Hoarding cash makes perfect sense as valuations surge

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Here and abroad, shares, bonds and commercial property are trading at valuations that are seen by many investors and commentators as "overstretched", "extreme" or "at bubble levels".

Are asset prices about to deflate? Or might they move mainly sideways for an extended time as the fundamental influences slowly improve? Maybe, investment markets will reach much loftier heights before the days of reckoning arrive?

The appropriate response to these questions is, probably, "all of the above but it's hard to say in which order". Now is a good time to assess current valuations, look at the dominant forces driving investment markets and work through a list of the key identifiable risks.

The most-used measure of market valuations is the price-earnings ratio, or p/e. For the share market, the p/e is the average share price divided by average earnings per share — and it comes in three versions: the prospective p/e (using expected earnings over the coming 12 months); the lagging p/e (based on earnings for the last twelve months); and the cyclically-adjusted p/e or CAPE (usually calculated with average earnings over the preceding ten years).

Currently, all three ways of calculating p/e ratios suggest share market valuations are well-above "normal" levels. For example, the US and Australian share markets are selling on prospective p/e ratios of about 17.5 times — noticeably above the multiples of about 15 times that are generally seen as comfortable for times of low inflation. The question then becomes can investors accept these "stretched" valuations because interest rates are atypically low?

P/e ratios can also be used to value other asset classes. For example, at time of writing, a ten-year government bond in Australia yielded 2.38 per cent; it was trading on a p/e of 42 times. In the US, Japan and Germany, ten-year bonds were trading on p/e ratios of, respectively, 52, 303 and 556 times. Investment housing in Australia seems headed to an average net yield of about 2.25 per cent, giving it a p/e of about 44 times.

Six and a half years after the GFC, most asset markets look highly priced — and this is mainly the result of sustained low interest rates and printing of money by the central banks of the US, Europe and Japan. The monetary stimulus that's resulted has boosted asset markets far more than it's raised spending on goods and services. China, too, is now easing its monetary policy, via reductions in the reserve requirements on banks and cuts in interest rates; property prices there have continued to weaken but share prices have risen strongly.

Here’s my list of the main identifiable risks in the investment outlook — any one of which could puncture the confidence that’s been driving investment markets:

1. The global monetary stimulus could be cut back prematurely. This is a small risk. The central banks of Japan and Europe are committed to programs that will add about $US2 trillion ($2.5 trillion) to the global money base in the two years to end-2016 — raising it above $US10 trillion. And with the Fed’s new emphasis on acting with “caution”, it’s likely to be a long time before the US cash rate is at levels that are uncomfortable to most borrowers.

2. That said, the Fed could make a heavy-handed move, as in May 2013 when it initiated the “taper tantrum” that caused a sharp sell-off in bonds and shares. The Fed would have learnt from that incident; but with its every comment and move analysed by millions of investors and commentators, risk of another stumble is high.

3. World growth could be downgraded further, forcing share and property investors to reduce expectations for profits and rents. This risk can’t be ruled out. At this stage, though, the US economy seems to have moved up a gear; Germany is lifting Europe out of its recent slump; Japan is forecast to have positive but slender growth; and China has a reasonable prospect of avoiding the hard landing that’s been long predicted for it. For the first time in many years, growth in the Australian economy seems softer than the global average.

4. Big and unexpected moves in exchange rates could destabilise investment markets. Since early January, the US dollar has risen by 17 per cent against the euro (and by 10 per cent against the Aussie dollar). Strong further increases in the value of the US dollar against the major currencies would seriously cut into US business revenues and confidence — and aggravate problems for emerging countries with significant debts in US dollars.

5. Any hint of inflation, particularly in the US, would seriously unsettle bond markets in the US and many other countries.

Investment markets are likely to be volatile in coming months — and vulnerable to further changes in news and views on US monetary policy, reports on US inflation, growth in the major economies, and corporate earnings.

The global monetary stimulus seems likely to continue on a scale that, over time, will raise global growth. Many investors are building up cash holdings, in anticipation of share markets turning weaker for a while and of bonds dropping in price as the cycle in bond yields turns up again. At current valuations of shares and bonds, that strategy has a lot going for it.

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