

Markets Insight: Central banks will keep equities afloat

By Michael Heise

Continued monetary easing means there are no reasons stock markets should see a steep slide

Four months ago, I argued in this column that financial markets were running ahead of a turn for the better. Today they are still in bullish mood. But they are not buoyed by encouraging data – which are still rare – but by the realisation that expansionary monetary policy is set to rule the roost for a while yet.

Indeed, recent highs on many stock markets seem out of sync with the current weak economic indicators. A clear pick-up in the economy is evident neither in Europe nor in the world economy. Many institutions are now forecasting 2013 world GDP growth of only 2.5 per cent or less. In the eurozone average growth is likely to be negative. But financial markets remain unfazed, taking this as more evidence that monetary accommodation is here to stay for the foreseeable future.

Confirmation was recently provided by the European Central Bank, with its 25-basis-points cut to a record low of 0.5 per cent. The move was prompted by the ongoing weakness in the economy and by sliding inflation.

In the current environment, and with transmission channels still impaired, the overall impact of the ECB move on eurozone growth will remain muted.

The ECB's decision came on the heels of the recent announcement by the Bank of Japan that it plans to double the monetary base by the end of 2014. If in future the Japanese central bank is going to be gobbling up some two-thirds of government bond issues, close to zero interest rates on Japanese government bonds are practically guaranteed. Given the size of the Japanese market, this will also push down global yields.

However, the flood of liquidity and the low interest rates, which central banks hope will help resuscitate lending demand and unblock dysfunctional monetary transmission channels, are having ambivalent effects.

On the one hand, monetary accommodation is facilitating funding of high debt levels for public or private borrowers and enhancing the attractiveness of even modestly profitable investment projects. On the other, it is severely eroding the income flow for all savers. The alternative is to resort to higher-yielding but more risky investment forms. Shares are the beneficiary; their charm has risen considerably despite the economic uncertainties.

There is a general fear on markets that excessive liquidity supply may at some point spawn asset bubbles without fuelling inflation in goods prices. But with a view to equity markets, only lonely voices already see evidence of a bubble. Indeed, some fundamental factors argue for equities.

They have more than a decade of low gains behind them. The corporate earnings picture is broadly upbeat and the long-term trend is favourable. Therefore, even if the economic pickup, supported by monetary policy, remains moderate, there will be ongoing earnings momentum, making current valuations on most stock markets look attractive.

There are therefore no reasons for a steep slide on stock markets. A downright collapse would only be on the cards if the euro debt crisis were to escalate again or, in the event of buoyant economic growth with higher inflation, monetary policy were to reverse direction after all. Both scenarios currently look unlikely.

At present, anything but an exit from unconventional monetary policy is on the agenda, despite the considerable risks this entails. One reason why the ECB will be reluctant to undock from the other central banks is the likely impact on the euro.

In the current environment, a steep rise in the euro could spawn deflationary risks in the eurozone. As long as the US Federal Reserve, the BoJ and the Bank of England remain on a path of forceful accommodation, it would be difficult and risky for the ECB to change its stance. Hence, a genuine turnaround in European monetary policy is not very likely in the foreseeable future – even if evidence of an economic recovery firms up.

All this indicates that financial markets have become even more dependent on monetary policies than just a few months ago. Rock-bottom policy rates and abundant liquidity will keep yields on benchmark government bonds low for the rest of 2013. In the event of an economic recovery beginning later this year, yields on 10-year US Treasuries and German Bunds may start to rise moderately, but look unlikely to exceed 2 per cent even in 2014. The difficulties for defensive investment strategies will therefore persist.

Stocks will continue to show a solid performance. The test for market resilience will come when the ultra-loose monetary policy stance changes. This is not around the corner – look for 2014 at the earliest – but the longer the markets get used to ultra-low rates, the more they will be rocked once a monetary turnaround commences.

Michael Heise is chief economist and head of corporate development at Allianz SE