A puzzling disconnect…

Summer is upon us and in the UK we are actually enjoying some sunshine as are equity markets notably in the US. Fixed interest markets too are still sitting close to all time low yields and "shock horror" Spanish ten year rates are now below both UK gilts and US Treasuries. No I don't know why either but Dr Aghi is sitting comfortably at the ECB having told the markets yet again that the sanctity of the euro is sacrosanct and woe betide anyone who disagrees with him.

Without a doubt the central banks are now running the show which is unfortunate as their track record, particularly in avoiding stock market excesses, is patchy to say the least. Janet Yellen, the latest incumbent chair at the Fed is quoted as saying that she is not at all concerned about valuations on Wall Street

In other words she is complacent about complacency, but no different from her predecessors who couldn't see a housing bust coming (Greenspan) and thought that the subprime debt market was under control (Bernanke).

The Bank for International Settlements (BIS – the central banks' central bank whose mission is to serve central banks in their pursuit of monetary and financial stability) agrees with our view,

"Financial markets have been exuberant over the past year, dancing mainly to the tune of central bank decisions. Volatility in equity, fixed income and foreign exchange markets has sagged to historical lows. Obviously, market participants are pricing in hardly any risks."

The S&P 500 Index, gained almost 20% in the 12 months to May 2014, whereas expected future earnings grew less than 8% over the same period. The cyclically adjusted price/earnings ratio of the S&P 500 stood at 25 in May 2014, six units higher than its average over the previous 50 years.

It is no different in bond world…"Low corporate bond yields not only reflect expectations of a low likelihood of default and low levels of risk premia, but also contribute to the suppression of actual default rates, in that the availability of cheap credit makes it easier for troubled borrowers to refinance. The sustainability of this process will ultimately be put to the test when interest rates normalize." In other words how secure are the interest payments on the high yield bond you have just put into your retirement account?

"Once more, communication from the Federal Reserve and the ECB helped support credit and equity markets, with the major stock exchanges reaching record highs in May and June 2014."

They go on to say that..."It is hard to avoid the sense of a puzzling disconnect between the markets' buoyancy and underlying economic developments globally....As history reminds us, there is little appetite for taking the long-term view. Few are ready to curb financial booms that make everyone feel illusively richer. Or to hold back on quick fixes for output slowdowns, even if such measures threaten to add fuel to unsustainable financial booms. Or to address balance sheet problems head-on during a bust when seemingly easier policies are on offer. The temptation to go for shortcuts is simply too strong, even if these shortcuts lead nowhere in the end." Apart from driving asset prices higher and higher has QE really worked as intended? Answers on a very small postcard…or as the BIS puts it…

"The global economy continues to face serious challenges. Despite a pickup in growth, it has not shaken off its dependence on monetary stimulus. Monetary policy is still struggling to normalize after so many years of extraordinary accommodation. Despite the euphoria in financial markets, investment remains weak. Instead of adding to productive capacity, large firms prefer to buy back shares or engage in mergers and acquisitions. And despite lackluster long-term growth prospects, debt continues to rise." As does the ability of the creative accountants to produce "ever" rising earnings growth.

But don't worry the central banks know what they are doing don't they? "Market participants seem to have become convinced that monetary conditions will remain very easy for a very long time. But markets may be taking more assurance than central banks wish to give, and they may be considering only a very narrow spectrum of potential outcomes. Such overconfidence is dangerous. It may encourage excessive risk-taking, and may add to the pressure on central banks to postpone policy normalization."

Their conclusion is based upon much common sense but don't hold your breath waiting for it to happen.

"There is a common element in all this. In no small measure, the causes of the post-crisis malaise are those of the crisis itself – they lie in a collective failure to get to grips with the financial cycle. Addressing this failure calls for adjustments to policy frameworks – fiscal, monetary and prudential – to ensure a more symmetrical response across booms and busts. And it calls for moving away from debt as the main engine of growth. Otherwise, the risk is that instability will entrench itself in the global economy and room for policy maneuver will run out."

Might we suggest that the BIS restate their mission which should be to "save" central banks from their pursuit of monetary policy? It would be a much safer world without them.

Clive Hale –The View from the Bridge - July 1st 2014
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