AGENDA

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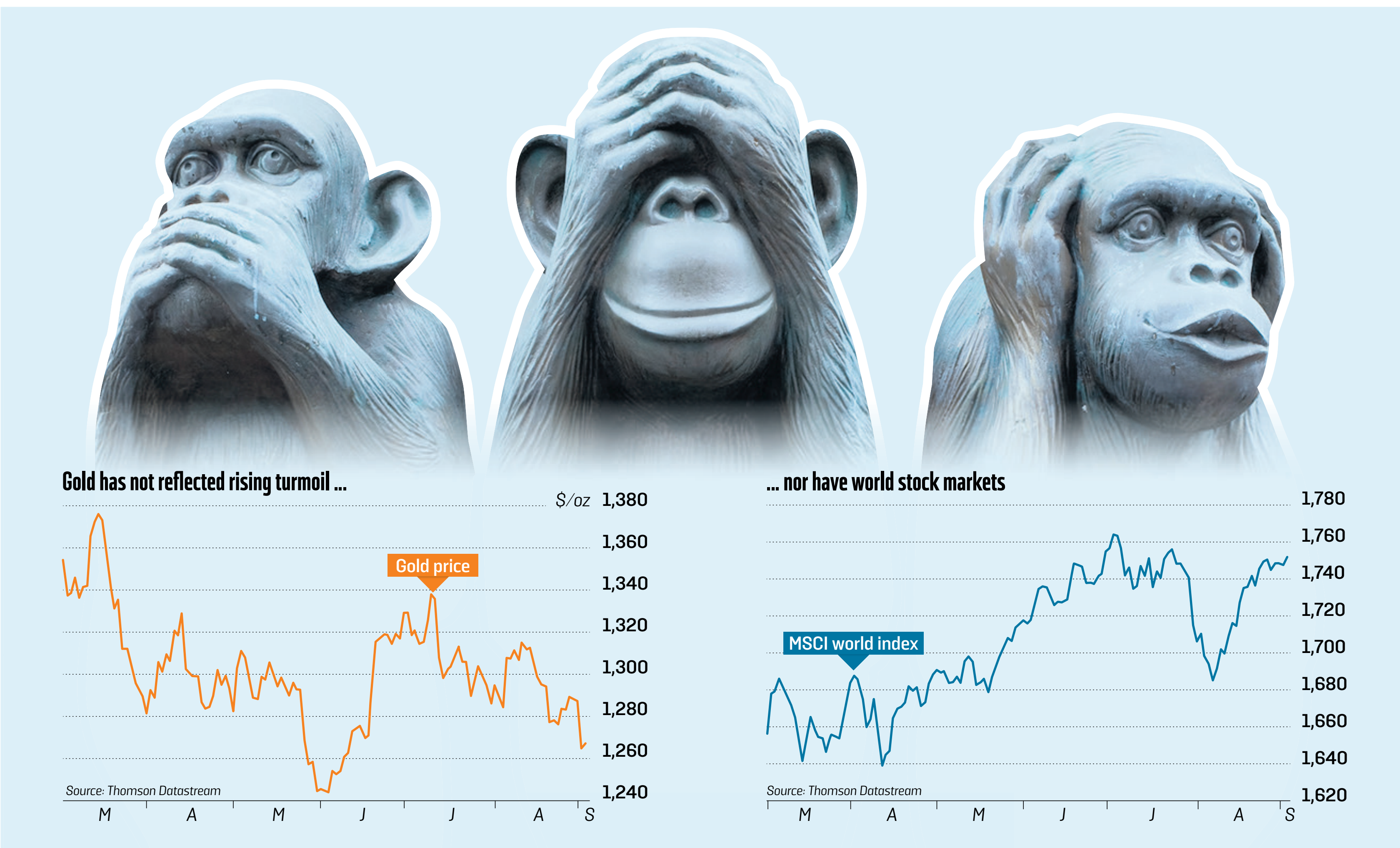
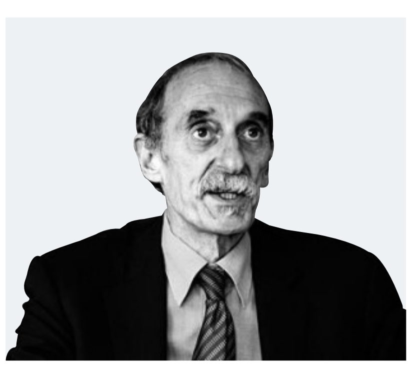


Turmoil is spreading but markets ignore the risks



GEORGE MAGNUS
ECONOMIC OUTLOOK

It is unsettling, to say the least, that in 2014 we are remembering the 100th anniversary of the outbreak of the First World War, but witnessing some of the most potent threats to the stability of the global system since 1914.

In Europe, the borders of Ukraine are being reshaped by force for the first time since the end of the Second World War. No one knows how or where this will end. In the Middle East, the borders laid down by the 1916 Sykes-Picot agreement are being shredded before our very eyes with unpredictable implications for the region and the world.

