Lower rates should mean higher sharemarket gains (for now)

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US Federal Reserve chairman Jerome Powell. Picture: AP

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I have often said investment markets depend on the direction of interest rates. In that context we are now looking at lower rates and corresponding negative-yielding government bonds, which are going to be a troubling feature in the future.

In Copenhagen last week, I attended the biggest investment conference in the world, the FundForum. There I heard predictions of cuts to US rates of 50 basis points, or 0.5 per cent, or as much as 100 basis points (a full 1 per cent) in the next 12 months.

This must be set against the backdrop that the quantum of negative-yielding debt globally is now more than $US12.5. trillion ($17.8 trillion).

Nonetheless, Fed chairman Jerome Powell's most recent statement shows a willingness to extend what will shortly be the longest post-World War II rally, with shares in some markets such as the S&P 500 near or above 52-week highs and our own ASX testing its record high set in November 2007.

Many refer to what is happening as the "Japanisation" of the European and US economies, where you get decreasing interest rates that crush growth. We are pursuing premature interest rate cuts: note that the Fed has never cut interest rates by 1 per cent without there being a recession.

Going back to 1995, when the Fed last cut rates and there was no growth, we saw shares rise and a genuine push up in the real economy. We may see shares rise again now both on world and Australian markets, but I question the extent of any push up in the economy because of further interest rate cuts.

The overall effect of rate cuts in Europe and the US is to extend the cycle and, by the very nature of central banks buying bonds, increase leverage in the system.

One area of disagreement in discussions at the Copenhagen conference was over inflation.

Those that argued as to the dangers of future higher inflation, particularly in the US, argued that the evidence for this is both cyclical (tight US labour markets having surpassed previous peaks and tight immigration policies, and highlighting that industrial strikes in the US are at their highest levels since the 80s, signalling where the pricing power lies) and structural (the US is importing higher prices through its tariff war as it increases consumer prices via its own policy actions).

A cut in interest rates, especially in the US, will create a rush to equities as investors chase positive yields. The result might be a melt-up in global equity markets.

As equity markets in the US are at record highs, the boost for demand on the back of bond yields will distort further valuations at already high levels.

Let's be clear: sharemarkets are risk-based asset classes. Investing in equities is about investing for capital returns balanced with income, not for income alone. - Investors who invest in equities for dividends alone risk a capital shock at some stage when the cycle does eventually turn.

Author Michael O'Sullivan was concerned that the S&P 500 five-year returns have been 11-12 per cent per annum, twice the 100-year average. With bonds at negative yields, there is only one way for these to go; these returns have eaten up medium-term returns for the future. My caution is more against complacency while acknowledging lower-interest rates must inevitably lead to lower longer-term returns.

We are late cycle. Copenhagen conference goers kept reminding themselves of this and the fact we just cannot underestimate that we are in the longest bull market ever. There is the added concern of the unpredictability of the trade wars. It is worth remembering that best returns are always late stage and central banks are going to help us in the short term as well.

For those considering these themes in the context of Australian investment, the key way to manage is a strategy built on diversification. My approach will be to sell into sharemarket rallies for the rest of this year.

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