Iain Stewart: Reality check would expose central bank fairy tales

The market continues to swallow the 'policy is working' narrative, which has led to a belief that authorities have investors' backs no matter what, says Iain Stewart, leader of the real return team at BNY Mellon boutique, Newton.

By Esther Armstrong, BNY Mellon Investment Management

"It surprises us central banks' credibility does not yet seem to be undermined by their continual overestimation of the impact of their policies on the real economy. Markets appear quite literally now to be under policymakers' spell and investors believe the central banks will support asset prices in all circumstances," he says.

With such a mindset, all news can be good news for a while, since bad news is likely to be associated with yet more intervention, Stewart adds.

Bond markets

The latest phase of policy easing can be likened to a scene Alice would have recognised from *Through the Looking Glass* he explains: low interest rates have morphed into 'ZIRP' (zero interest rate policies), and now negative rate interest policies.

Removing interest rates in this way, or applying a levy on cash deposits, shifts distortions out along the yield curve and into 'risk' spreads, Stewart explains.

Recent figures from Deutsche Bank show just how widespread negative yields have become, and at the time of writing around 24% of eurozone sovereign bonds were carrying a negative running yield. Investors will even go as far as to pay a company like Nestle to take their cash for three years (Nestle three-year bond yields fell to negative on 3 February).[1]

Equity markets

Meanwhile, in equity markets the response to quantitative easing has become quite Pavlovian, Stewart continues: "Official bond-buying has been associated with rising equity markets in the US and in Japan. In Europe the announcement of European Central Bank quantitative easing created an outsized move in equity markets, even before a single bond had been bought, despite the fact that having to resort to bond-buying stimulus (with bond yields already the lowest on historical record) was hardly a vote of confidence in the resilience of the eurozone economy or the central bank's ability to counter its weakness."

Stewart believes the *Pied Piper* tale is a more apt literary analogy for equity markets, with investors led along by the central bankers' tune.

"What could test investors' willingness to be led blindly? Perhaps it is that the Pipers in this modern-day tale are themselves becoming increasingly unsure about where they are going."

Reality check

The fact policymakers within the same central banks seem to be increasingly at odds about if, when and how policy is likely to be normalised supports this. Stewart says the speech from Federal Reserve chairwoman Janet

[1] Financial Times, 3 February 2015

Yellen in March, which followed the US Federal Open Market Committee's announcement, demonstrates how beholden policymakers remain to growth expectations.

Yellen said: "The actual path of policy will evolve as economic conditions evolve, and policy tightening could speed up, slow down, pause, or even reverse course, depending on actual and expected developments in real activity and inflation."[2]

This is significant because unorthodox monetary policy was kicked off by the US economy in this cycle and, importantly, is where such policy had been seen by consensus as having worked, Stewart says.

Yet he does not believe this failure of policy to yield the desired result will be enough to lead to a rethink. "To date disappointment has led only to more interventions by authorities, and we expect this will continue."

He stresses the eye-popping returns across various asset classes in recent years have increasingly been accompanied by growing risks for investors and has also led to many markets looking expensive in aggregate.

"Being prepared to pay a high valuation implies investors expect either a sharp acceleration in profits and/or believe they require less compensation for risk in the current environment of apparent central bank support for asset prices. There is a risk investors are disappointed on both counts. It's hard to be a patient investor when the state is compelling us to take risk, but we need to try to be. There remains no lack of good ideas, just a lack of good value," he concludes.

[2] Normalising monetary policy: prospects and perspectives, Janet L. Yellen, 27.03.15