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Investment viewpoint

A new paradigm for central banks?

Asset Management

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A new paradigm for central banks?

After years of targeting inflation, central banks are facing a new paradigm in conducting monetary policy. It will force some of them to choose between strictly meeting their inflation targets and safeguarding financial stability.

This is evident in countries like Canada, where the central bank is gradually coming round to the idea that higher rates will be needed to prevent further increases in financial stability risk stemming from the housing market and extremely high household leverage – despite the fact that inflation, both headline and core, remains in the lower half of the target range.

Excessive valuations

The US Federal Reserve highlighted recently that it could be facing a similar challenge, albeit to a lesser degree. Comments this week by senior officials suggest that the Fed may be growing concerned by asset valuations, especially in equity markets. Chair Yellen herself said that asset valuations have risen to levels that are "somewhat rich" by standard metrics. On the same day, Vice-Chair Fischer appeared to echo that concern, noting in a speech that equity "price-to-earnings ratios now stand in the top quintiles of their distribution."

The Fed is anxious about financial stability because excessive asset valuations are often linked to increased risk appetite, leading to more risk-taking and leverage. In turn, that increases the vulnerability of financial markets. If valuations were to fall, leveraged equity investors may face significant losses, which could cause contagion to other markets.

So despite low inflation in the US, the Fed continues to signal that further increases in the policy rate will be needed in the near future. Raising the cost of borrowing would help prevent some of the leveraging that high valuations and increased risk-taking lead to, ultimately reducing the risk being baked into the system.

Eurozone ripples

In the Eurozone, European Central Bank (ECB) President Draghi caused ripples this week as the market overreacted to his comment that "deflationary forces have been replaced by reflationary ones." This was interpreted as a sign that the ECB is contemplating reducing its asset purchase programme in the near future.

The EUR strengthened and bond yields surged higher in a move that reminded many of 2013's "taper tantrum". It was also reminiscent of the sharp increase in bund yields above 1% in June 2015, on investors' perception that inflation was set to pick-up – only for them to decline into negative territory the following week on the back of the ECB's asset purchase programme and continued weakness in inflation.

ECB Vice President Constancio subsequently corrected his superior somewhat, saying that the slack in the economy looks bigger than the ECB had previously thought. He added: "That being the case, it justifies fully what [Draghi] said at the end of his speech, that we need persistence" – meaning that any reduction in monetary stimulus would be gradual.

While we agree that – in light of the broad-based cyclical recovery in the Eurozone – the decline in deflationary risks will eventually warrant a reduction in the amount of monetary stimulus from the current extraordinary level, ongoing weakness in inflation suggests stimulus is still needed. There is no rush for even a very marginal and gradual reduction in the amount of stimulus.

Continued concerns about the banking sector and the impact of negative rates on bank profitability add further weight to the view that stimulus is required to safeguard financial stability. A premature tightening in financial conditions would be negative for the recovery. In addition, given the current polarised environment, political considerations may also play a role a keeping the monetary policy easy.

We have proposed that the ECB should consider Japan-style yield-curve control to help banking sector profitability while still providing stimulus to the economy (see *"Europe enters a sweet spot (for a change!)"*, Global Perspective, May 2017).

What would Yellen recommend?

