

Interest rates, equities, bonds and FX. Yield Droughts and Yield Junkies.

Interest rates will stay low for a long time. The implications for higher interest rates are sufficiently dire that policy has no choice but to ensure low rates across the major currency curves for the foreseeable future. OK, longer than that.

Stocks look undervalued on a yield gap basis. The implication of yield gap analysis must be either that stocks are cheap or that government bonds are much too expensive. From our thoughts on interest rates above, we must conclude that stocks are cheap.

Stocks look undervalued relative to corporate bonds. A corporate bond yield to equity yield gap analysis leads one to the conclusion that either stocks are cheap or bonds are very expensive. The rationale for corporate credit has been that since governments have basically bailed out the private sector, it pays to invest in the private sector instead of in government securities. Since risk aversion is still high, investors seek a senior claim on corporate earnings and assets. Hence corporate bonds and in particular high yield.

The interest rate policy and the parlous state of sovereign balance sheets has led to a perplexing phenomenon. Credit could be a bubble relative to stocks and treasuries. Corporate yields are too low and equity valuations are even lower, but only if interest rates continue to remain low for a long time.

What could change all this? The major developed world central banks will likely keep interest rates low until they cannot. They will be able to continue unless inflation confounds the strategy, and the only threat to inflation (for various reasons I shall defer to another article) is the exchange rate. Japan has had low rates for this long in great part because inflation has been so low, and in greater part because the high savings rate internally funds the public sector. A weak JPY would require a costly defence which would see higher rates and bankrupt (further) the country. Without a high savings rate or foreign reserves, the currency would have weakened and rates would rise, all other things being equal.

All major economic regions therefore need to be able to keep rates low to avert a major repricing of equities and bonds. To do so, exchange rates cannot trend too far from where they currently are. Stationary volatility, even if elevated, is not a

problem.

Exchange rates are therefore as important as LIBOR to the central banks. How much more transparent are FX markets than rates?

The problem with the wholesale and long term suppression of interest rates is that it can be inflationary, costly, distort funding markets, and plays fast and loose with relative prices in the economy. It also encourages excessive leverage, which was one of the fundamental problems leading up to the financial crisis in the first place.

The coherence of policy must be questioned. We began with excessive debt which we transferred to more stable hands and which we now hope to pay down over time. As we pay it down we want interest burdens to remain low, so we suppress interest rates. For all the public and private pensions and any institution with long term liabilities which it needs to fund, or indeed any investor wishing to preserve future purchasing power, this creates a yield drought which drives them into riskier investments for a given level of return. In 2001, the Greenspan induced yield drought drove the financial industry to create the instruments tailored to the yield junkies, triple A high yield. In less than a decade these instruments have failed. In the current yield drought, human ingenuity will without a trace of doubt find a way and a product to feed the yield junkie.

In each yield drought, the correct response and indeed the initial intention was to delever the system. The final result, once the symptoms of the initial condition were addressed, has been either a resumption or acceleration of credit creation. Because this time its different.