Further away from breaking news, but nonetheless important, China's more truculent behaviour towards Japan, its Asian neighbours, Hong Kong and, ultimately, America is raising the spectre of instability in Asia too. You would think, perhaps, that global financial markets would be in a funk, fearful of the unknown, and pricing for the risk of deglobalisation, if not outright conflict. In fact, of course, nothing could be further from the truth as we survey global equity, bond and housing markets.

As in 1914, financial markets are unmoved by the rumblings of geopolitical stress. In the UK , the FTSE 100 index rose in this past week to a 14-year high. In the US, some analysts expect the already feisty S&P index to rev up for an assault on the 3,000 level over the next five years. The beleaguered eurozone economy has not impeded the continued appreciation of share prices, and even emerging market equities, which had lost their shine for global investors, have reached a three-year high.

According to a recent report in The Economist, house prices have become frothy in many states in both the West and in emerging world, reaching overvalued levels relative to rents and incomes in many places. Bond yields, the accepted weather vane of market tensions, betray no signs of nervousness at all, or so we are told. In a half-dozen EU countries yields on government bonds with two years' maturity are now negative — that is, you have to pay the government when you lend money. The more widely followed 10-year bonds continue to trade at exceptionally low yields, whether here in Britain or America and in the eurozone. And the spreads at which sovereign, corporate and other loan obligations trade over major government bonds remains "skinny" to use financial market jargon.

Put another way, there is very little pricing for risk in what are traditionally regarded as riskier debt instruments. Spain can borrow money more cheaply than America, while in an industry known for bankruptcy and difficult financial conditions, Ryanair can finance itself more cheaply than, say, many a technology company. If you hadn't guessed it by now, you are definitely not in Kansas any more. Welcome to Oz.

How can we reconcile what are serious and troublesome geopolitical conditions in the world with what seems like a couldn't-care-less attitude in finance? And what are the implications?

It is possible to argue that markets are not very adept at pricing for geopolitical risks for the simple reason they are unable to anticipate political outcomes in the same way they try to anticipate economic or corporate events. They work on the premise that the majority of geopolitical incidents haven't stopped the onward march of economic integration and advancement for very long, if at all.

The Korean war and the Cuban missile crisis did frighten investors at a time when finance was far less sophisticated and much more tightly controlled than today. And the quadrupling of oil prices in the wake of the 1973 Arab-Israeli war and the oil embargo imposed by Opec also sent markets into a dive. These aside though, there have been few, if any, incidents that caused more than a short bout of nerves.

These arguments, however, count for much less than the Pavlovian behaviour of financial markets to quantitative easing (QE) and zero interest rates, otherwise known as cheap money. For almost a year, investors who were unconvinced by the prospects for a durable recovery in economic growth, productivity and profits have been capitulating to the willingness of central banks to sustain low interest rates, not just this year and next, but in the medium term as well.

We don't know for a fact that low interest rates will endure for the next five years or so, but as things stand the central banks in the US, UK, Japan and eurozone are telling us that this will be the case. True, the US Federal Reserve will have come to the end of QE soon, and a lively debate is going on as to when in 2015 the first rise in rates will occur. And in the UK, the monetary policy committee looks to be even closer to sanctioning a first rise in Bank rate, perhaps even later this year.

Yet there is no mistaking the dovish language of both central banks in the light of continuing dysfunction in loan and labour markets and of nervousness about the foundations of their economies. Neither Japan nor the eurozone is even close to their peers. Japanese QE is in full swing as a part of Abenomics, while in Europe, where economic stagnation is deeply entrenched and the risk of deflation is rising, the European Central Bank is inching towards new forms of monetary stimulus, even if it does not, in the end, adopt full-blown QE. Monetary largesse is the child of our post-crisis economic predicament, and central banks remain more or less protective parents.

Financial markets have grown accustomed to this new regime and they love it, almost regardless of economic fundamentals and geopolitical shocks. But they also view it through a very narrow lens, and sooner or later they will probably have a rude awakening.

Our obsession with unusual monetary policies such as QE, to the exclusion of what governments should be doing, is harmful. Excessive reliance on monetary stimulus and low rates is distorting the price of capital, and leading to resource misallocation such as borrowing for share buybacks rather than investment, and to income inequality, none of which is good for equities in the end. Moreover, excessively low bond yields are a sign of trouble not success. In Europe they reflect deflation risk. In America, they reflect the dominance of price-insensitive central bank purchasers, such as China.

Markets may come to reflect political risks in some of the world's hotspots more if event risk itself rises, or as the Fed and Bank of England finally start raising base rates. In the meantime, there are other political events that have the capacity to shake market confidence. Here in the UK, a "yes" vote in the Scottish independence referendum could easily knock sterling and UK financial asset prices down a few pegs. In America, the mid-term elections in November could strengthen the Republicans in Congress sufficiently to make the country even less governable than at present. And in Beijing, the combination of President Xi's anti-corruption campaign and a secular decline in the role of property and construction investment are liable to cause China's growth rate to fall even further, adding to the threat of economic instability.

The end of summer seems an appropriate time to recall the traditional phrase of making hay while the sun shines. Financial markets certainly are, and may go on doing so for a while, and certainly while central banks are on "easy street". But buying equities willy-nilly now is a 'punt', not a strategy. It will become all the riskier if political events, regarded until now as irrelevant or peripheral, should cease to be so. As well they might.

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