from Luca Benati at the ECB showed that replacing today’s central bankers for those of the 1970s would have made no material difference to recent macro outcomes in either the US or Europe.

Chart 8: Contribution of housing diminished...



Source: OECD, TS Lombard

Chart 9: ...and that of consumer durables



Source: OECD, TS Lombard

Table 1: The Great Moderation

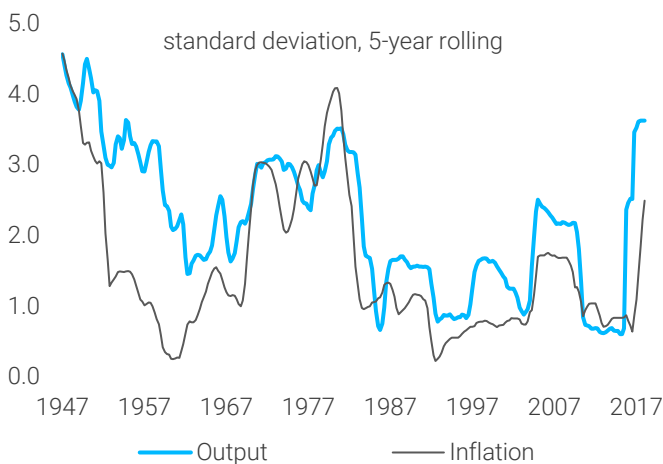
Country	Ratio of low to high volatility	Date of switch to low vol
	Per cent	
Australia	45.8	1984 Q3
Canada	58.0	1988 Q1
France	54.2	1976 Q3
Germany	48.3	1971 Q3
Italy	50.8	1980 Q2
Japan	62.9	1975 Q2
UK	51.5	1982 Q2
US	50.8	1984 Q4

Source: What Caused The Great Moderation? Some Cross-Country Evidence. Peter Summers

2. THE GREAT VOLATILITY

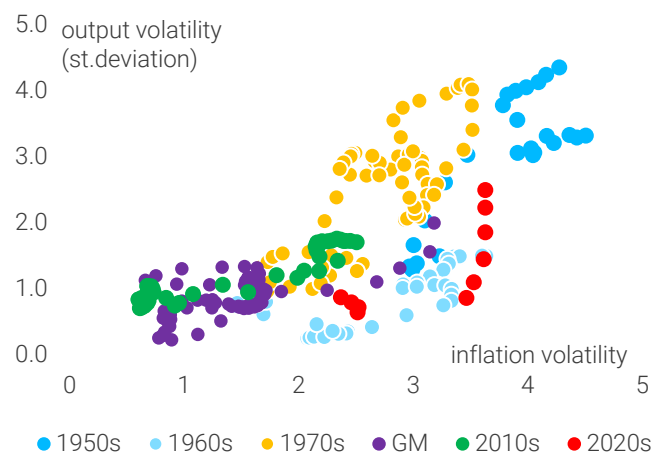
The debate about the Great Moderation is likely to be settled over the next decade because there is a distinct possibility that central bankers’ luck is finally running out. Not only are some of the favourable supply shocks of the post-1980s now shifting into reverse, but we are seeing profound structural changes in the developed economies that could make them inherently more vulnerable to periods of macro instability. Some commentators, such as Adam Tooze, even believe the world is entering a period of “polycrisis”, which is the complete opposite of the Great Moderation – a scenario where various systemic problems (including inflation, climate change, war, political turmoil in the US and economic turmoil in China) interact in deeply unstable and reflexive ways, producing a total “system failure”. And central banks are poorly equipped to deal with these issues, not least because of their penchant for simplistic “mean-reverting” economic models in which inflation continuously converges on 2% and GDP growth always returns to trend. Policymakers once regarded as “maestros” might be about to discover the limits of the powers.

