Why shares will bounce back after US rate rise

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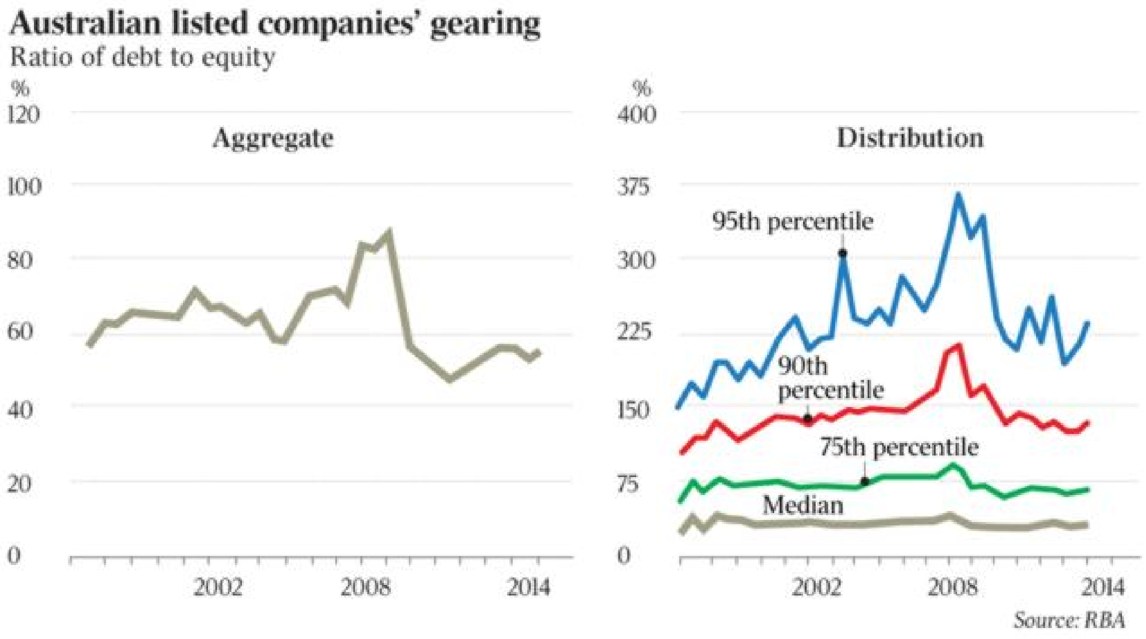

Debt to equity. *Source:* TheAustralian

In the stressful times of the global financial crisis, 6½ ago, the US central bank — the Federal Reserve — cut its cash rate to the range of zero to 0.5 per cent. The US cash rate remains unchanged, despite a repaired banking system, a convincing cyclical rebound in the US economy and booming asset markets.

Understandably, many investors are giving a lot of thought to when the Fed will raise its cash rate, what course will the US cash rate take over the next several years, and how will this impact shares, bonds, property and exchange rates.

Many investment commentators expect share markets to weaken sharply as and when the US cash rate is increased (they see equity valuations as too highly priced and expect US earnings to be trimmed by higher rates).

But the forecasts are also that bond markets will sell off only modestly (bonds are already priced for sub-par growth and negligible inflation).

In my view, both shares and bonds will initially sell when the first increase in the US cash rate is deemed to be imminent — but I also expect shares to subsequently rebound while bonds weaken cyclically.

My assessment could be wrong, but here are the reasons I hold this view.

●“First-for-this-cycle” rises in the US cash rate haven’t generally inflicted lasting damage on share markets. As Scott Minerd of Guggenheim Investments pointed out recently in Barron’s magazine: “A rate increase is not necessarily a bad thing for (US) equities.

“When that has happened in the past, there is a short-term shock. But historically, the trends for equities have been pretty good.

“For the six-month period leading up to a Fed tightening, the S&P 500 has returned about 9.5 per cent on average … (and the US share market) averages about a 10 per cent return following the beginning of the Fed tightening.”

● Both shares and bonds are highly priced but bonds trade, on average, at more extreme valuations than bonds. Currently, shares are trading on prospective price/earnings multiples of about 17 times in both the US and Australia, but 10-Year government bonds are priced on multiples, respectively, of about 54 times and 43 times. Given the scale and duration of the global monetary stimulus, bond valuations look particularly unsustainable.

● With inflation low and growth moderate rather than strong, the US cash rate is likely to be raised only slowly to its “normal” level. To quote Scott Minerd again, what the Fed would like “is to raise rates slowly over a period of years and watch the impact of each rate increase unfold”.

Best-laid plans, even of central banks, sometimes have to be varied but US cash rates seem unlikely to reach levels that, at least in the next year or two, will choke economic activity and puncture share market confidence.

● The tightening of bank regulation since the financial crisis is diminishing the liquidity of bond markets; as a result, we’re likely to see wider swings in bond prices, particularly should a lot of investors rush to exit holdings of long-dated or low-quality bonds. The Bank of England recently expressed its concern about bond markets becoming more “fragile”.

● Since the financial crisis, most companies have cut back on the use of debt.

In aggregate, companies listed on the Australian Stock Exchange, have reduced their gearing ratio close to historical lows — and a similar trend is evident elsewhere, including the US.

These strengthened balance sheets should help shares to better cope with the forthcoming increases in the US cash rate.

● A final point: the timing and pace of the “normalisation” of the US cash rate is still uncertain. Fed chair Janet Yellen says she expects “conditions may warrant an increase (in the US cash rate) sometime this year” and the Fed’s actions will be heavily “data dependent”.

But she adds that “a significant pick-up in incoming readings on core inflation will not be a precondition for me to judge that an initial increase in the federal funds rate would be warranted”.

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