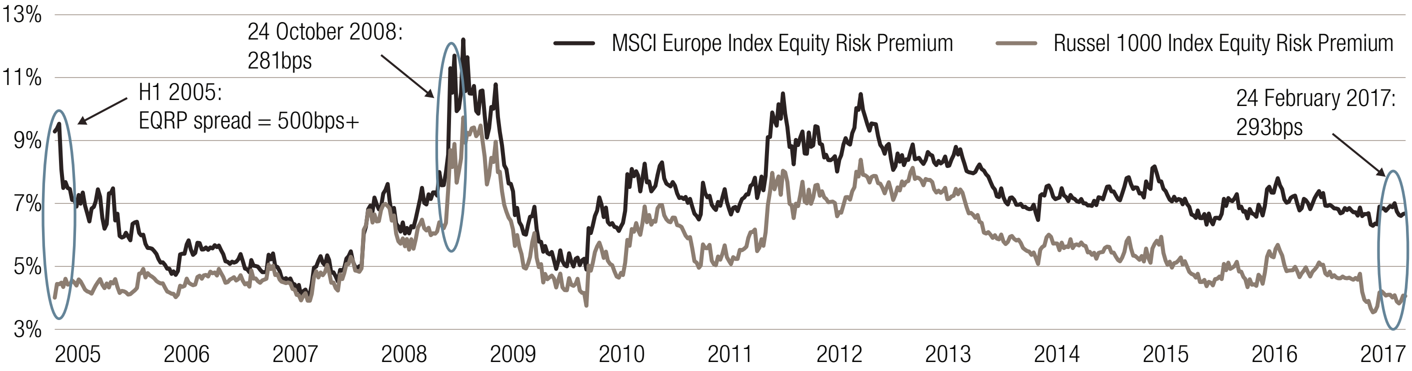
It is extremely unusual for central bankers to comment on asset valuations. Yellen has hardly ever done so in the past, suggesting that something is definitely worrying the central bank.

The divergence in the monetary policy paths of the US and Europe will have some impact on equity markets. Valuations in the US are already high, boosted by expectations that deregulation, tax reform and infrastructure investment will promote growth and improve profitability. However, increasing doubts that the Trump administration will be able to pass its stimulus and deregulation agenda mean that growth and profits may not pick up for some time.

The expected gradual removal of monetary stimulus by the Fed will further reduce the likelihood of another rise in valuations. Higher borrowing costs will make it harder for firms to leverage to increase profits, diminishing the attractiveness of the US equity market.

In contrast to the US, European equities remain cheap (again, see our comments in *"Europe enters a sweet spot (for a change!)."* The equity risk premium – the excess annualised return one can expect from investing in equities rather than government bonds, given current valuations – is higher in Europe relative to the US than it has been for over a decade.

FIG. 1 THE VALUATION GAP BETWEEN EUROPEAN AND US EQUITIES IS AT ITS WIDEST FOR OVER A DECADE



Source: Bloomberg, LOIM calculations. Data as at 31 March, 2017.

The relative cheapness of European equities exists despite supportive underlying economic fundamentals, and the fact that European companies enjoy much greater exposure to the strengthening recovery in the emerging world and continued monetary stimulus. These factors are likely to be positive for profit growth in Europe and should support European equities going forward.

FIG. 2 MARKET AVERAGE RETURN ON EQUITY

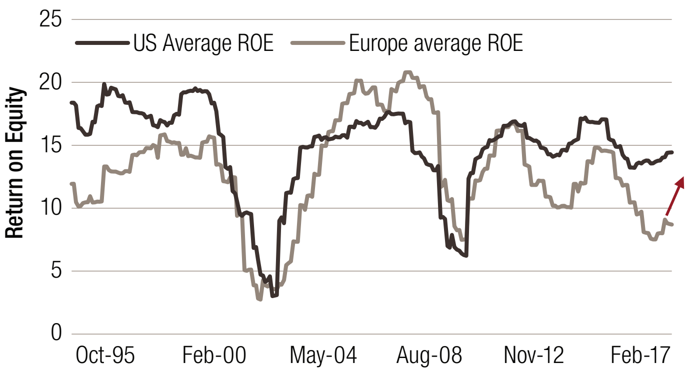
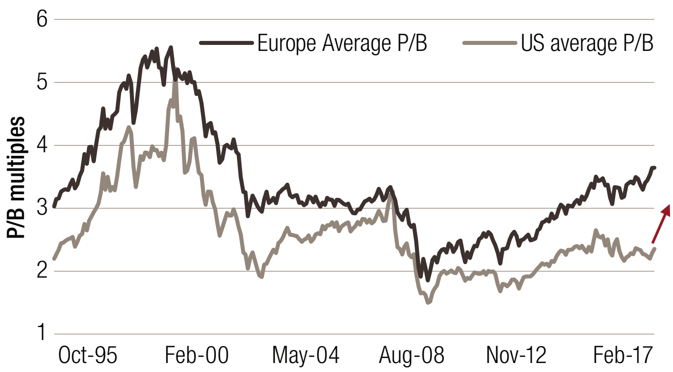


FIG. 3 MARKET AVERAGE PRICE TO BOOK



Source: LOIM. Past performance does not guarantee future results.

