Financial markets out of balance?

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Among investors there is still a deep divide in sentiment between optimists hoping that developed economies will muddle through the debt crisis, and pessimists fearing that the financial system itself may be broken. Certainly in the major developed economies, the long trend of consumption-driven growth fuelled by increasing debt appears to be reversing. But in such an uncertain investment world, do the lessons of history or the longer cycles in markets help guide which asset classes will deliver the best results in future?

In preparing the long-term data tables in the latest edition of the *Sarasin & Partners Compendium of Investment*, we find a number of financial indicators and asset prices at extremes relative to their historic ranges, in particular the yields on US, UK and German government bonds which have fallen to lows not seen in the data going back to 1900. Will yields "revert to the mean" or has the elastic snapped?

This article looks at some of the instances of extremes in long-term financial market data and then reaches some conclusions as to why markets have performed the way they have and what we might expect to see going forward.

Government bonds

Over the last 30 years the yields provided by UK and US 10-year government bonds have declined from over 15% to 2%. This trend tracked a significant decline in the rate of inflation but, slightly counter-intuitively, also occurred at a time of a huge increase in the supply of bonds as governments racked up ever greater long-term liabilities.

Just prior to the default of Lehman Brothers in 2008, Gilt yields were still over 4.5%. Since then government debts have ballooned even further as bank liabilities have been assumed and tax receipts have fallen. There appear to be two principal reasons for the latest decline in yields; "financial repression" and fear of deflation.

Throughout history, when facing seemingly insurmountable liabilities, governments have used different tools to reduce the debt burden: default, inflation, a growth strategy and finally, financial repression. The main goal of financial repression is to keep long-term interest rates lower than they would otherwise have been, reducing the cost of the government's debt servicing bill. If they can push the interest rate below inflation, they also transfer money in real terms from the savers to the borrower (the government). They achieve the low interest rates by using regulation to force banks, insurance companies and pension funds to buy bonds and through Quantitative Easing (QE), under which the central bank "prints" new money and buys bonds too.

Given the enormous size of government debts in the developed world today (not to mention unfunded liabilities such as future pension promises which are not included in the debt figures), an increase in interest rates would be unaffordable, so it seems likely that financial repression will remain a core government strategy on both sides of the Atlantic for some time to come.

The threat of deflation is harder to judge. On one hand, there is downward pressure on prices as government austerity policies are shrinking demand, rapid advances in technology are generating remarkable productivity gains, unemployment and globalisation force down wages in the developed world and consumers pay down debt and increase savings. On the other hand, the expanding population and rapid improvement in living standards in the emerging world are increasing demand for food and energy, putting pressure on supplies and pushing prices up. For the developed world, where food and energy costs make up proportionately less of the household shopping basket than in emerging markets, the deflationary influences are closer to gaining the upper hand, especially if economic growth falters.

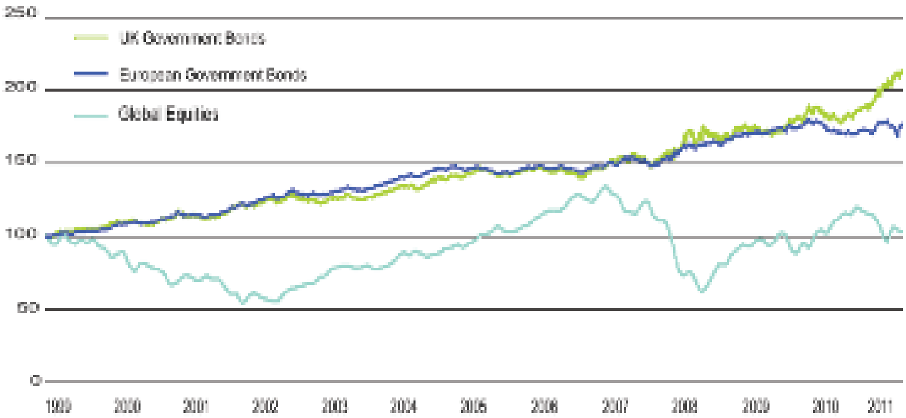
One disturbing parallel drawn by those fearing deflation is the experience of Japan over the last 22 years. In 1989 Japan fell into a period of recession that has persisted ever since, and the authorities have struggled to lift the growth potential of the economy. Japanese government bond yields fell below 2% in 1997, heralding a period of deflation that has stubbornly resisted all policy initiatives to address it. A further factor cited in studies of Japanese deflation is the ageing population: Japan's working age population has been declining and several other major western nations are just reaching a similar demographic tipping point.

That said, in the first half of 2012 the US is managing to achieve modest growth and there is increasing optimism that some developed economies are steering a course that will avoid deflation. Ben Bernanke, chairman of the US Federal Reserve, studied the Japanese depression when he was an academic and has been a strong advocate of imposing low interest rates (financial repression) ahead of the decline in growth potential in the hope of preventing it. The strong policy action taken by central banks suggests that there is some chance in the medium term that inflation will gain traction, starting in the emerging markets where demand is strongest and then being imported into the West.

If the Japanese experience is not replicated, then the elastic may begin to rebound and bond yields will eventually rise, with inflation, rather than deflation becoming the investors' major concern. Rising yields mean that bond prices fall and investors will start to see capital losses on their bond holdings.

