Have we forgotten the financial crisis already?

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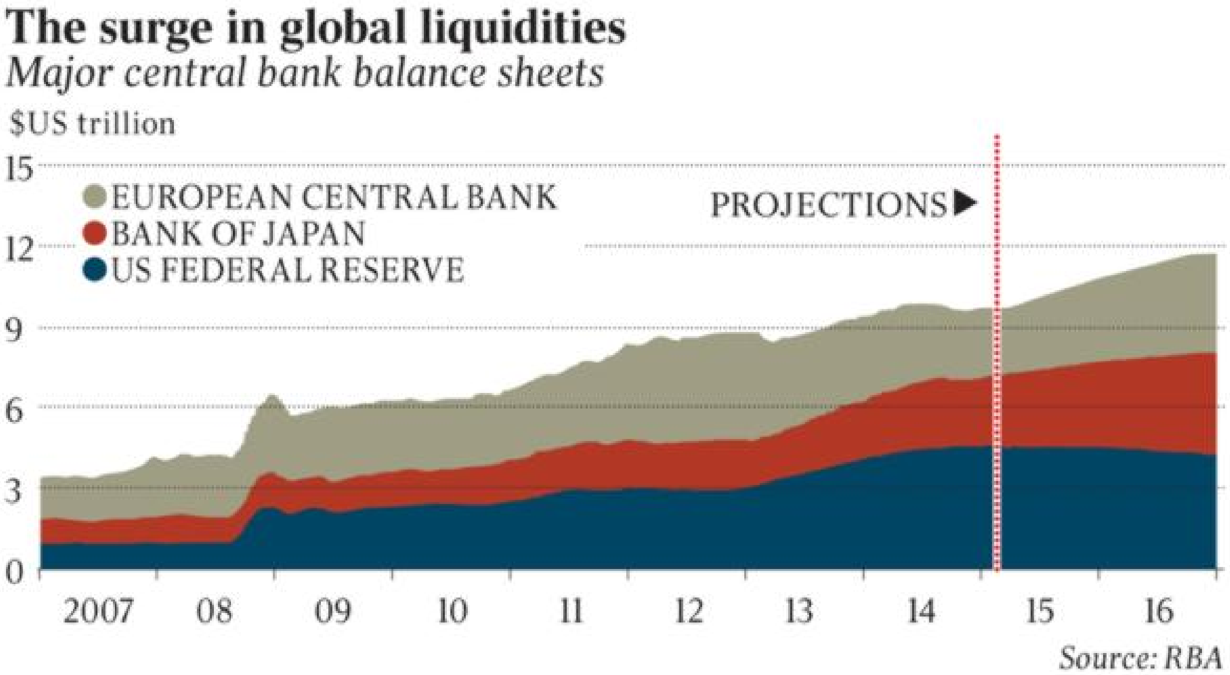

Surge in global liquidities. *Source:* TheAustralian

From their lows around March 2009, sharemarkets in advanced economies have delivered strong returns. These gains rank among the longest-lasting and least-volatile bull markets of all times — and perhaps the least-heralded.

We often hear this boom in share prices can't last, that shares face powerful headwinds and a correction is overdue. With the bull market now in its seventh year, and ageing, an update on the identifiable headwinds, tailwinds and crosswinds affecting shares seems timely. Which of the three winds is likely to be dominant? Will they take turns; if so, in which order?

First, though, an important wealth warning: much of what happens in investment markets reflects surprises and can't be predicted by even a detailed look at the key influences.

Let's start with prospective headwinds:

● US interest rates. Prospects are the US job market will remain firm — and the Fed, by end-September, will have raised its cash rate for the first time since 2006. The risk is that bonds and shares sell off. Certainly, pricing in futures markets shows that investors are much more pessimistic than the Fed on the US and global economic outlooks; investors don't expect a hike in the US cash rate until March 2016. Market reaction to any cash rate increase this year will depend on how well the Fed explains its move.

● Earnings. Many investors expect growth in company earnings to slow, as global growth softens and producers of energy and minerals are hurt by weak commodity prices.

● Valuations. Sharemarket valuations look stretched, especially those based on price-to-earnings or price-to-book.

Given these worries, why are sharemarkets so buoyant — even ebullient — and with lower-than-usual volatility? That's because of two powerful tailwinds:

● Monetary policy. Around the world, monetary policy settings are extremely easy. The US, Japan and Europe have negligible cash rates and, as the chart reminds us, the money bases of the three big economic blocs have expanded rapidly. China has relaxed its monetary policy, to reduce the risk of a financial crunch and recession as the overheated property market unwinds. In the mid-sized economies, including Australia, expectations are for monetary policy to remain "easy and for longer". Central banks are fuelling investors' hunt for yield and risk-taking.

● Acquisitions and buybacks. Average share prices are being boosted from mergers, acquisitions and share buybacks — and many companies that can't find suitable opportunities for new capital spending have increased their dividends. This year, large US companies are expected to spend more than a trillion US dollars on buybacks and dividends — of course, raising concerns about prospects for future growth.

Lastly, a look at crosswinds likely to buffet sharemarkets:

● Valuations. As mentioned, sharemarket valuations based on price-to-earnings or price-to-book suggest average shares are highly priced; some investors say dangerously so. But on price-to-earnings considerations, bonds and residential property look more overpriced than shares. And average share prices don't look so stretched when shares are valued by a comparison of their earnings yield with the bond yield.

● Cautious moves by the Fed. Moves in the US cash rate are likely to be made cautiously — at least until inflation has clearly revived — but market sentiment on the outlook for the US cash rate will swing widely

● Changing views on the global economy. With the US economy well-placed to grow at least moderately, Europe pulling out of its mild recession, and China avoiding its much-predicted economic hard landing, maybe there'll be upward revisions to forecasts for profits — but not for a while.

All major asset classes have uncomfortably high valuations, pushed by easy monetary policy and the hunt for yield.

Investors need to recognise there's been a big increase in risk-taking that many lessons from the global financial crisis of just seven years ago are being ignored, and volatility in investment markets has been unusually low.

But is the bull market in shares about to end — or will that await a more significant tightening in US monetary policy than we'll likely see in the next year or so?

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