ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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With stock markets almost back at pre-Lehman levels – something we thought unlikely before the year's end – one question is emerging forcefully: who, for heaven's sake, is driving the stock market rally? Common wisdom is that it wasn't the insurers. They have been reducing their public stock market exposure, at least until recently. Nor was it pension funds or balanced funds that were also reluctant to go back into equities. Private investors missed at least a part of the rally, but started to re-enter the market in the second quarter, as shown by net inflows into equity-linked funds. So who was it? Hedge funds and banks? Hedge funds moved relatively early to take long positions on stock markets. But especially banks have been generating big profits from equity investments and equity trading. They have abundant liquidity from central banks, it is cheap and it is not being absorbed by corporate lending activities, where either the demand is low or the risks are too high.

So, once again, the first part of a post-recession stock market rally is being driven by liquidity and low interest rates. Money market rates and bond yields (especially of shorter duration) are low because central banks have repeatedly committed not to exit from expansionary policies until the economic recovery is stronger and self-sustained. Central bank policy is the link in explaining the seemingly wide gap in expectations on stock markets and bond markets. While stock prices are soaring in the expectation of a strong recovery, 10-year bond yields are close to 3% – in the euro area that is not far from the levels seen during the peak of economic and financial distress last winter. In a way, central banks, which are themselves rather downbeat in their economic projections, have put a lid on bond yields and thereby helped to make stock and other asset prices rise substantially.

Will the period of very low bond yields last well into 2010 as most forecasters expect? The arguments are not that convincing. Firstly, inflation will have returned into positive territory by year's end, if only because of a very strong base effect in commodity prices. If oil prices remain at USD 74 until December 2009, they will then be twice as high as a year ago. Secondly, central banks – especially the ECB – will have to further notch up their economic projections for 2009 and 2010. The large output gap in most economies may look quite different in one or two years' time as demand is recovering and supply capacity is being reduced (think of construction, cars, banks). Thirdly, there is a high probability that central banks will start reining in (cheap) excess liquidity. High liquidity is not an acute risk for inflation because it is not yet being passed on to households and businesses, as can be seen in rather weak growth of the broad monetary aggregate M3. But, on the other hand, the narrow money aggregate M1, usually a good indicator for economic recovery, has accelerated sharply in most regions. Furthermore, even if the short-term risk of inflation is low, central banks will have to think about reducing the degree of accommodation now if they want to avoid pro-cyclical inflationary effects one or two years down the road. Monetary policy instruments percolate through to the economy with such a time lag. Part of this transmission of monetary policy takes place through higher asset prices fueled by cheap money and a return of speculative behavior. Without some leaning against the wind by central banks, we risk entering a new bubble formation and the next boom-bust cycle.

Will monetary policy succeed in gradually changing course without disrupting markets? Given the presently low level of yields – they are still two standard deviations below the ten-year average – the potential for a backlash in prices is there. It is not clear that the reaction of markets to a turn of monetary policy will be particularly calm. We see 10-year rates at or above 4% in the euro area and the US in three to six months' time. A steeper rise will be prevented by cautious central bank communication and some liability-driven investments into bond markets by institutional investors.

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