Why I’m not worried about houses and banks

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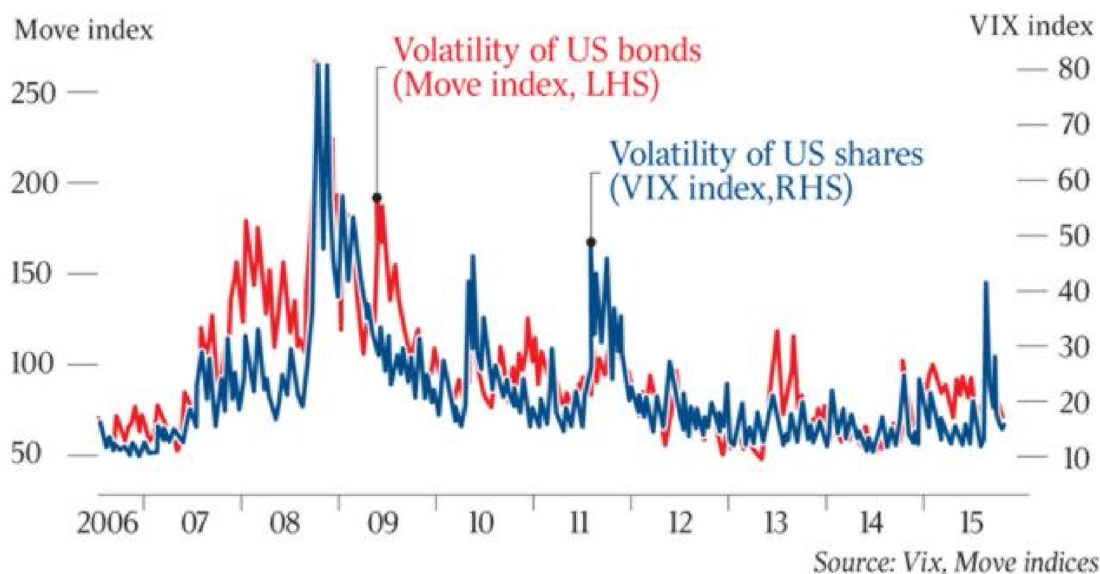

Volatile time for shares. *Source:* TheAustralian

What would you say are the key features of investment markets in 2015?

I’ll mention my top five; interestingly, they have a common cause.

1. For many investors, returns over 2015 are looking paltry. On Australian shares, the average gain since early January is 3.4 per cent; on a 10-year government bond the return has been about 2.7 per cent; and a cash trust has paid around 2.2 per cent.

2. But two major asset classes have provided double-digit returns. Thanks to the Aussie dollar’s 12 per cent fall against the greenback, Australians holding assets denominated in US dollars, and with their currency exposure unhedged, are well ahead for the 10 months. And median house prices in Melbourne and Sydney have risen by 12 per cent.

3. In August and September, sharemarket volatility heightened; bond markets stayed unusually calm.

4. In each of the major asset classes, investors are putting more effort into stock selection.

5. There’s a lively debate going on as to whether investors should hang on to, or toss, their shares in Australian banks.

The common cause of these themes? It’s the combination of the extremely accommodative monetary policies around the world and of the prevailing view of investors that these policies cannot generate the economic growth that governments and the monetary authorities have hoped for.

Easy money has done too little to boost global growth, but a lot to impact on investment markets.

As a result, share investors, who usually focus on the prospective earnings and on price-to-earnings valuations, are also having to decide how much to pay for shares while interest rates are negligible — especially shares with modest growth in earnings. As a result, small changes in sentiment can bring about big swings in share prices.

The dominant sentiment of bond investors is closing in: a view the world is suffering secular stagnation — that is, rates of economic growth will be slow and inflation won't be a problem for a decade or so. Hence the strong demand for bonds, even though yields are at or about the lowest levels they have ever been.

Housing markets differ a lot from country to country. In Australia, easy credit and low interest rates have pushed house prices in the biggest cities well into boom-time levels.

Prospects are that monetary policy in the big four economies (and in Australia) will remain accommodative.

The US central bank says increases in its cash rate will be "gradual". China, which has reduced interest rates five times this year, hints at further reductions. The European Central Bank, which has the cash rate set at a negative 0.2 per cent and a heavy program of bond purchases, is willing to ease further, too. Japan is continuing to print money on an unprecedented scale.

What sharemarkets need, to move higher, are signs that the recent slowdown in world growth has about run its course.

I've been putting the case in this column that expectations for a hard landing for the Chinese economy seem overdone. In the US, too, growth forecasts seem currently to be unduly pessimistic.

Yields on government bonds — which on 10-year maturities have recently been 2 per cent in the US and 2.6 per cent here — seem unsustainably low.

When the Fed delivers its long-foreshadowed increase in the cash rate, or there are signs of global growth strengthening or of inflation returning, bond yields could move sharply higher, and at short notice.

The strong upward moves in average house prices in Melbourne and Sydney seem now to be running out of puff; and momentum could slow further as the cutbacks in lending for investment housing, the new requirements on banks to boost their capital, and declines in rental yields take effect.

But I can't see median house prices falling very much. In Australia, when house prices rise too strongly, the usual correction is to move sideways for an extended time. And that's one of the reasons I'm less pessimistic than a good number of other investors on the outlook for bank shares.

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