Chart 10: The return of macro volatility



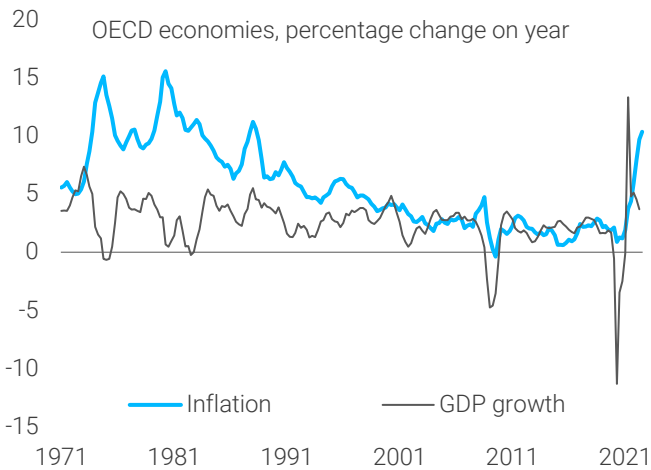
Source: BEA, BLS, TS Lombard

Chart 11: The Taylor boundary shifted outwards



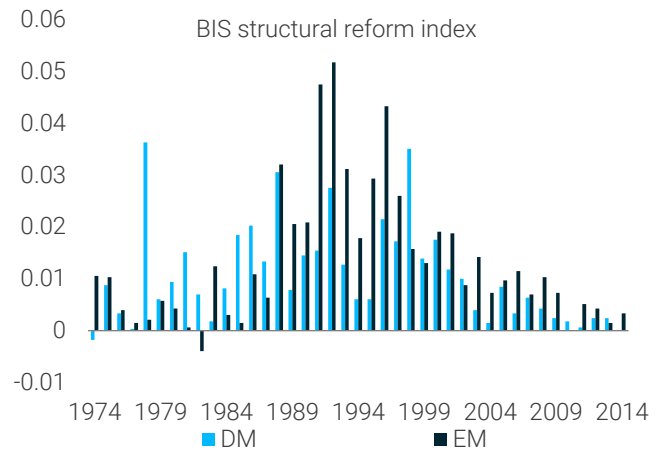
Source: BEA, BLS, TS Lombard

Chart 12: Has the Great Moderation ended?



Source: OECD, TS Lombard

Chart 13: Structural reform agenda has stalled



Source: BIS, TS Lombard

An era of instability

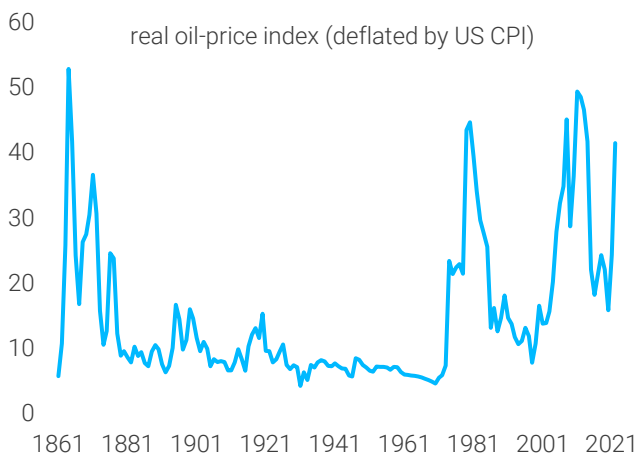
It is difficult to know whether the world is truly on the brink of a polycrisis. Perhaps, [as Noah Smith points out](#), such talk suffers from a recency bias, or [an availability bias](#), because it is always easy to think we live in an era uniquely full of risks, disasters and problems. When it comes to climate change, for example, we simply do not know what will happen if temperatures continue to rise – perhaps we are reaching a tipping point, [beyond which the impact on the global economy \(and our lives in general\) becomes highly “non-linear”](#). But you do not need to assume this worst-case scenario to believe that the Great Moderation is over. The global economy is facing various challenges, which – at an absolute minimum – point to an era of much greater macroeconomic volatility and profound uncertainty in the 2020s:

