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MARKETS INSIGHT

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Investors are playing a ‘greater fool’ game

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Market anomalies abound as debt levels rise and interest rates stagnate

Speculative euphoria, even when encouraged by central banks, is defined by the way it ends — not with a whimper but with a bang. In this context, the so-called Bund “tantrum” may be no more than a hiccup in the context of deeply anomalous financial market conditions.

Investors are still chasing low or negative yields in bond markets, fairly or fully valued equity markets, and rising property markets. Yet, it seems increasingly that, long-term investors aside, they are playing a greater fool game.

One of the biggest anomalies in global financial markets is the persistence of zero real, or inflation-adjusted, policy rates in most advanced economies and zero or negative real bond yields alongside a surge in the volume of public and private debt that shows no sign of subsiding.

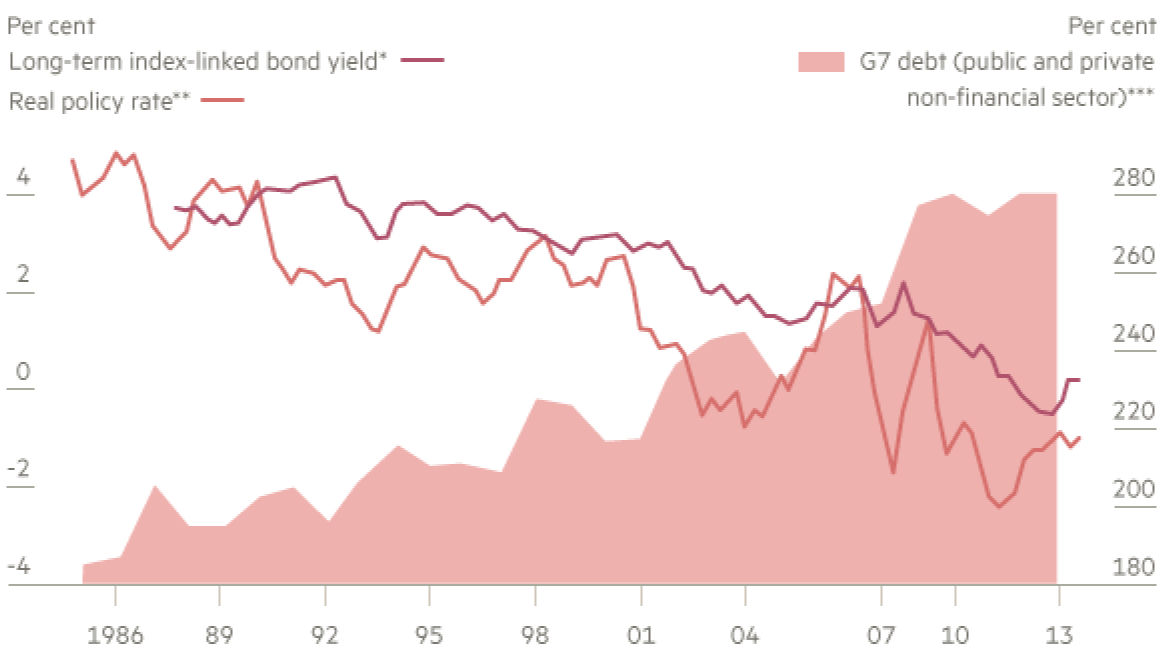
The Bank for International Settlements has mapped a 50 per cent rise in debt outstanding in the world’s 12 largest economies since 2007 to more than $125tn at the end of 2014. A recently published McKinsey report on debt, covering 47 countries, highlighted an increase over the same period of $57tn to about $200bn, or a rise of about 20 per cent of GDP to just under 290 per cent of GDP.

While developed markets accounted for the lion's share of the build-up in debt up to the financial crisis and still dominate the aggregate debt-to-GDP league table, it is in emerging countries, least affected by the financial crisis, that debt has erupted since 2008.

The most significant shift has occurred in Asia ex Japan, especially China, where aggregate debt to GDP has quadrupled over the past decade and the limits to debt capacity are fast approaching. While domestic credit rises at twice the rate of money GDP growth, the toxic combination of rising leverage and slowing growth will continue to erode the nation's ability to sustain debt accumulation. Eventually the authorities will have to clamp down on credit expansion.

Global bond and equity markets remain largely oblivious to the relentless rise in indebtedness. The commonly accepted but also questionable narrative is that the Federal Reserve is severely constrained when it comes to raising policy rates, the European Central Bank and the Bank of Japan remain committed to quantitative easing, and China is accelerating the pace of monetary accommodation. Cheap money, therefore, is around for the foreseeable future, and asset price inflation, even with occasional wobbles, is a given.

Low interest rates in a time of debt



* From 1998, simple average of France, the UK and the US; otherwise only the UK

** Weighted averages for G7 economies based on 2005 GDP and PPP exchange rates

*** Sum across G7 countries converted to $ at market exchange rates

Sources: IMF; national data; BIS estimates

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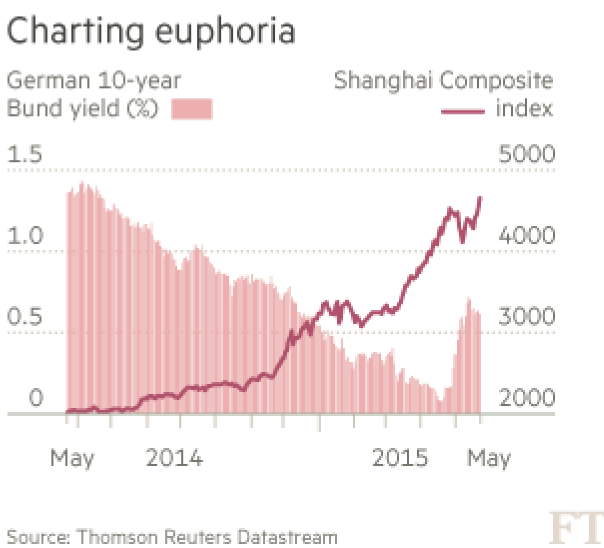
Rationalised in macroeconomics, this is essentially about "secular stagnation". Economic growth is soft; trend growth is lower, not least because of the legacy of the financial crisis; and with high and rising leverage, central banks cannot risk a rise in nominal interest rates that would pull up real rates without aborting economic recovery and beckoning further stagnation. Whatever the Fed and others mean when they refer to restoring "equilibrium real interest rates" over the next two to three years is a cover for self-validating, abnormally low real interest rates.

We should beware this narrative, even if the secular stagnation hypothesis turns out to be right. Policy rates are on the floor, first, because "lowflation" has reduced nominal growth, which justifies low rates but undermines earnings. Second, because central banks have been trying to get market rates down to align them, as far as possible, with the slump in the "natural" interest rate, reflecting the protracted weakness of investment relative to savings.



Moreover, the persistence of low real interest rates implies an environment of low real investment returns. So any euphoric returns today will be counterbalanced as night follows day. Central banks may be going boldly to the outer limits of monetary policy to encourage investors to buy risk, but it is difficult to reconcile the appetite for risk with what those policy actions actually imply.

Should investors throw in the towel? It is a conundrum. Institutions are still buying European debt on negative yields. Investors who have missed the doubling of the Chinese stock market since mid-2014 wonder if they can afford to stay out. Emerging market currencies are down but asset returns have barely moved despite a steady deterioration in currency reserves, capital flows and growth.

In July 2007, Citigroup chief executive Chuck Prince famously said the group was "still dancing", not least because there was so much liquidity around in markets. This time round, with valuations stretched, we do not even have that, as the Bund tantrum aptly demonstrated.

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