THE START OF THE 'GREAT REPRICING'

This year will see a changing of the guard at several central banks. How will an increasingly radical global monetary stance impact risk? wonders David Bowers

"You can always count on Americans to do the right thing – after they've tried everything else." Winston Churchill's observation proved as astute as ever as US politicians scrambled to navigate the fiscal cliff at the 11th hour in January. While the political battleground will now shift to the US debt ceiling, the fact remains that one of the biggest uncertainties that overshadowed 2012 has been taken out. It matters because, for much of last year, investors were fixated with what to own 'for the end of the world', for that moment when the next 'unknown, unknown' showed up.

Since Lehman Brothers failed, we have been in a world where the past appeared to offer little guide to the future. Policymakers were seen as impotent, incapable of providing a dynamic narrative that could reduce the high and persistent level of uncertainty. Consequently, markets have ended up being dominated by exogenous events and by fear of discontinuities. The business cycle was deemed at best irrelevant and at worst 'dead'.

But the world has not ended. If anything, the biggest threat to investors' current positioning is that the business cycle makes a major comeback, and that we shift from a world dominated by uncertainty to one where risks can once again be assessed and managed. We think that there are two important developments that could herald such a regime shift.

The first is that the US housing market has now turned. House prices are higher than a year ago; rental vacancy rates are the lowest in a decade; and interest in house purchase has picked up as rents have risen and mortgage rates fallen. This is on top of a lack of supply, pent-up new household formation and falling unemployment. Against this backdrop, 5-10% house-price inflation could well be sustained. As we all know, there are two ways to delever: you can either pay back the debt... or you can inflate the asset side of the balance sheet. Sustained house inflation and a buoyant equity market have the potential to bring US consumer deleveraging to an end. This is important because the macro regime of the past four years can be defined by the absence of the US consumer. Lehman tore the heart out of US domestic demand; could 2013 be the year the consumer recovers its 'mojo' in a way that redefines the investment landscape?

The US consumer is a necessary but not sufficient catalyst, however. The second development we need to look out for is a shift in the global monetary regime. Such moments are hard to predict and usually happen at the time or as the result of a systemic threat or incident. But there are reasons to think that something radical may be under way. For a start, central banks are under pressure to do more. The comments of Shinzō Abe, Japan's new prime minister, epitomise the growing frustration within political circles with the impotence of monetary policy to bring deflation to an end.

At the same time, central banks are introducing measures unthinkable a year ago, ranging from the European Central Bank's outright monetary transactions programme through to the Bank of Japan's 'stimulating bank-lending' facility. Just look at how the word 'unlimited' has taken hold in the central bank lexicon. Monetary policy is now under growing pressure to assist the debtors at the expense of the creditors. On top of this, there is a changing of the guard. The central bank governors that oversaw the introduction of inflation targeting, the Great Moderation, the credit bubble and what they thought would be temporary experiments with quantitative easing will almost all be gone by the end of 2013. This year sees new leadership at the central banks of England, Japan and Canada, and probably the People's Bank of China, too. Looking at the list of G20 central bank governors who witnessed Lehman's collapse, as few as three could be there at the end of January 2014. This generation will have a very different agenda.

A broadening of the US recovery coupled with an increasingly radical global monetary stance could be the trigger of the 'Great Repricing' of risk. As the saying goes, it is not the risky assets that damage your investment performance; rather, it is the ones you think are risk-free that have the capacity to do real damage. The issue is whether 2013 will be the year where the premium on defensive assets evaporates, and where investors reward companies that are running themselves 'for growth' rather than 'for cash'.

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