Not only would rising bond yields end a prolonged run of positive returns for bond investors, but it would challenge a standard approach to portfolio construction: government bond holdings are often included in portfolios as a "safe anchor" and have historically been viewed as a "risk free" asset by some investors, providing a different sort of risk from corporate bonds or equities. The risk of governments defaulting has been seen as almost negligible; after all, the government can always print the money to pay you back. However, exceptionally high debt levels in the public sector and the additional liabilities they have adopted to maintain solvency in the banking system have called into question the credit quality of many governments. Recently the US and France have lost their coveted AAA credit ratings. Today fewer than 30% of all sovereign bonds are AAA and Standard & Poors estimate that this will drop to 15% of the total issued globally by 2020 and there will be almost no AAA sovereign bonds left by 2030. So much for "Gilt-edged".

Figure 1: Global Equities, UK and European Government bond returns since 1998



Source: EcoWin

A reversal from extreme low levels of bond yields would have significant implications for investment strategy. When long-run trends in interest rates and bond yields reverse, significant losses can follow over many years.

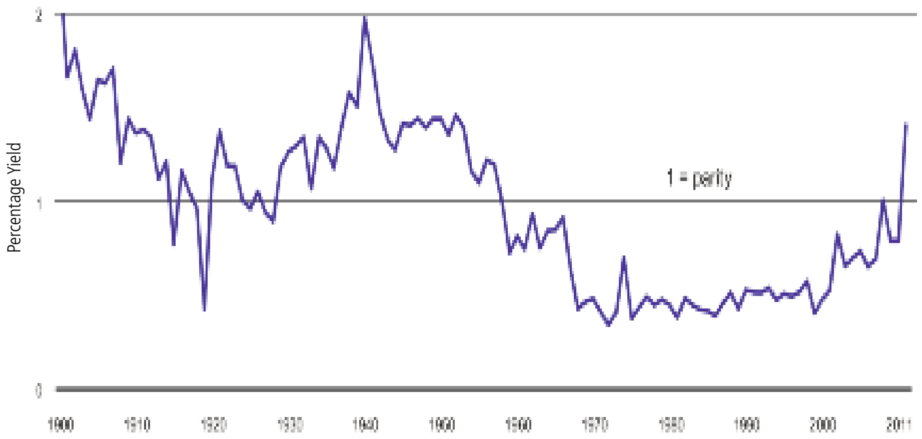
Bond/Equity Yield Ratio

The major equity markets have made no progress for a decade and a generation of investors have little proof that equities outperform bonds and other asset classes. On the contrary, bonds have delivered remarkably good returns for a decade or more, outperforming equities in the UK by 2% per annum over the past 15 years with much lower volatility and with a similar pattern in global markets as shown in Figure 1.

With the collapse of the banks in 2008 and the near collapse of the euro in 2011, faith in the financial system has been further undermined, causing the pendulum of risk tolerance to swing towards extreme levels. Echoing an infamous quote attributed to Mark Twain, investors have been more concerned with the return of their money than the return on their money.

The "cult of the equity" it is said, was started in the 1950s by George Ross Goobey. As the pension manager of the Imperial Tobacco Pension Fund, he went entirely against the conventional wisdom for pension funds at that time, which was to invest the majority of pension fund assets in "safe" government bonds (Gilts). He put the whole fund into equities. He recognised that Gilt holdings were not delivering a real return after inflation. He saw that companies were able to raise prices and thus profits and dividends to keep pace with inflation, and concluded that an asset where the income increased ahead of inflation should be valued more highly, and thus yield less, than an asset with a fixed income stream.

Figure 2: UK Equity - Gilt Yield Ratio



Source: EcoWin

From the mid 1950s, equity prices rose as other pension funds and long-term investors followed suit and yields dropped to levels beneath Gilts. Equities continued to perform better as dividends increased ahead of the prevailing rates of inflation, justifying their "premium" valuation. However, the recent fall in bond yields has reversed the relationship.

Why has the relationship broken down? Equity yields have risen a little as prices have stayed low but they are not far from their longer-term average. The real change has been in lower bond yields. As discussed above, a fear of deflation rather than inflation may justify this yield shift. There have been few periods of prolonged deflation over the last century, but the Great Depression from 1929 to 1932 saw profits, dividends and stock markets collapse. The Japanese equity market has also recorded dismal returns since it fell into deflation in the mid-nineteen nineties.

An alternative explanation for the reversal of the Bond/Equity Yield Ratio is that markets may be anticipating a drop in profitability for the corporate sector, matched by a cut in dividends. The past ten years have already seen relatively poor dividend growth – in the UK dividends have grown by about 1% per annum less than inflation: a rare occurrence. However, if the worst fears are not realised and economic policies lead to an inflationary environment, the historic record would suggest that there is scope for the bond equity yield ratio to "normalise" back to a point where equities yield less than gilts once again. This could of course be achieved just by bond yields rising, just equity yields falling, or a combination of the two.

Conclusion

Many of the extremes in markets today appear to be driven by a fear of deflation and levels of risk aversion only witnessed on a few occasions in the past. If these fears turn out to be justified and if deflation were to take hold, then only a limited number of investment strategies make sense. Investors would continue to buy gold and government bonds, despite the low nominal returns. But if the elastic has not snapped and government reflation policies take effect, the lessons of history propose that the reverse strategy applies. Current market levels suggest that government bonds are expensive compared with any historic non-deflationary environment and that, relatively, equity markets may benefit from a reallocation of assets seeking yield and long-term real returns.