- (i) **The transition to higher interest rates:** The immediate challenge is how the global economy – and financial markets more broadly – adapt to the rapid tightening in monetary policy that has taken place in 2022. The sectors that are most sensitive to higher borrowing costs, such as housing markets and durable goods production, are already under enormous pressure, and there is a distinct possibility of a global recession sometime in the next 18 months. But the probability, timing, depth and duration of this downturn all remain extremely uncertain. Will inflation fall quickly enough to allow central banks to support their economies or will current pressures persist? Can a world with historically high debt levels eventually tolerate higher interest rates? Or is something in financial markets about to “break” after a decade-long search for yield? A long or severe recession could leave a lasting imprint.
- (ii) **Physical disruption from climate change:** Global temperatures are rising and weather patterns are becoming increasingly extreme, with scientists warning that this will only get worse over the next decade. Extreme weather disrupts agriculture, damages international trade and destroys capital (including infrastructure). Higher temperatures [may also affect productivity](#). While these are all examples of negative supply shocks, we should not forget their potential impact on demand. Extreme weather can destroy wealth, undermining confidence and discouraging business investment. At a minimum, these physical effects from climate change are likely to make inflation much more volatile, primarily through their impact on commodity prices. Extreme weather events lower food production and raise inflation in countries

that rely on imported food. If, at the same time, food exporters were to resort to protectionist policies, the impact on the rest of the world would be even greater.

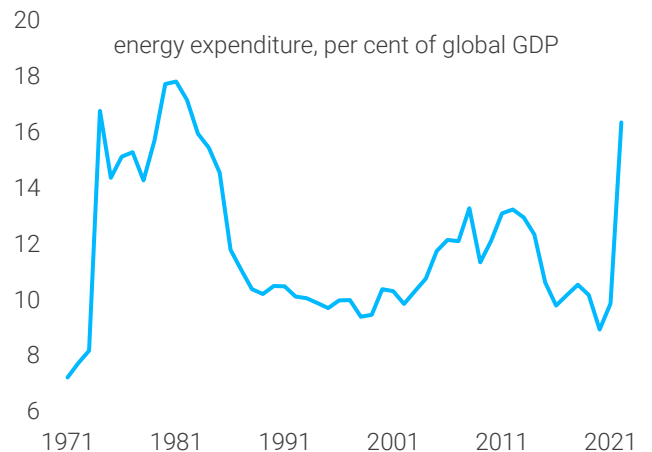
- (iii) **The energy transition:** To mitigate the physical impact of climate change, the world is attempting to make a rapid transition to new “green” energy sources. Yet decarbonomics is likely to make inflation only more volatile, not least because we are transitioning to new energy supplies, such a wind and solar, that are inherently more intermittent than fossil fuels (at least based on existing technologies). These effects were apparent in Europe even before Putin invaded Ukraine. At the same time, the green transition will create enormous demand for certain commodities, especially metals (such as copper, aluminium, nickel and zinc) and rare earths. Even if the transition proceeds smoothly, which seems unlikely, there is a strong possibility of “green bottlenecks”, which add to the macro instability. And we should not forget that decarbonomics will also create massive dislocations in the economy, by rendering existing parts of the capital stock – perhaps entire industries – obsolete. With Russia, in effect, cut off, the world is already facing a significant energy shortage, and it could get worse until new green technologies are available.