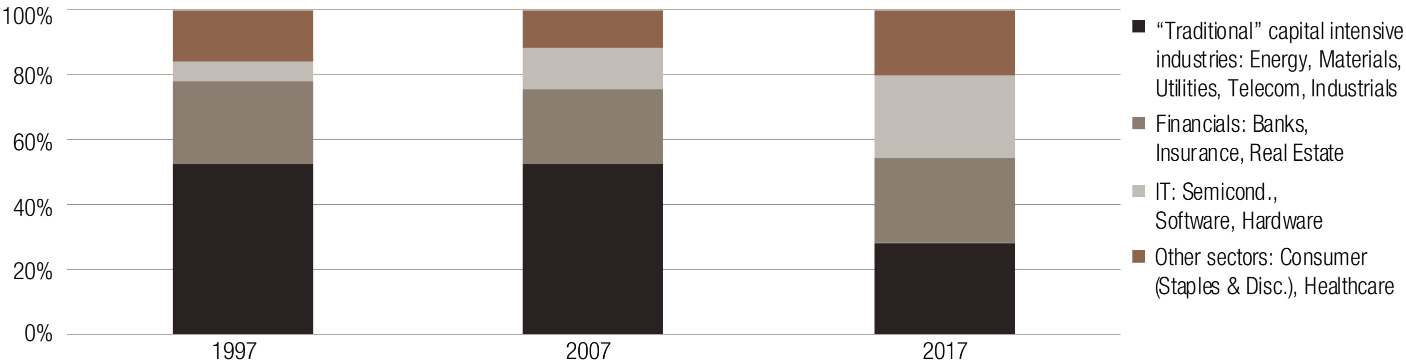
We believe the valuation gap is largely attributable to investors' high expectations for US corporates following Donald Trump's election, and to the political uncertainty in Europe – though this has dissipated considerably with the recent blow to Marine Le Pen's ambitions in France, the resurgence in the polls of Angela Merkel's Christian Democratic Union in Germany and the poor performance of the Five-Star Movement in the Italian local elections.

Broader implications: Emerging Markets

We believe that the modest reduction in monetary stimulus in the developed world is unlikely to have a major impact on emerging markets as the continued improvement in economic fundamentals will continue to support equities.

Moreover, emerging equity markets have changed fundamentally in recent years. They used to be heavily influenced by the commodity cycle, but the share of commodity-linked equity in emerging equity indices has declined in recent years relative to other sectors. As a result, emerging equity markets appear more resilient as a result of the falling beta to commodity prices. Simply put, EM equities no longer require an increase in commodity prices to outperform and rely more today to structural improvement making them more domestic demand driven. As such, we remain bullish on emerging equity but we continue to closely monitor the current shift in bond market dynamics.

FIG. 4 CHANGES IN EMERGING EQUITY MARKET SECTORS



Source: LOIM.

We also see a favourable outlook for EM bonds in local currencies, as the positive fundamentals driving equities are also supportive of local bonds. In addition, we think that EM currencies remain undervalued. This could be corrected in the near future, as market participants catch up with the improving fundamentals in the region.

European and EM equities to outperform the US

Financial stability concerns may be starting to be influencing central banks policies, as suggested by the recent comments from the Federal Reserve on equity valuation. However, this is not the case for the ECB, which remains concerned by the amount of slack in the economy and the lack of inflationary pressures. We believe a gentle reduction in the pace of asset purchases may be on the cards, but we do not think that a policy rate hike is imminent as long as inflation remains subdued. As such, we believe markets have overreacted to Draghi's comments since a reduction in monetary stimulus is not as imminent as some market participants believe. The difference in valuation and prospect for monetary policy and path for profitability means that European and EM equities should outperform US equities in coming months.

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