

Global equity markets look up

Pursuing a very loose monetary policy for a long time may not be a good idea, as it feeds inflation and is not a sound base to start a strong economic cycle, argues **Peter Hensman**.

In a matter of weeks, the debate in markets has swung from concerns that the Federal Reserve would embark on a series of rate increases from the end of 2009, as sentiment swung toward believing in the possibility of a V-shaped economic recovery, to more recent concerns that a second fiscal stimulus package is required in the US because of increasing disappointment at the support to employment and the economy from the US\$787 billion stimulus plan already enacted.

The policy statement from the US Federal Open Market Committee meeting on June 24 did make an apparently large shift. Where the prior meeting in April was concerned that “inflation could persist for a time below rates that best foster economic growth and price stability in the longer term”, recent increases in commodity prices would only be prevented from feeding through into a more generalised increase in consumer prices by “substantial resource slack [that] is likely to dampen cost pressures”.

Despite increasing criticism of Federal Reserve policy under former chairman Alan Greenspan, particularly maintaining interest rates at a low level for a prolonged period in the period following the NASDAQ collapse, the Fed still expects to maintain interest rates at “exceptionally low levels...for an extended period”. Arguably this is because, unlike the European Central Bank (ECB) and the Bank of England that are mandated to meet an inflation target, the primary function for the Fed is influencing “monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates”.

With US unemployment at 9.5 per cent¹ and rising, it will be little surprise if rates are maintained at the current -0.25 per cent for at least another 12 months.

This bias toward maintaining loose monetary conditions extends beyond the US. In the Eurozone, the ECB conducted its longest ever “repo” operation. In this, the ECB offered to enter into an unlimited sale and repurchase of assets (by commercial banks). A total of 1100 banks “repo’d” EUR442 billion of assets on a one-year term. This means that the banks have exchanged a wide range of assets held on their balance sheets for cash for 12 months, the intention being that banks should feel more comfortable about the cash positions (liquidity) on their books and, as a result, be more willing to lend.

New developments

Another unusual development has been the introduction of a -0.25 per cent deposit rate by the Riksbank in Sweden. This means that bank deposits held at the central bank will be required to pay (not receive) interest for the privilege of holding the funds “safely” at the Riksbank. As with the repo operation at the ECB, the intention is clearly to encourage banks to put their balance sheets to work, rather than continuing to hoard cash.

One slight exception to this general policy stimulus is China. Having seen bank loans soar by some 34 per cent year on year in June, maintaining the rapid rate of increase evident in the first six months of the year, there are early indications that the aggressive push to grow lending is coming to an end. This is most apparent in the resumption of bill auctions by the People’s Bank of China

(PBoC) after an eight-month hiatus. By resuming bill sales, the PBoC is acting to “mop up” some of the excess funds in the system. As a result of this change, one-month inter-bank interest rates have risen from the steady one per cent level that has been relatively constant since the start of the year to 1.4 per cent. Despite this apparent shift, it is equally true that this rate remains at a historically low level.

It is likely to be true that these loose monetary policies aimed at encouraging savers out of cash and incentivising an increase in indebtedness are unlikely to create a sustainable reversal in the deleveraging process. Besides, a policy based on the piling more debt onto the apparently excessive amounts that contributed to the turmoil of the credit crunch is not a sound base on which to build a strong economic cycle. But for now, it seems that some of the concerns about the current policy stance are outweighed by the short-term policy sugar-rush.

With equity valuations undemanding and equities being a real asset (i.e. offering some protection against the consequences of inflation), current conditions should support stock market returns. While concerns have grown about the return of a valuation premium on emerging markets relative to the developed world, the greater traction that the reflation policy is likely to gain in these economies that are less encumbered by the legacy of the last cycle suggests that, as occurred in the early to mid 1990s, this premium can expand and support further outperformance.

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