Chart 14: The big oil price shocks



Source: Bank of England, TS Lombard

Chart 15: Energy bill approaching record highs

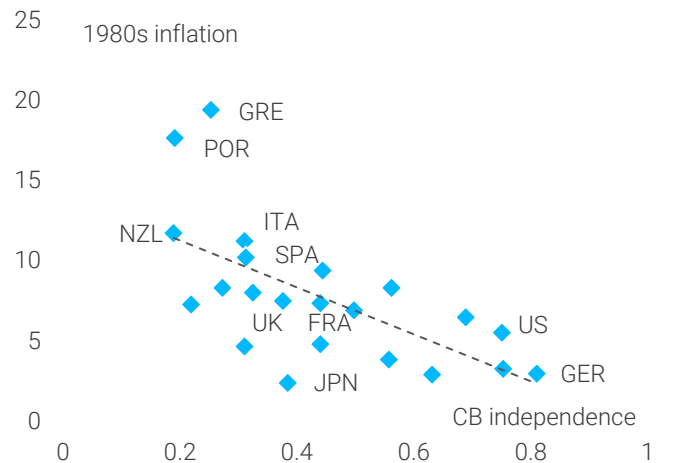


Source: OECD Economic Outlook, November 2022

- (iv) **New inefficiencies in supply chains:** Super-efficient supply chains played a crucial role in the Great Moderation. Inventory-induced swings in output, which had been a feature of most economies in the decades immediately after WW2, were no longer a problem. Companies deployed computers and new forms of communication to manage their stock levels more efficiently, taming the infamous “bullwhip effect”. At the same time, they created long, complex international supply chains that allowed them to break down production into its constituent parts, securing big gains from the enhanced division of labour (typically cheaper labour from overseas). Now, however, many of these trends seem set to reverse. Following the combination of COVID-19 and the war in Ukraine, governments and businesses are increasingly looking to shorten and reconfigure their supply chains around regional trading blocs in line with new geopolitical allegiances. Of course, the technologies that facilitated better inventory management are still available, but the transition period looks disruptive.

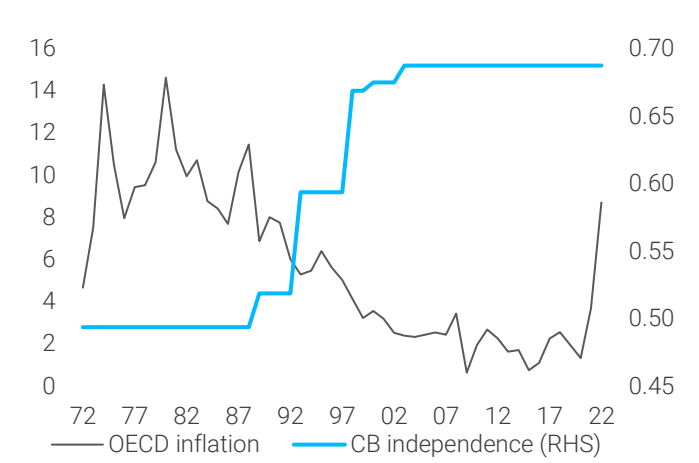
- (v) **The return of manufacturing:** Governments are keen to take advantage of deglobalization to rebuild domestic manufacturing capacity. In some sectors, particularly those that are strategically important – such as food, energy, defence and semiconductors – there are strong geopolitical reasons for wanting to do this. COVID-19, meanwhile, has produced a new appetite among consumers for durable goods, a trend that is likely to continue if governments are serious about tackling income inequality. Labour shortages among low-income earners have already delivered rapid wage growth at the bottom of the income distribution, which seems to have been responsible for the continued resilience of durable-goods consumption even as most economies have fully emerged from the pandemic. While it is not clear whether governments will be successful in their attempts at reshoring and tackling inequality, it is important to remember that any renaissance in manufacturing will inevitably add to the short-term cyclical of the economy.
- (vi) **More uncertain macro policy:** Economic policy is becoming more uncertain, in part because elected politicians are beginning to play a more active role. The neoliberal regime of deregulation, free trade and limited state intervention seems to be ending. This is a big shift for financial markets, not least because the central bankers who dominated the Great Moderation were a largely homogenous group that deployed a relatively limited toolkit – some variant of interest rates – and all followed the same basic doctrine. As the politicians take over, particularly in a world of rising populism, we are likely to see more extreme policy shifts and less tractable behaviour. Worse, as we have seen recently in the UK, there is a greater risk that monetary and fiscal policy will interact in dangerous and more explosive ways, which could lead to bigger swings in inflation and interest rates. Reduced international cooperation and weaker global institutions could be another problem, adding a further degree of reflexivity.

Chart 16: Did 'good policy' give us low inflation?



