Investment Spotlight

ANZ Wealth Chief Investment Office

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A central bank's got to know its limitations

Mark Rider's recent research trip to the United States identified a number of key themes across politics, markets and the economy. The complacency in bond markets and the implications for shares is the major short-term concern. Donald Trump also provides another potential source of unease. Read on for more.

Trump vs Clinton

It was hard to get away from the United States (US) Presidential election campaign. The mainstream media began most days with reports on either the latest gaffe by Donald Trump or Hillary Clinton's use of a private email server whilst serving as US Secretary of State and donations from foreign donors to the Clinton Foundation.

There is a clear sense that the vote is for the least unpopular candidate, rather than the most popular. A poll by Washington Post/ABC News Polls has Trump and Clinton as the most unfavourably rated candidates at any point during a campaign in the past 30 years.

In the wake of the Republican convention, Trump's standing in the polls fell sharply and he was very much on the back foot, although in recent weeks he appears to have reversed this trend. However, Trump's continued reference to "crooked Hilary Clinton" may be beginning to bite.

It's dangerous to write off Trump's chances of winning the election, given the issues still dogging Clinton, as it is (largely) a two horse race. A look at the sector trends in the share market, such as strong infrastructure, weak pharmaceuticals, suggest the market has been moving to price in a Clinton victory, and is therefore vulnerable to this assumption.

Historically, a good indicator of who will win the Presidential election is the performance of the US share market (S&P 500) in the three months preceding the election. In 19 of the past 22 elections a rise in the share market during this period favoured the incumbent party. From 8 August to 12 September the US market has fallen by a modest 1%. While there are still two months to go, all signs are pointing to a tight contest.

Complacency vs New Reality

A sense of complacency was evident towards financial markets, in particular bond markets. There appears to have been a total capitulation towards the view that bond yields will remain low for an extremely long time, with little upside risk. While inflation is rising modestly in the US, normally an indicator of higher interest rates to come, there's an expectation that it's different this time.

The US Federal Reserve (the Fed) is expected to raise rates once before the end of the year, probably in December, and then very gradually thereafter. In addition to this there is US$3 trillion of bond purchases by major central banks this year and next, which is more than US$800 billion in excess of what is being issued by governments. This is expected to keep yields anchored for the foreseeable future.

Governments are buying more bonds than they are issuing

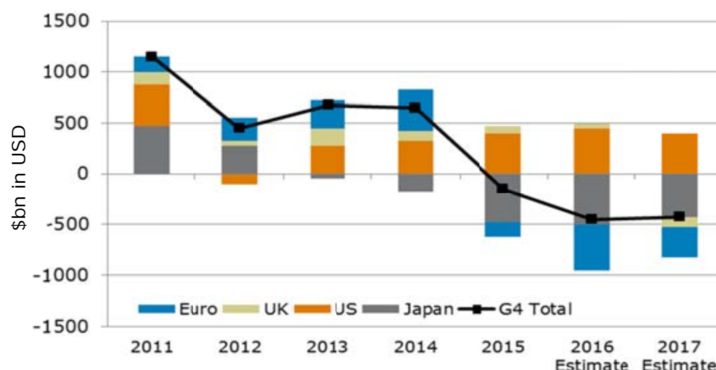

Chart shows bond issuance after Central Bank purchases
Source: Lazard Asset Management, Morgan Stanley

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With interest rates so low, there's a view that there is no alternative to shares as an investment, despite the risks. One fund manager commented that we are in a new reality and we just have to get used to it.

Academic Robert Shiller, Nobel Prize winner and author of "Irrational Exuberance"[1], was quoted in the media about the "new normal bubble". The new normal refers to the current lower growth and inflation/low interest environment. The bubble reference is to how low rates and the search for yield has driven share markets higher into expensive territory.

"Paradoxically when most people are most pessimistic about their future, stock prices are at their highest level"

What is different this time is that rather than greed driving investors due to the fear of missing out on a profitable opportunity, this time it is the fear of the economic outlook that is the catalyst. The low interest rates that accompany this fear are driving share prices higher as investors search for even a modest positive return. While this is different, this time we still have a "conventional wisdom" driving asset prices - that interest rates will be lower for a very extended period of time. This suggests share markets are vulnerable to a back-up in yields, with the sustainability of current share prices called into question. This particularly applies to defensive, income generating shares such as Real Estate Investment Trusts (REITs), utilities and infrastructure which have outperformed the market in the past few years.

Demographics and monetary policy

There is also increasing acceptance of the view, one we have been arguing, that potential growth in the US economy has fallen due to demographic factors; a fall in overall population growth, and the retirement of more productive, older workers which saps the economy's potential to grow.

With the US unemployment rate now below 5% there are increasing signs that the labour market is beginning to tighten. Wages growth is picking up, the unemployment rate for the least skilled workers, those who did not finish high school, has fallen by 2% in the past year and real median household income has finally recovered back to the pre-GFC peak. The maturing and normalisation of the US recovery, with more broadly based rising real incomes, provides support for consumption, a positive for the sustainability of the economic expansion.

US wage pressures gradually rising

Chart uses Atlanta Fed - Median wage growth 3 month moving average (%)
Source: Lazard Asset Management, Morgan Stanley

As this is taking place, there is increasingly a debate about the effectiveness of monetary policy, and that the negative interest rates in Europe and Japan are having perverse impacts. In particular, rather than stimulating consumer spending, lower expected investment returns from low interest rates may just be making things worse as investors increase savings in an attempt to make up for lower returns.

Fiscal policy is seen as needing to carry more of the burden, although in Europe just how much is hard to tell given the already high levels of government indebtedness and Germany's aversion to pushing it any higher. A groundswell is building for central banks to stop additional easing measures, building pressure on governments to adopt policies aimed at higher government spending.

In conclusion

A number of risks are building for markets. The US Presidential election is one of these as the improving polls keep Trump in the race for the White House. Markets look to be pricing a Clinton win, so are vulnerable to a Trump victory.

That said, complacency in bond markets and the implications for shares is our major concern at the moment. With bond and share markets both expensive, the risk is for weakness in both markets in the shorter term.

The increasing criticism of central banks and the effectiveness of their ultra-low interest rate policy may prove a catalyst as markets are disappointed on a lack of further easing or an earlier or more aggressive Fed tightening program. An increased focus on fiscal policy would be another factor putting upward pressure on rates.

A rise in yields does not necessarily mean the end of the expansion phase for the share market. But it certainly will give the market pause for thought, at least in the shorter term.

[1] Shiller, Robert J. (2000). Irrational Exuberance

Stewart Brentnall, Chief Investment Officer

Stewart leads ANZ Wealth's Chief Investment Office. He is responsible for delivering an overarching investment strategy, including responsibility for asset allocation, investment themes, investment manager and product selection and monitoring, and investment compliance, risk and analytics.

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Mark is responsible for driving ANZ Wealth's investment strategy and management of diversified funds within Australia and New Zealand.

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