The Economist

Buttonwood

Ghostbusters

Markets will prove fragile if central banks tighten too fast

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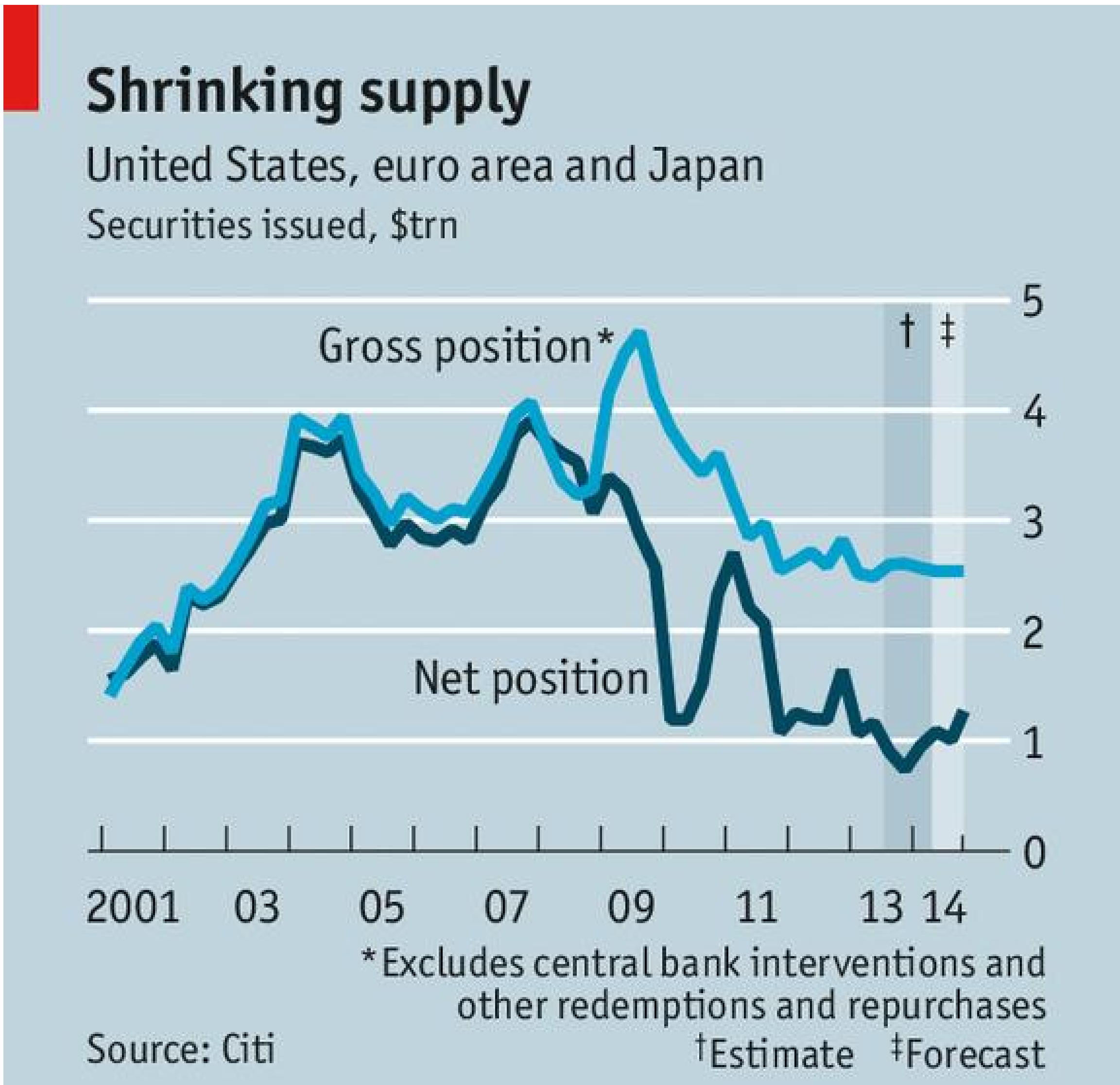

A SPECTRE is haunting global markets: the withdrawal of central-bank support. The Federal Reserve is “tapering” steadily, reducing its bond purchases by $10 billion a month. The Bank of England has stopped its quantitative easing (QE) programme altogether. Interest rates may start to rise some time next year.

Although some hope that the European Central Bank may rescue markets with its own round of QE, and the Bank of Japan is still manning the pumps, there is a sense that a new era is beginning. Ever since 2009, central-bank policy has been aimed at lowering borrowing costs for both short- and long-term debtors. The low yields on risk-free investments have encouraged investors to buy riskier assets, such as equities and corporate bonds. That is one explanation for why stockmarkets are near record highs and bond yields near record lows.

Not everyone accepts that QE has been instrumental. Low government-bond yields can be explained by weak economies and low inflation. The strong performance of the American stockmarket may simply be the result of profits, which are close to a post-war high relative to GDP.

But it seems likely that the Fed's programme has had a significant impact by cutting the volume of securities that investors can buy: the same demand is chasing a smaller supply. Citibank calculates that, back in 2007, the net issuance of new securities was almost $4 trillion. In recent years, allowing for the impact of central-bank purchases, it has been running at less than $2 trillion (see chart).

So as QE is withdrawn and rates rise, which assets are likely to suffer most? Perhaps none at all: the Fed is giving the markets lots of notice by tapering gradually. All the bad news may be priced in by the time central banks start raising rates.

But even if sophisticated investors are braced for change, it is possible that companies and consumers might not be. In particular, many might assume that the first rate rise in the cycle will rapidly be followed by many more—an idea central bankers have dismissed. And if people in the "real economy" panic, the financial markets might follow suit.

Corporate bonds are one plausible candidate to take a hit. Companies pay a higher interest rate than their governments to borrow, with the difference determined by how risky they are. Issuers of junk bonds are currently paying a spread of just over four percentage points, compared with a five-year average of more than six. If yields on government bonds rise, investors in corporate bonds could face a double whammy as spreads rise as well.

Equities are the next-most-likely victim. They have already done less well this year than most investors expected, barely making any progress in the first four months of the year. Some of that sluggishness may be tied to the upheaval in Ukraine, or to the stalling of the growth in American profits.

There is also a problem with share valuations, at least in America. Janet Yellen, the Fed's head, rather bizarrely used the prospective price-earnings ratio, one of the weakest of all measures, to justify a statement that Wall Street was not overvalued. (This was doubly strange since her husband, George Akerlof, co-wrote a book with Robert Shiller, who has championed a much better measure, the cyclically adjusted price-earnings ratio.)

GMO, a fund-management group, uses a combination of measures to argue that American equities are 65% overvalued. John Hussman, author of a well-known newsletter, thinks the range is between 75% and 125%. None of this means the market is about to fall immediately; equities were overvalued for much of the late 1990s but kept on rising. Jeremy Grantham of GMO thinks the S&P500, currently between 1,800 and 1,900, may reach 2,250 before its inevitable retreat.

Indeed, the very vulnerability of the economy may be the markets' saving grace. Overall debt-to-GDP ratios have barely shifted since 2007; the debt has been shuffled around, moving from the private sector to the government's balance-sheet. Together with low interest rates, this has allowed debtors to scrape by. But it is far from clear that debtors could handle interest rates that would have been classed in the past as normal—3% to 4%, say—or indeed that governments would welcome bond yields of that level and above.

That suggests that central banks will have to proceed with extreme caution when tightening, and that they may even have to retreat if the markets falter. The "Greenspan put"—the idea that the Fed was underwriting the markets—may soon become the Yellen put.

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