Source: Ed Balls, James Howat, and Anna Stansbury

Chart 17: Central banks face their gravest test

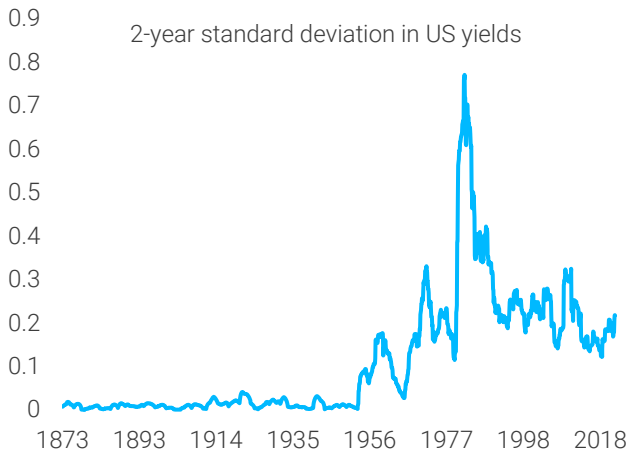


Source: OECD, Davide Romelli estimates for CBI

We have argued for some time that the world is passing an important inflection point in the global macro supercycle, which paves the way for a gentle but sustained (secular) rise in inflation and interest rates. For the first time since the early 1980s, the forces we have listed above will shift the balance of power away from capital towards labour. But even if we are wrong about the prevailing tendency of inflation and interest rates do move higher, it seems inevitable that we are facing an era of greater macro volatility. For investors wondering about long-term shifts in financial markets, this regime of higher volatility could be just as important as the question of

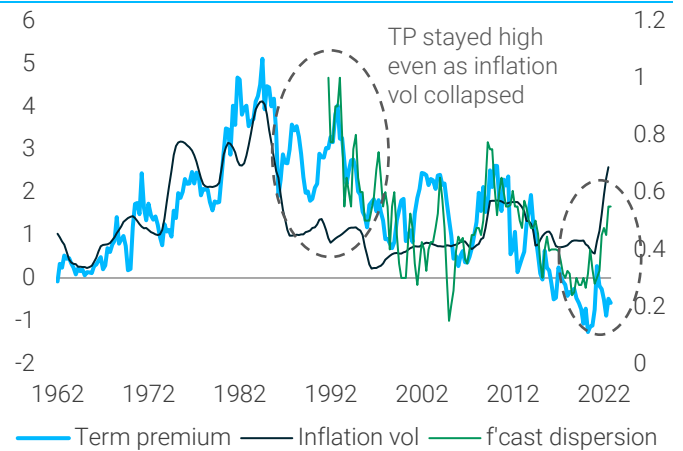
whether inflation will average 2% or 4% over the next decade. If the Great Moderation is over, we might expect financial markets to behave in radically different ways during the 2020s.

Chart 18: Bond volatility remains low



Source: Robert Shiller database, TS Lombard

Chart 19: Term premium is slow to adjust



Source: NY Fed, TS Lombard

3. REVERSE MINSKY MOMENT

An era of heightened macroeconomic volatility could have profound implications for financial markets. Risk premia are likely to rise, particularly in asset classes that were always priced for perfection during the Great Moderation. Fixed-income markets look more vulnerable than equities, although the dilution of the “central-bank put” could also prevent a return to the buy-the-dip mentality of pre-COVID stock markets. It is not all bad news, however. Somewhat ironically, a regime in which inflation is prone to larger swings and recessions are more frequent (but milder) could prevent the build-up of deeper, more hazardous financial imbalances and threats. After all, the Great Moderation never really deserved its name because it concealed more protracted credit cycles, dangerous systemic risks and an endless series of asset bubbles. Perhaps, to misquote Hyman Minsky, we are entering an era in which “instability breeds stability” – a world of greater short-term macro volatility but narrower tails and less extreme kurtosis.

