Easy-money policies driving hunt for yield

- DON STAMMER
- THE AUSTRALIAN

- SEPTEMBER 09, 2014 12:00AM

SO far in 2014, investors have enjoyed positive returns on most asset classes. Risk margins are narrow. Volatility has diminished.

Can these benign times last? To address that question, it's useful to look back at how buoyant and stable investment markets have been — and ask what's brought about that happy state of affairs.

Bond prices have climbed high — and bond yields have dropped to extremely low levels (including 0.9 and 2.25 per cent on 10-year government bonds in Germany and Spain, respectively). Yields on riskier bonds have shrunk relative to those on low-risk bonds.

Sharemarkets in rich economies have recently traded at multi-year highs; some, including the US, have been at record levels. Sharemarkets in emerging economies lagged in the first half of the year; some are beginning to catch up.

Foreign exchange markets have been unusually calm, with the US dollar strengthening modestly against the euro and the yen. The Australian dollar has held higher and steadier against the US dollar than was generally expected.

These several features of financial markets are the result, mainly, of near-zero cash rates and of money-printing in the big economies. This ultra-accommodative monetary policy has fuelled an unprecedented global hunt for yield.

In bond markets, investors' anticipation of very low rates of global inflation this year and next, plus the prospects of mild deflation in Europe, have brought bond yields down to exceptionally low levels.

In sharemarkets, the combination of negligible cash rates and money printing in the US has had a surprise consequence: investor sentiment has responded positively to both good and bad economic news. For example, strong data on the US economy has created hopes of better profits — and driven up share prices. And weak data on the US economy boosted share prices because of the view that interest rates would then stay "low for longer".

In the big economies, monetary policy will remain highly accommodating for several years at least.

In the US, however, the high tide of extreme ease in monetary policy has begun to turn: the Fed's program of bond purchases will soon end; and, in my view, market sentiment will start factoring in an early move up in the cash rate.

Money-printing will continue in the US but at a slowing pace.

At the same time, the European Central Bank will be implementing the new program of monetary easing announced last week, including big purchases of asset-backed securities.

This long-discussed move is urgently needed in the eurozone economy where, despite the eurozone's risks of deflation, recession and sustained high unemployment, its money base has been contracting recently; at last, there's a commitment to the heavy lifting.

The Bank of Japan will keep a heavy foot on the monetary accelerator. And China seems on course to ease its monetary policy further, both to avoid financial stress and to keep growth in 2014 at about 7 per cent.

Investors need to take stock of how far the hunt for yield has now run, especially in bond markets, and how skinny are the returns from taking on additional risks on lower-grade bonds. Bonds, and particularly riskier bonds, seem overbought.

When sentiment in bond markets turns cautious, the initial effects are generally negative for shares.

But sharemarket valuations, particularly in the US and Australia, appear to be reasonably close to fair value. After the initial jolt, share prices should be able to track higher — at least shares in companies with good prospects of improving earnings.

The changes now under way in the relative settings of monetary policy in the US, eurozone and Japan also seem compatible with the US dollar moving up further against other major currencies — and add to prospects for the Australian dollar to drop modestly against the US currency.

don.stammer@gmail.com.

Don Stammer chairs QVE, is a director of IPE, and is an adviser to the Third Link Growth Fund, Altius Asset Management, Philo Capital and Centric Wealth. The views expressed are his alone.