Three lessons I've learnt from past crises

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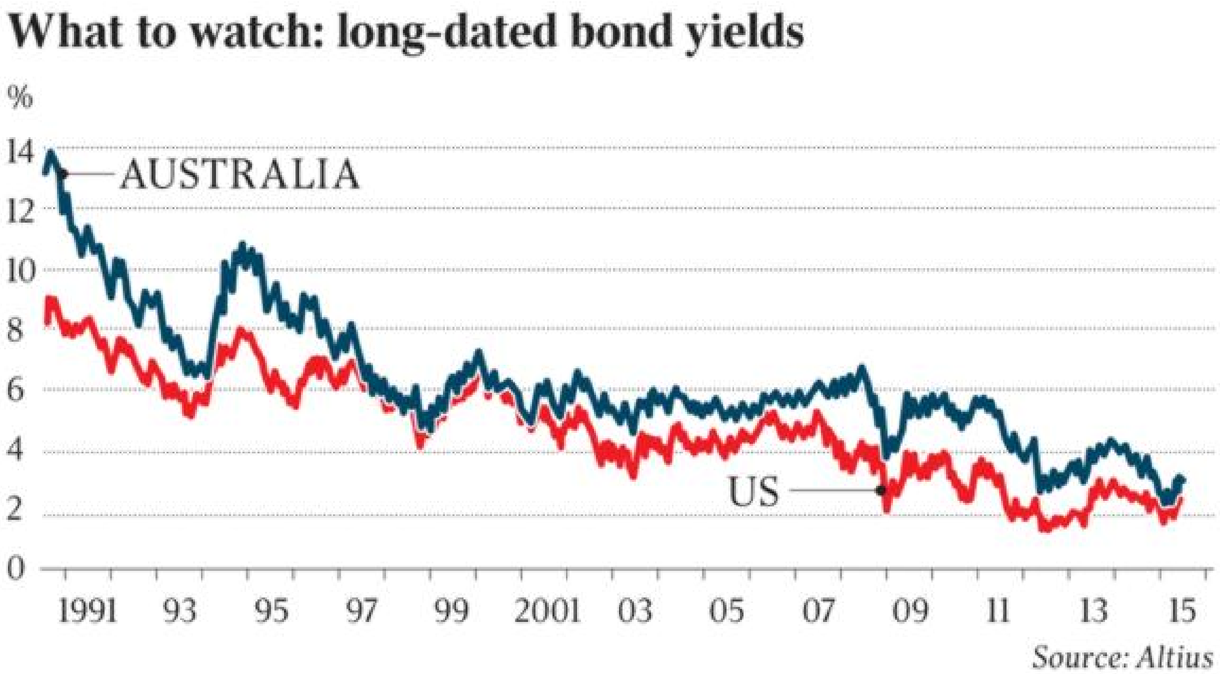

Bond yields *Source:* TheAustralian

Sentiment in investment markets has changed direction — for the fourth time in six months.

From January to April, the dominant view in global markets was Europe would suffer recession and deflation. Bond yields plummeted and the "hunt for yield" drove share prices higher. Then, on stronger economic data from Europe — and with continuing gains in US job numbers — bond yields spiked and the sharemarket sold off. In late June, the Greek financial crisis, which had been building for years, came to a head; bond yields dropped and shares weakened. Late last week, bond yields rose and shares rebounded.

In the half century since I first took an interest in investments, there been dozens of financial crises of various sorts — some serious and others quickly forgot. The investment lessons I've learnt to take from financial crises are these.

I wouldn't lose any sleep about the risk of default on bonds issued by Australian governments (though the Premiers' Plan in the 1930s cut interest on government bonds holdings of domestic investors).

More generally, there are a fair number of governments around the world whose debts might reasonably be seen as having a near-zero risk of default, thanks to their repute, their taxing powers and, in extreme circumstances, their central bank financial support.

But even investors holding bonds issued by creditworthy governments face risks:

First, there is market-pricing risk. Interest rates and market prices of bonds move inversely: bond prices rise when market interest rates fall; and bond prices fall when interest rates increase. On longer-dated bonds, market-pricing risk is greater than on shorter-dated bonds.

Second, there is inflation risk. Most government borrowings are by way of “conventional” bonds — they carry a fixed “coupon” rate of interest and at maturity repay the sum of money originally invested. If prices of goods and services rise a lot during the life of the bond, bond holders are likely to suffer a serious loss of real spending power. With inflation and interest rates currently at historical lows, the inflation risk on conventional bonds seems high — hence many investors also hold inflation-linked bonds.

It’s too early to say how the Greek financial crisis will play out: Greece’s indebtedness is huge; the economy is shot; and the Greek government is extremely confrontational in its dealings with creditors.

On the other side of the coin, however, the risks of financial contagion spreading from Greece to other members of the eurozone are much less than a couple of years ago when Spain, Portugal and even Italy were heavily stressed financially.

In my view, the financial crisis in Greece is unlikely to result in major or sustained damage to the European economies — unless Greece’s intransigence leads to political disruption elsewhere in Europe — or to the US economy.

Now the Greek crisis has come to a head, central banks in Europe and the US are likely to accept highly accommodating settings in their monetary policies even longer than before.

As and when Greece’s financial problems slip from worldwide attention, interest rates on government bonds could well move higher — and investors will return to considering what effects rising bond yields will have on sharemarkets.

The answer will probably be it depends on what’s causing bond yields to increase: if it’s stronger growth in the global economy, sharemarkets could well make further gains.

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