Market implications

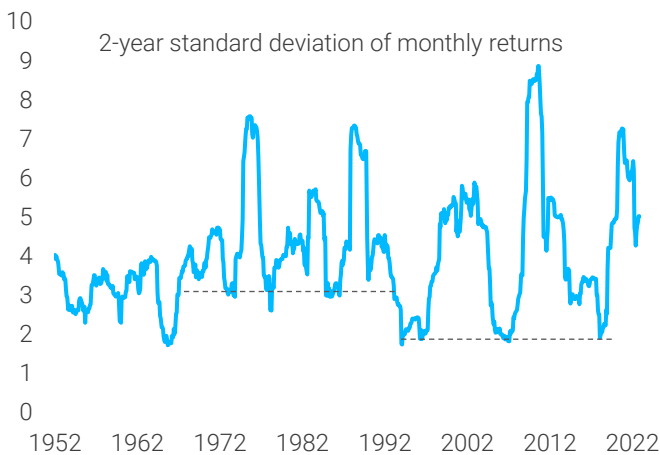
It seems obvious that increased uncertainty about the economy should warrant wider risk premia in financial markets. Investors typically lose monetary during recessions or, if they have invested in bonds prior to a spike in consumer prices. Perhaps the clearest implication is for fixed-income markets, where term premia now look egregiously mispriced. Remember that the term premium is the extra-compensation investors should demand for holding long-duration paper rather than rolling over a series of shorter-dated securities. If the long-term inflation outlook is suddenly more uncertain – because prices are prone to more extreme volatility – the term premium should widen. But so far, the term premium has barely budged, even as the dispersion in CPI forecasts has increased. And even this wider dispersion in economists’ forecasts does not reflect the real extent of the uncertainty we are facing because the sellside has an unshakable faith in central banks’ ability to meet their targets (or, more likely, they assume the authorities will achieve their objectives without putting a great deal of thought into those forecasts). Funnily enough, the term premium was also slow to adjust to the reverse move in inflation volatility after the 1980s (Chart

19, above). Even as consumer prices became more stable, investors were reluctant to get back into bonds – presumably because they had been burnt by the Great Inflation. Perhaps we are seeing similar psychological dynamics today, which is why the term premium remains low.

Wider term premium

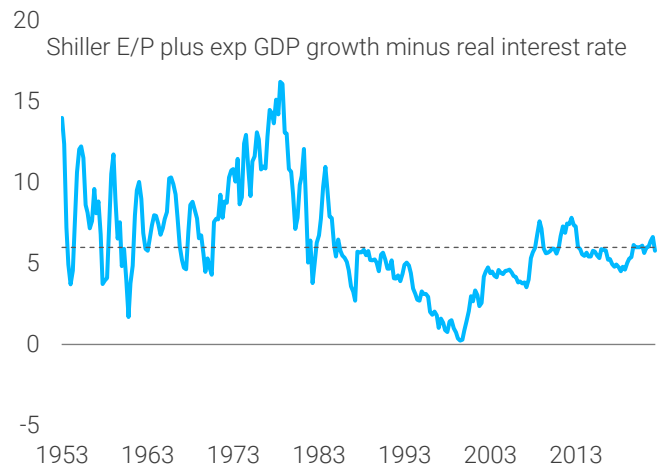
Of course, inflation uncertainty is not the only thing that influences the term premium. During the Great Moderation, bonds and equities were usually negatively correlated, which endowed fixed-income markets with natural hedging properties. When stock markets sold off, bonds typically rallied. And since holding bonds was akin to having an insurance policy against certain portfolio losses, investors were generally prepared to pay a fee – which meant a lower term premium. But in a world where supply disruption happens more frequently, we should expect more periods in which inflation is not only higher but also countercyclical. Inflation will rise and profits decline. Even if this is not the new normal – i.e., even if we are not entering a world of persistent stagflation – more regular supply shocks should weaken the hedging properties of fixed-income markets, which, over and above the extra uncertainty related to inflation, should widen the term premium. If the Great Moderation is over, the secular bull market in bonds has ended, too.

Chart 20: Equity vol hit extreme lows



Source: Datastream, TS Lombard

Chart 21: Equity risk premium to rise?



