WESTMINSTER

ASSET MANAGEMENT

***Kicking the can down the road*: Article 3 of a series of articles on the global economic challenges impacting investors by Investment Strategist Peter Lucas.**

Once upon a time, interest rates were set by governments. Unfortunately, politicians being politicians, this meant that interest rates were often changed for electoral rather than economic reasons. After the high inflation years of the 1970s, countries around the world realised that this might not be such a good thing and responsibility for monetary policy was passed to independent central bankers. And so, thus began the period now known as the Great Moderation: thirty-plus years of low inflation and low economic volatility.

Freed from the diktat of the electoral cycle, central banks set interest rates at levels that were deemed appropriate to keep inflation low and stable. They raised them as the cycle matured and resources became scarce and did the opposite when the economic climate deteriorated. Investors were reassured by what they saw, and real bond yields trended gradually lower over time. Economic stability, lower interest rates and financial deregulation fostered a greater appetite to borrow, which in turn supported asset prices (most notably property), which reassured the banks, who were then even happier to lend. A veritable virtuous circle. Job well done. Or was it?

Perhaps the most celebrated central banker of the past thirty years was Fed Chairman Alan Greenspan. After a shaky start to his tenure, Greenspan soon won the confidence of the markets, which came to hang on his every word. But did he really deserve the praise that was heaped upon him at the time? Certainly, investors loved the 'Greenspan put' as it was known – the way in which he always came to the markets' rescue when the skies darkened. But at the same time, he presided over one of the biggest stock market boom-busts in US history. We will leave historians to debate that question, but one suspects that the ultimate verdict will not be entirely favourable.

Central banks and governments have tried to smooth the economic cycle, but their efforts have essentially been self-defeating. First, the way in which they 'rescue' the economy – increased borrowing and pumping up financial markets – merely kicks the can down the road. They 'steal' growth from tomorrow to 'save' today. A more certain today comes at the price of a more uncertain tomorrow. The second problem is one of moral hazard: the safer that people feel, the more recklessly they behave. Stability ultimately begets instability.

We will deal with the issue of debt in more depth in another article but suffice to say that most developed world economies are now swimming in it, particularly after the recent COVID-19 shutdown. The scope to keep piling debt upon debt is surely limited. Certainly the 2008/9 financial crisis and the extraordinary monetary policies that followed in its wake suggest that we may be close to the end of the road. Meanwhile financial market valuations in America have reached levels that imply negative real returns in the next 10-20 years from both bonds and equities. That does not bode well for the wealth effect or the solvency of (generally underfunded) pension schemes.

None of this tells us anything about what markets will do in the next year or two. Expensive markets can (and probably will) get even more expensive in the short-term. But high debt levels and overvalued markets combined with poor policy making (see our last article on populism) and unhelpful demographics does not paint a pretty picture for markets in the long run.

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