

Central banks' monetary policy now key factor in investor success

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Central government bonds outstanding by country

Per cent trading with negative yields

\$US trillions



Source: Bloomberg, RBA

Trading of central government bonds. Source: TheAustralian

Sharemarkets in the rich economies have delivered strong returns over the past six years. That's because global monetary policy has been extremely accommodating, and because the strong increase in US profits has turbocharged US shares — the S&P 500 index has more than tripled — giving a positive lead to other sharemarkets.

Bond investors have also made good profits (as bond yields have dropped) because global monetary policy has been extremely accommodating, and because of deflation fears, especially in Japan and Europe.

The scale of the easing in global monetary policy is unprecedented. Central banks in the US, Japan and Europe have cut official cash rates — to levels so low the “hunt for yield” has become the dominant challenge for many investors — and between them are printing money on a huge scale.

The intentions of the major central banks have been, and are, commendable. Initially, they pulled out all stops to ensure the global financial crisis wasn't followed by a global depression. Subsequently, the aim was to reduce unemployment. More recently, avoiding

deflation has been an additional objective. In China, the main objective is to manage the property crisis.

The extremely accommodating setting in monetary policy has strengthened global economic conditions much less than it has boosted asset prices. The exception is the US economy, at last back on track. An unexpected consequence is that \$US7.6 trillion (\$9.8 trillion) of bonds issued by developed economies — almost a quarter of their government bonds outstanding — have recently had nominal yields at or below zero. Monetary policy is likely to continue as a force in investment markets, but its impacts are becoming more complex:

- by midyear, the Fed is expected to have announced the first change to the US cash rate since December 2008. It's also likely to suggest a series of "patient" and "gradual" increases in the cash rate over the next few years. Whether it can deliver such an "orderly" program remains to be seen.
- even then, the setting of global monetary policy will shift just one gear — from "extremely accommodating" to "highly accommodating", with cash rates well below normal levels and lots of money being printed. The hunt for yield will remain an important factor. Investors will likely continue favouring shares paying good, and rising, dividends. Stock selection will become more challenging.
- medium-dated and long-dated bonds are now priced for the expectation of near-zero inflation over many years. There's no allowance even for a mild cycle in inflation as the US economy gathers momentum and Japan and Europe get back to growth. Even a hint of inflation in the major economies could lead to a sell-off in bonds.
- the divergence of economic growth across the major economic blocs, and the decoupling of monetary policy that's likely to result, is expected to push the US dollar higher. Central banks are increasingly trying to influence the level of their currencies, mostly to keep the exchange rate lower. The resulting push-and-shove will add to volatility and uncertainty in foreign exchange markets.
- Investors looking a few years ahead should bear in mind the damage unexpected inflation does to investment planning, particularly in self-funded super.

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