Source: Robert Shiller website, Survey of Professional Forecasters

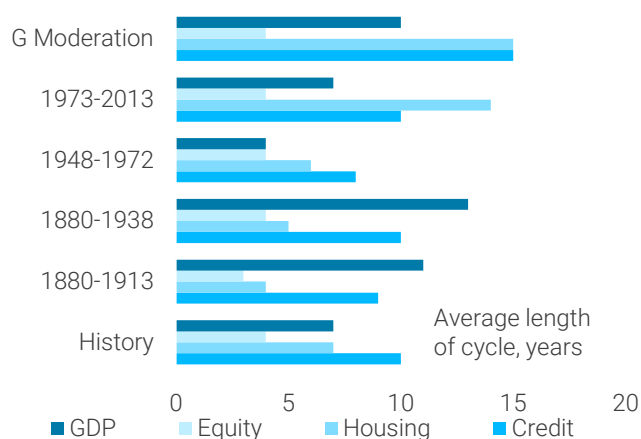
Implications for equity markets

While the implications for bond markets are clear, the impact on equities is more complicated. Chart 20 shows that equity values remained volatile even during the Great Moderation, thanks to several large boom-bust cycles. In fact, on average, the standard deviation of the US stock market was not materially outside its historical norms. The difference, of course, is that while there were bouts of extreme volatility, they did not last long – investors suffered steep losses but volatility quickly returned to historical lows, where it remained for unusually long periods. While these long periods of calm were mainly the result of longer unbroken economic expansions, it is likely that investors’ belief in the “central-bank put” played a role, too. With inflation always threatening to drop below central banks’ 2% targets, monetary policy became hypersensitive to any risks originating in the financial sector. Investors believed most drops in asset prices were just a buying opportunity because central banks would ultimately protect their portfolios.

But in a world that is prone to supply shocks, spikes in inflation are more likely to be the actual cause of economic downturns. This creates a dilemma for central banks, which dilutes the

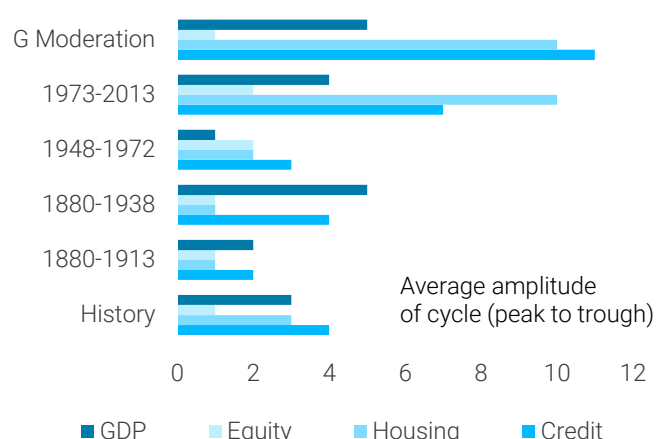
“central-bank put” and means it will not always be appropriate for investors to buy the dip. So, we should expect equity markets to behave in a subtly different way compared with how they performed during the Great Moderation. Volatility will not necessarily be higher on average – since it was already in line with historical norms – but we are unlikely to see a repeat of those long periods in the 2000s and 2010s in which volatility collapsed. In general, we might also expect stock-market valuations to be lower and the “equity risk premium” to rise. But this is an issue mainly for those sectors of the market – such as long-duration US tech stocks – that experienced a large rerating based on the expectation of permanently low bond yields. As we explained [in a previous Macro Picture](#), some sectors – typically the value stocks – should outperform. Overall, we suspect the implications for equity markets are far more nuanced than they seem right now.

Chart 22: Great Moderation – longer cycles



Source: [Global Financial Cycles since 1880](#)

Chart 23: Great Moderation – bigger crashes



Source: [Global Financial Cycles since 1880](#)

