

Safety margin is becoming perilously thin



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Markets insight

We are almost four years into the current cyclical bull phase for stock markets. The rally began on the solid foundations of valuation and corporate earnings growth, but those supports have long since been kicked away. More risk is being taken than investors acknowledge and complacency is a major danger.

Stock markets have been distorted by unorthodox monetary policy in the form of zero real interest rates and money printing, but these policies are now suffering from the law of diminishing returns.

Valuations are looking stretched and economic growth expectations for western countries are well ahead of the fundamental reality. I have no confidence that the secular bear market in stocks that began in 2000 is over. As stock markets approach their highs of 2000 and 2007, it is prudent to be cautious.

In recent months, anecdotal evidence of investor capitulation has been building. There is a whiff of panic to invest cash at any price.

Investor surveys point to the highest level of bullishness since 2007.

Stock market volatility, as defined by the Vix Index that reflects how much investors will pay to insure against volatile equity prices, is at its lowest since 2007. Even sceptics of the rally have thrown in the towel and started to join in.

“High yield” has become an oxymoron. Junk bonds are now not only yielding less than in 2007, but are also offering the lowest returns ever. Record issuance and record low yields are evidence of the next great capital misallocation. So are emerging market bonds, another investor favourite. Bolivia, a country whose government, led by president Evo Morales, has expropriated assets from overseas investors, can borrow for 10 years at a mere 4.75 per cent and

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Indonesia at 3.3 per cent. The credit supply conveyor belts of the City and Wall Street will run around the clock to ensure the income-starved are fed. Optimists overlook the inconvenient truth that bubbles do not burst on tighter monetary policy. They pop when the surety of the income is questioned.

With bond yields having



Is his word his bond? Evo Morales, president of Bolivia AFP

collapsed, equities are the final game in town for those scrabbling feverishly around for income. Yet bond investors make very nervous equity investors, because they are not used to big losses.

Since 1970, the most that global equity investors have lost in a year is 48 per cent, while the most that bond investors have lost is 16 per cent. In the topsy-turvy markets of today, the most cautious, with the most to lose, are taking ever more risk. We appear to have entered a bizarre phase of reluctant speculation in which tomorrow's income is being converted into today's (perhaps temporary) capital gain.

I fear the yield bubble is shifting to equity markets. Certainly the demand for UK and global equity income funds has been strong in recent years. Investment Management Association data confirm that, of the £3.4bn of net UK fund sales in 2012, £2.3bn was directed into the two income sectors.

The yield on the FTSE All Share Index at the time of writing is 3.3 per cent. It has

been lower in the past, but nevertheless it is near the bottom quartile of its long-term range of between 5 per cent and 3 per cent. Another 10 per cent rise in the stock market would diminish the yield to 3 per cent and then the alarm bells really would start ringing.

By coincidence, another 10 per cent gain would take the FTSE 100 back to its 1999 high of 6,950 and in a world where a 3 per cent yield looks mouthwatering (at least compared to bonds) the overvaluation could always stretch even further.

Savers feel forced to buy assets they would not otherwise buy at prices they would not otherwise wish to pay. There are no guarantees of an immediate reversal in the price of stocks but the margin of safety is becoming perilously thin again. Investors seeking to preserve capital would do well to remember that markets have a tendency to climb the stairs – but to go down in the lift.

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