Share markets can handle a US rate hike

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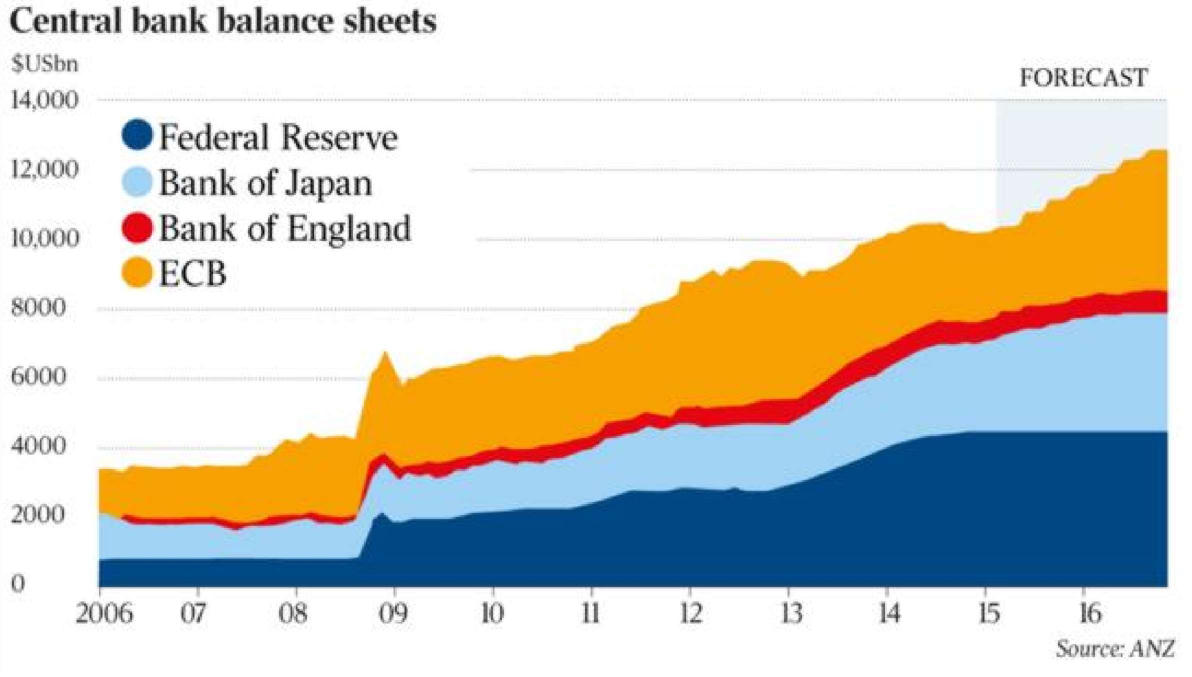

Balance sheets. *Source:* TheAustralian

So far this year, returns on growth assets such as shares, commercial property and housing have outperformed returns from the safe asset classes of bonds and bank deposits.

On Australian shares, average returns were 7 per cent (plus franking benefits) over the first seven months of the calendar year. Global shares (and with the exchange rate unhedged) delivered a return of 17 per cent. On listed property trusts, investors are ahead by 13 per cent. And median house prices in Sydney and Melbourne have risen by another 10 per cent.

The composite index of returns on bonds shows an average return of 2 per cent, well below the levels investors have grown used to. Australia’s cash rate was 2.5 per cent when the year began; it’s now 2 per cent.

The pattern of recent returns from investments reflects three key influences:

• Globally, monetary policy has been highly accommodative. Short-term interest rates have been low for so long they’re now crimping returns from fixed interest assets.

• There is renewed confidence the US, Europe and Japan will avoid the economic problems many investors were fearing when the year began — that the US recovery would fade, that Europe would suffer recession and deflation, and that Japan would have near-zero growth. These recent changes in sentiment have been broadly positive for shares and property but negative for bond prices.

• Even with somewhat improved prospects in the big three economies, commodity prices have been weak — because of additions to available supplies of oil and iron ore and because of heightened (and, to my thinking, exaggerated) concerns of China tipping into an early hard landing.

There are two key top-down influences on investment returns for investors to keep a watch on: first, is the Fed's moves as it begins normalising the US cash rate — and whether this ends the highly-accommodating setting in global monetary policy that's supported investment returns. Second, which we'll return to in a week or two, will be how much the Chinese economy slows.

Early in the year, the majority view of investors was there'd be no increase in the US cash rate until 2016. With the good average gains in US jobs, expectations are swinging to the view the Fed will announce an increase by year's end — and moving the cash rate target to the range 0.25 to 0.5 per cent.

In recent months, the Fed has commented that the normalisation of the US cash rate will likely be a very gradual process.

The Fed was highly embarrassed by its unintended release of forecasts by its top people, which suggested the cash rate would be 3.1 per cent in late 2017.

Current expectations within financial markets are for an extremely subdued trajectory for the cash rate, suggesting it will be just 1.6 per cent at the end of 2017.

The safest views for investors to take might run along these lines:

● Increases in the US cash rate could well be gradual next year and 2017, as the Fed often argues — but move somewhat higher than market expectations currently allow. That's mainly good news for shares but not for bonds.

● Investors don't seem to be at all concerned about inflation. Signs of US inflation rising above the Fed's target (which is 2 per cent a year) might not immediately cause the Fed to speed up its timetable for normalising the cash rate — but would quickly add upward pressure to bond yields.

● Even with the US raising its cash rate, global monetary policy is likely to remain quite accommodative for another couple of years, because of the actions of the European Central Bank and the Bank of Japan, as today's chart indicates.

● In such an environment, shares would seem well-placed to deliver positive — though volatile — returns over the medium term.

But bonds could disappoint. Investors should maintain sensible holdings of interest-bearing assets even if prospective returns on those assets aren't all that flash.

With share market valuations already running at relatively high levels, stock selection of equities will be all-important.

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