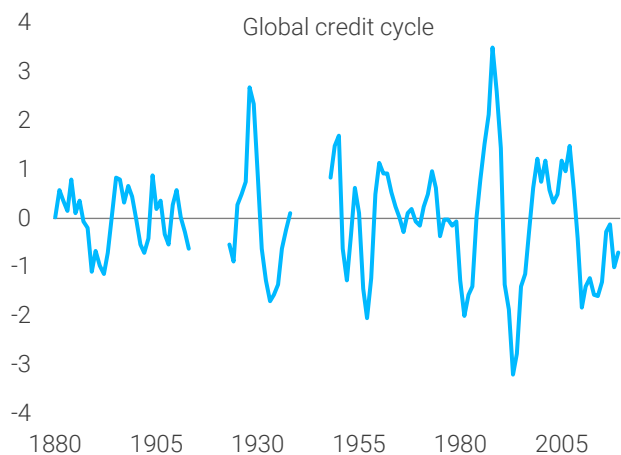
Instability breeds stability

One of the ironies of the Great Moderation is that the relative tranquillity of the macro economy concealed deep underlying vulnerabilities. Volatility plunged, but kurtosis – the possibility of extreme tail risks – increased. At the start of the pandemic, the Bank of England published a fascinating piece of historical research on the [“global financial cycle since 1880”](#), which went unnoticed because financial pundits were (understandably) more interested in epidemiology. The BoE showed not only that business and financial cycles had become more synchronized over time – taking on a strong, truly international component – but also that credit and housing cycles had become longer and more protracted during the Great Moderation (Charts 23 and 24). And when something went wrong, the repercussions were often disastrous – consider what happened in Japan in the early 1990s or the Asian “tigers” in the late 1990s or the US during the subprime crash or the collapse of the EMU periphery economies in 2009-12. This is important because it highlights one of the dangerous features of the Great Moderation – systemic risk.

Long periods of relative calm – particularly when central banks are keeping interest rates extremely low in a futile attempt to reflate their economies – have often encouraged households and businesses to take on more debt. But a more leveraged financial system is inherently more dangerous, because when something eventually does go wrong, it is more likely to lead to balance-sheet stress, default and asset fire sales. In fact, as former MPC member Gertjan Vlieghe explained [in one of our favourite central-bank speeches](#), the whole dynamic can become highly reflexive because “fatter tails” in the financial system increase the demand for safe assets, which reduces equilibrium interest rates and encourages further debt accumulation. Stability breeds

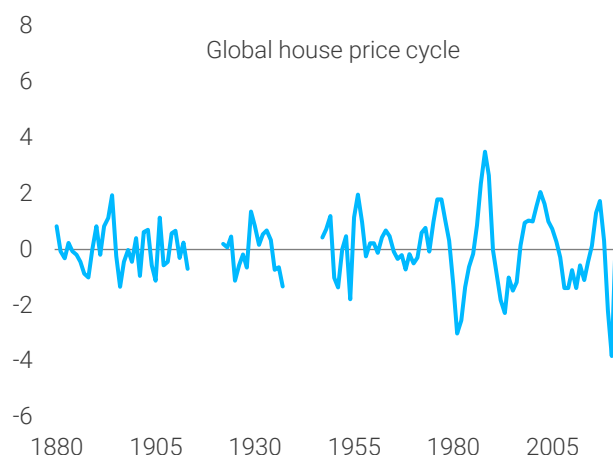
instability, as Hyman Minsky famously pointed out. Conversely, one of the side-effects of an era of more volatile inflation and more frequent recessions could be that financial system is less vulnerable to systemic risks, resulting in milder downturns and fewer bubbles. Higher interest rates are not necessarily a bad thing, if they tame this more sinister side of the Great Moderation.

Chart 24: Long and extreme credit cycles



Source: [Global Financial Cycles since 1880](#)

Chart 25: Housing cycles more extreme, too



Source: [Global Financial Cycles since 1880](#)

Bottom line

There has long been a debate in macroeconomics about whether the post-1985 Great Moderation was the result of good luck (fewer/more benign supply shocks) or good policy. For obvious reasons, the authorities came down firmly on the side of the latter, arguing that their new policy frameworks – chiefly, central banks with greater independence and more “credible” inflation targets – were responsible. Well, the next decade is going to severely test their hypothesis. Policymakers are facing a decidedly less benign environment, as globalization shifts into reverse, supply chains become less efficient (and, for a time, less reliable) and climate change – both its physical consequences and the transition to new intermittent energy sources – causes large swings in commodity prices. While not every investor will accept our view that we are entering a new supercycle of higher inflation and interest rates, there can be no doubt that we are moving to a regime of significantly greater macro volatility. And this, in turn, will have major repercussions for markets, particularly government bonds, which, like in the 1980s, have been slow to recognize a structural break in inflation vol. The good news is that the Great Moderation was not always as “great” as it seemed. Steady GDP growth and stable inflation masked deep underlying imbalances and extreme systemic risks. Recessions might become more frequent in the 2020s, but they should also be milder – and less likely to end in total systemic collapse.