Much Ado *About* Nothing

Why today's financial market optimism is overblown.

BY MOHAMED A. EL-ERIAN

Behavioral economists have popularized the term "recency bias" to describe our tendency to be disproportionately influenced by the latest events compared to earlier ones. Could this cognitive phenomenon explain why numerous analysts have a rather optimistic tilt for the world economy in 2024? Or are there really positive trends counterbalancing the obvious and mounting challenges to global growth?

A recent *Financial Times* editorial reflected the prevailing optimism, proclaiming that "after this year's resilient showing, there is every chance that the reality next year will also be better than expected." The trends that supported the global economy's unexpected resilience in 2023 "also offer plenty of reasons to be optimistic for 2024."

This upbeat mood has spread to financial markets. A growing number of commentators have predicted that stock markets will finish the year above the already elevated levels of 2023, which were buoyed by a remarkable year-end rally.

Today's optimistic sentiment stands in stark contrast to the grim predictions that dominated the run-up to 2023, when Bloomberg Economics asserted that there was a 100 percent probability that the United States would fall into a recession. It is also at odds with a range of economic, financial, geopolitical, and political developments. Notably, it appears to be predominantly driven by a single factor: central banks aggressively cutting interest rates amid the softest of all soft landings for the U.S. economy.

To be sure, central banks have enormous sway over financial-market sentiment. Since the 2008 global financial crisis, central bankers have acted as

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the world's leading policymakers—flooring interest rates, flooding economies with liquidity, fueling huge gains across virtually all asset classes, and facilitating a notable shift in wealth distribution that overwhelmingly benefited the wealthiest. But this trend reversed in 2022 when central banks, led by the U.S. Federal Reserve, belatedly responded to rising inflation by embarking on one of the most aggressive cycles of interest rate hikes ever. The subsequent losses in both high-risk and low-risk assets seemed poised to continue into 2023 until the consensus forecast shifted toward significant rate cuts and renewed talk of a "Fed put."

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While central banks have had a significant effect on market confidence, their impact on actual economic outcomes has been limited. Their ultra-dovish policies during the 2010s helped keep the global economy afloat, yet overall growth remained disappointingly low, unequal, and still detached from climate realities. The 2022 shift to tighter monetary policies was expected to lead to higher unemployment and sluggish growth; instead, the U.S. unemployment rate ended 2023 at a remarkably low 3.7 percent, and third-quarter annualized growth accelerated to 4.9 percent. Moreover, the extent to which aggressive interest rate hikes contributed to reducing inflation has become the subject of debate among economists.

These developments suggest that central bank policies alone—investors currently expect the Fed to cut interest rates by around 1.5 percentage points—may not be enough to generate the necessary growth momentum to withstand the headwinds facing the global economy.

In fact, one would be hard-pressed to find a systemically significant economy poised for breakout growth in 2024. As China remains saddled with an economic model that yields diminishing returns, the authorities have acknowledged that its growth rate is constrained by domestic inefficiencies, pockets of excessive debt, increased global fragmentation, and the West's weaponization of trade and investment. Europe, for its part, is unlikely to replicate last year's unexpectedly strong performance, given especially the sluggishness of global manufacturing and Germany's economic stagnation.

Once again, commentators seem to be placing their hopes on U.S. economic exceptionalism. But things have evolved over the past year. Lower pandemic-era household savings and higher debt act as headwinds to America's remarkably agile and resilient economy. Moreover, recent interest rate increases are likely to continue to constrain new household mortgages, companies navigating the mountain of corporate debt expected to mature in 2025, and highly leveraged non-bank institutions dealing with their losses.

The current geopolitical climate also is not conducive to robust growth. The devastating aftermath of Hamas's brutal October 7 attack against Israel, in which Israel has destroyed much of Gaza and is reported to have killed more than 23,000 Palestinians—mostly civilians, including thousands of women and children—has challenged hopes of containing the crisis. Israel and the Iran-backed Lebanese militia Hezbollah appear headed toward greater hostilities, and attacks against commercial vessels in the Red Sea by the Yemeni Houthis are already disrupting global trade in a manner that renews stagflationary pressures on the global economy.

Beyond the Middle East, Western democracies and many developing countries face important elections in 2024.

Given these circumstances, the chances of robust global growth in 2024 appear tenuous. Nevertheless, there are two ways to mitigate the threats posed by an increasingly fragile economic and geopolitical environment. First, policymakers need to launch major economic policy overhauls, focusing on structural reforms aimed at cultivating the growth and productivity engines of tomorrow. Second, the international community needs to do better to end the atrocities in the Middle East before that conflict spreads even further across the region and fuels geopolitical turmoil beyond it. Without these interventions, today's optimists will be sorely disappointed by year's end. ◆

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